

## **Investment Review and Outlook Second Quarter 2007**

### **Fixed Income Markets**

Treasury yields reversed course and ended higher in the second quarter of 2007 as the manufacturing sector rebounded from its weakness earlier in the year, while the labor market and personal income growth maintained their firm tone. Yields on the two-year Treasury note and 30-year Treasury bond rose by 28 bp to 4.86% and 5.12% respectively, while the five-year Treasury yield increased by 39 bp to 4.92%. At the end of the quarter, the 2-year/30-year Treasury yield curve was unchanged at 27 bp.

The credit sector's strong performance in April and May was eroded in the final month of the quarter as higher yields and problems with hedge funds invested in the mortgage sub-prime market weighed on credit spreads. For the second quarter, the credit sector was still the best performing fixed income sector with an excess return of 4 bp. Despite the increase in volatility, the corporate credit curve continued to flatten as long maturity corporate bonds outperformed intermediate issues by 44 bp. The credit quality curve also flattened with the BBB-rated sector outperforming the single-A rated sector by 41 bp. Within the major credit sectors, the utility sector was the best performing sector with an excess return of 38 bp. Higher interest rates and mortgage-related problems caused the underperformance in the finance sector which posted an excess return of -16 bp. Economic-sensitive sectors such as paper, building materials, packaging and automotive were strong performers for the quarter, while interest rate-sensitive and defensive sectors such as consumer finance and insurance were underperformers.

The securitized sector was the worst performing sector with -54 bp of excess return as it was hit hard by the 6 to 7 bp widening in swap spreads. The fixed rate mortgage-backed (MBS) sector posted -56 bp of excess return while the Agency hybrid ARM sector underperformed by 14 bp. Within the MBS sector, a steeper Treasury yield curve enabled 15-year passthroughs with their lower extension risk and lower volatility exposure to outperform their 30-year counterparts by 22 bp. Premium coupons outperformed the rest of the coupon stack during the quarter as the rise in yields triggered convexity selling in June that caused discount coupons to lag considerably. The FNMA 5% coupon, for example, had -83 bp of excess return while the FNMA 6% coupon's excess return was -53 bp. Seasoned mortgages with their lower duration profile and built in home price appreciation outperformed TBAs by 7 to 15 bp. The significant widening in swap spreads caused both the commercial mortgage-backed (CMBS) and asset-backed (ABS) sectors to underperform Treasuries, by 44 bp and 17 bp respectively. Additional weakness in CMBS spreads resulted from Moody's announced concerns about aggressive CMBS underwriting standards. Spreads in the consumer ABS sectors held up better despite continued volatility in the sub-prime market. The auto sector was the best securitized sector with -4 bp of excess return. The home equity ABS sector posted -10 bp of excess return as the turmoil surrounding the Bear Stearns hedge funds surfaced during the month of June.

Yields in most international developed markets underperformed the U.S. as interest rates in those markets rose more than in the U.S. during the quarter. Two to three-year interest rate differentials moved unfavorably in the United Kingdom, New Zealand, the Euro-zone and Canada by 5 bp, 12 bp, 16 bp and 32 bp respectively. Australia and Japan were among the exceptions with short-maturity yields in those countries outperforming the U.S. by 12 bp and 8 bp respectively. Strong economic data along with a rebound in crude oil prices during the quarter reversed the market's expectations for no change in Canadian monetary policy through the end of 2007. While Australia and Japan have also

had positive economic data, tame inflation numbers in both these countries have helped limit the rise in local interest rates. Currency movements reflected the changes in yield differentials with all major currencies appreciating against the U.S. dollar. The New Zealand kiwi and the Canadian dollar were particularly strong with each rising about 8% against the U.S. dollar. The New Zealand currency has benefited from the continuation of the carry trade. The Japanese yen declined 4.3% against the U.S. dollar during the quarter reversing the slight gain seen in the first quarter of this year.

## **Outlook**

While the growth in personal income and employment remain firm with the unemployment rate at a six year low of 4.5%, elevated energy and food prices are likely to weigh on consumer spending. The continued weakness in the residential housing market is also a detrimental factor. Mortgage equity withdrawals have been a major catalyst for the strong consumer spending since the last recession in 2001. However, the most recent reading for the home equity loan delinquency rate shows that it has reached the highest level since the 2001 recession. A pullback in consumer spending will have negative implications for the recent inventory rebuilding which provided a boost for the manufacturing sector. Despite our expectations for a deceleration in economic growth, the Federal Reserve is likely to keep monetary policy on hold since core inflation is still at the upper end of the central bank's range.

Investment grade corporate bond issuance in the first half of 2007 has been 10% higher than the comparable period last year which was also a strong issuance period. Although spreads were pushed wider in June, spreads in the credit sector are still at fairly rich levels. With no abatement in the leveraged buyout and mergers & acquisitions transactions being announced, the risk is for wider spreads. Issue selection, therefore, remains important. In the securitized sectors, short-dated asset backed and seasoned commercial mortgage-backed issues are likely to hold up better in the event volatility rises due to a worsening of the problems in the sub-prime mortgage market. The recent cheapening in the Agency mortgage-backed sector has created relative value opportunities particularly in the 15-year program. At current break-even spreads, Treasury inflation protected securities (TIPS) are attractive as an inflation hedge in the event that the increases in commodity prices become more broad-based.

Despite generally positive economic data, the outlook for the U.S. dollar is cloudy due to lingering concerns regarding the problems in the sub-prime mortgage market. Economic data for the United Kingdom, New Zealand and the Euro-zone continue to be robust, thereby, keeping the tightening bias intact for those regions. A continued confirmation of stronger economic growth for the U.S. will, therefore, be needed to regain a bid for the dollar. Potential opportunities for hedged interest rate convergence strategies in New Zealand and the United Kingdom continue to look promising. Selective unhedged strategies may also come into focus in the second half of 2007.