Investment Review and Outlook
First Quarter 2007

Fixed Income Markets

Economic activity in the United States during the first quarter of 2007 reflected a mixed picture with stronger personal income growth and a tight labor market but weaker manufacturing activity, particularly in the durable goods sector. Heightened geopolitical risks along with growing fears of spillover effects on employment and consumer spending from the problems in the sub-prime mortgage market resulted in lower Treasury yields and a steeper yield curve. The yield on the 2-year Treasury note declined by 24 bp to 4.57%, while the yield on the 30-year Treasury bond increased by 3 bp to 4.84% by the end of the first quarter. This resulted in the 2-year/30-year Treasury yield curve steepening by 27 bp from 0 bp at the end of 2006.

The strong performance for the credit sector in January was offset by spread widening in the following two months due to credit risk concerns from the sub-prime mortgage market. As a result, the credit sector outperformed Treasuries by only 1 bp for the quarter. Within the credit sector, the utility sector was the best performer with an excess return of 25 bp, followed by the industrial and Yankee sectors with excess returns of 23 bp and 13 bp respectively. The finance sector experienced significant underperformance with an excess return of -34 bp driven by the spread widening in banks and brokers due to concerns related to sub-prime mortgage lending. The corporate credit curve steepened as long maturity bonds underperformed intermediate issues by 7 bp. On the other hand, the credit quality curve flattened as the BBB-rated sector outperformed the A-rated sector by 41 bp. In the credit sector, economically sensitive and housing-related sectors such as railroads, retailers, chemicals, home construction and financial institutions were lagging performers. Leading sectors included defensive areas and those with more stable cash flows such as electric, natural gas, refining, integrated energy, oil field services, media-cable, and telecommunications.

The securitized sector was negatively impacted by the 5 to 8 bp widening in swap spreads with lower-rated tranches more adversely impacted by the recent turmoil in the sub-prime mortgage market. The Agency-backed residential mortgage-backed (MBS) sector was the best performer with returns in line with Treasuries followed by the asset-backed (ABS) and the commercial mortgage-backed (CMBS) sectors with excess returns of -9 bp and -18 bp, respectively. Within the MBS sector, the steepening in the Treasury yield curve enabled 15-year passthroughs to outperform their 30-year counterpart by 7 bp. The Ginnie Mae mortgage sector lagged for the quarter, posting -13 bp of excess return. Wider swap spreads and a lackluster response to new issuance over the last month hurt longer maturity CMBS tranches. Within the ABS sector, autos outperformed credit cards by 14 bp, while the home equity sector had the worst performance with an excess return of -44 bp.

On a U.S. dollar-hedged basis, most foreign developed markets underperformed the U.S. as yields in those markets climbed higher during the first quarter of 2007 as a result of strong economic growth and tight central bank policies. Two-year U.S. Treasury yields outperformed comparable maturities in the United Kingdom, Germany and New Zealand by 47 bp, 35 bp, and 51 bp respectively. On the currency front, the U.S.dollar underperformed all major currencies for the quarter. This reflected expectations for diverging central bank policies. Some of the notable currency gainers versus the U.S. dollar included the New Zealand dollar which rose 1.7%, the euro which was up 1.2% and the Japanese yen which climbed 1%. Due to the more pronounced effect from currency appreciation, most developed markets outperformed the U.S. on a currency unhedged basis.

Outlook

While income and job growth have remained firm, consumer spending in the U.S. has decelerated. The year-over-year growth in retail sales has slowed down to 3% from the 5% to 7+% pace seen since 2004. The manufacturing sector is also slowing down as companies focus on paring down inventories. Additionally, the fallout from the problems in sub-prime mortgage lending could extend to the broader residential housing market. New home sales could decline a further 20% this year as buyers find it more difficult to borrow for homes. The Federal Reserve has responded to the changing developments by taking out from its official statement the explicit reference to the possibility for further monetary policy tightening. However, the central bank is still concerned that there is risk that inflation will fail to moderate as expected. Core inflation is still above the central bank's preferred range of 1%-2%. As a result, monetary policy in the United States is likely to remain on hold for the near-term. The federal funds futures market is pricing in a 74% probability for a 50 bp cut in the federal funds rate to 4.75% by the end of 2007.

While strong credit fundamentals and rising demand from the creation of structured credit transactions have supported the richness in the credit sector, spreads will come under pressure from rising risk-aversion. Balance sheets will also gradually deteriorate due to increasing margin pressures, leveraged-buyout activities and share buy-back programs in 2007. Security selection, therefore, will remain an important factor. Defensive credit sectors with improving fundamentals and stable cash flows such as cable/telecoms, pharmaceuticals, integrated energy, insurance, and utilities are likely to perform well.

The securitized sectors are likely come under pressure from rising volatility and widening swap spreads due to counterparty credit concerns in the derivatives area. However, high-quality commercial mortgage-backed securities continue to be compelling alternatives to corporates based on relative values. The mortgage-backed sector remains attractive because of the relative richness of other asset-backed sectors. Program, coupon selection and seasoning are, however, important factors to consider. Strong demand is likely to continue for the short-dated asset-backed sector as investors look for opportunities to pick up yield without sacrificing quality.

The U.S. trade and budget deficits continue to have negative implications for the U.S. dollar. Economic data from several of the developed markets including the Eurozone, the United Kingdom, Australia and New Zealand have been mostly positive. The continued tightening bias for monetary policy in these regions is likely to also weigh on the dollar due to expectations for unfavorable interest rate differentials, especially if the Federal Reserve begins to cut rates.