

## **Investment Review and Outlook**

### **May 2007**

#### **Fixed Income Markets**

Treasury yields rose sharply in May on the heels of firmer economic data and rising equity markets. Short maturity yields rose by 32 to 34 bp bringing the yield on the 2-year Treasury note to 4.91%. Long maturity yields rose by less as core inflation remained contained despite higher energy and commodity prices. The yield on the 30-year Treasury bond increased by 20 bp to 5.01%, which is the highest closing level this year. The Treasury yield curve flattened with the 2-year/30-year yield spread narrowing by 12 bp to end the month at 10 bp.

The credit sector, with 17 bp in excess return, was the best performing fixed income sector reflecting the strength in the equity markets. Sectors beaten down earlier this year rebounded strongly in May as the economy rebounded. The home construction and automotive sectors, for example, posted excess returns of 155 bp and 149 bp respectively. While most of the credit sub-sectors had good performance, sectors such as metals and mining with event-risk names underperformed. A reduction in risk aversion was reflected in the flattening of the credit curve as well as the quality curve. Long maturity corporate bonds outperformed intermediate issues by 22 bp, while the BBB-rated sector outperformed the single-A rated sector by 24 bp.

The 1 to 3 bp widening in swap spreads contributed to the -5 bp excess return for the securitized sectors. The worst performing sector was the mortgage-backed sector (MBS) as increased supply was met with lackluster demand. However, the decline in implied volatility helped limit spread widening. Premium coupons were better performers as callability risk gradually diminished with the rise in Treasury yields. In the 30-year sector, Ginnie Maes outperformed conventionals by 10 bp. Conventional 15-years marginally lagged their 30-year counterparts as the yield curve flattened. The commercial mortgage-backed (CMBS) and asset-backed (ABS) sectors posted excess returns of 2 bp and 1 bp respectively. Tighter spreads in the CMBS sector were led by strong performance in the new issue market as investors re-emerged to pick up additional yield. Good demand for high quality assets resulted in positive excess returns for the auto, home equity and stranded asset sectors. The credit card sector posted -3 bp of excess return as demand faded a little during the month due to regulatory issues related to credit card disclosure and lending practices.

Yields in most international developed markets outperformed the U.S. as interest rates in those markets rose less than in the U.S. during the month of May. Two to three-year interest rate differentials moved in favor of New Zealand by 25 bp, while in Australia, Japan and the Eurozone the corresponding moves were 19 bp, 20 bp and 5 bp respectively. Canada was an exception as stronger than expected economic data resulted in a dramatic reversal of the market's expectation that rates would be on hold through the end of the year. Consequently, short maturity Canadian yields underperformed the U.S. by 12 bp. Currency movements reflected the changes in yield differentials with all major currencies underperforming the U.S. dollar. Again, the lone exception was the Canadian dollar which appreciated by almost 4% on the back of the 4% gain seen in April. The U.K. and the eurozone markets underperformed the U.S. on both a hedged as well as unhedged basis, while Japan and New Zealand outperformed on a hedged basis but underperformed on an unhedged basis.

## **Outlook**

Inventory rebuilding has provided a boost to the U.S. economy as companies replenish depleted stockpiles. The national association of purchasing managers inventory index reached a 5-year low at the end of 2006. Meanwhile, job and income growth remain sturdy. Consequently, gasoline prices over \$3 a gallon and the downturn in the housing market do not appear to have had a material impact on consumer spending. Consumer confidence remains near a 5-year high. The U.S. economy is also benefiting from the demand that is resulting from strong foreign markets, such as China and India which have economic growth rates in the 9 to 10% area. As a result, monetary policy in the United States is likely to remain on hold through the end of the year.

In the credit sector, investment grade new issue supply set a new monthly record of \$111 billion in May and is likely to reach \$90 billion in June. The large supply was absorbed well and credit spreads tightened in the secondary market by 1 to 2 bp due to strong demand from foreign and structured credit buyers. We, however, continue to remain concerned about the escalation in leveraged buyout and merger & acquisition activities. It is estimated that private equity firms have as much as \$400 billion still waiting to be invested. As a result, the potential for event risk remains high. We have a cautious stance on the home builders, paper, building products, retailers, and gaming/lodging/leisure sectors that are subject to more credit risks, while we favor defensive sectors with more predictable cash flows, such as telecom, banks/brokers, finance, healthcare, and cable.

The high-quality commercial mortgage-backed sector is a compelling alternative to corporate bonds. Higher yields have made the residential mortgage-backed sector attractive as negative convexity has declined. 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 has improved as economic growth in the U.S. picks up. With most foreign central banks maintaining their tightening bias, continued confirmation of stronger economic growth for the U.S. will be needed to sustain a bid for the dollar. Potential opportunities for hedged interest rate convergence strategies in New Zealand and the United Kingdom continue to look promising. On the currency front, the euro may have formed a near term bottom as expectations for continued rate hikes by the ECB get further entrenched.