Investment Review and Outlook
April 2007

Fixed Income Markets

Treasury yields were little changed during the month of April as the market digested mixed economic data. Residential construction and home sales continued to show weakness, while employment and personal income maintained a firm tone. Inflation indicators were benign as the core CPI for March rose a tame 0.1% from the prior month. As a result, the 2-year Treasury note's yield increased by just 2 bp to 4.59%, while the 30-year Treasury bond's yield declined by 3 bp to 4.81%. The Treasury yield curve flattened by 5 bp with the 2-year/30-year spread ending the month at 22 bp.

Mirroring the strong performance in the equity markets, the credit sector outperformed Treasuries by 17 bp in April. Within the credit sector, the utility sector was the best performer with an excess return of 28 bp, followed by the industrial and the Yankee sectors with excess returns of 24 bp and 13 bp respectively. The finance sector lagged as it posted an excess return of 8 bp due primarily to the 10 bp spread widening in the consumer finance sector as a result of lingering concerns related to sub-prime mortgage lending. The corporate credit curve flattened as long maturity bonds outperformed intermediate issues by 43 bp. The credit quality curve also flattened as the BBB-rated sector outperformed the A-rated sector by 23 bp. In the credit sector, economically sensitive and housing-related sectors such as packaging, lodging, chemicals, home construction and consumer finance were lagging performers. Leading sectors included defensive areas and those with more stable cash flows such as electric, natural gas, energy, media-cable, and telecommunications.

The securitized sector was negatively impacted by the 2 to 3 bp widening in swap spreads; however, lower volatility helped the residential mortgage-backed (MBS) sector post 3 bp of excess return. In the MBS sector, 15-year passthroughs and 30-year GNMAs outperformed 30-year conventionals by 4 bp and 5 bp respectively. In the 30-year conventional coupon stack, premiums outpaced discounts by 10 to 12 bp. The commercial mortgage-backed (CMBS) sector posted -14 bp of excess return, making it the worst performing securitized sector. CMBS spreads continued to widen, especially during the last week of the month due to sluggish demand for new issues priced near month-end. The recent deterioration in underwriting quality has raised investor concerns.

Yields in most international developed markets underperformed the U.S. as interest rates continued to rise in those markets during the month of April. Interest rate differentials moved in favor of the U.S. by 2 to 7 bp in Japan to as much as 21 bp in New Zealand. Australia was an exception as a lower than expected CPI print for the first quarter reversed the market's stance for a near-term rate hike. Higher interest rates, on the other hand, benefited the currencies in those markets. As a result, with the exception of Japan, all major currencies outperformed the U.S. dollar. The British pound strengthened by 1.6%, while the Canadian dollar rose by 4%. Noteworthy currency moves during April included the British pound moving above the $2 level for the first time since August 1992, and the euro moving close to its all-time high of $1.3676 set in December 2004. While most major non-dollar fixed income markets underperformed the U.S. on a hedged basis, the strong currency moves resulted in significant outperformance on an unhedged basis.

Outlook

The recent softness in the manufacturing sector may be nearing an end as companies rebuild inventories that have been worked down over the past several months. On the other hand, consumer spending remains guarded as the housing downturn continues and gasoline approaches the $3 mark even before the peak summer driving season has begun. The Federal Reserve is still concerned about potential inflation risks with core inflation hovering above its preferred range of 1% to 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 76% probability for a 25 bp cut in the federal funds rate to 5% by the end of this year.

The mergers and acquisitions and leveraged buyout bandwagon continues to roll around the globe. In the first four months of 2007, announced deals involving U.S. companies was just under $800 billion, which represents a 51% increase from the same period in 2006, a record year. Spreads in the credit sector, which are already at rich levels, will come under pressure as balance sheets gradually deteriorate due to increasing margin pressures, leveraged-buyout activities and share buy-back programs. 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, consumer staples and utilities are likely to perform well.

The recent spread widening in the high-quality commercial mortgage-backed sector makes these securities a compelling alternative to corporate bonds. 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 outlook for the U.S. dollar remains clouded given the mixed data on the economic front. With most foreign central banks continuing to maintain their tightening bias, stronger economic growth prospects for the U.S. will be needed to sustain a bid for the dollar. Foreign central banks' diversification needs for their reserves will also weigh on the dollar, while the euro and the British pound remain primary beneficiaries. There could be potential opportunities for hedged interest rate convergence strategies in New Zealand and in United Kingdom securities based on the yield pick-ups to U.S. securities.