

Investment Review and Outlook

July 2007

Fixed Income Markets

In July, Treasury yields were driven lower by the flight to quality which was precipitated by the collapse of two Bear Stearns hedge funds that had invested in collateralized debt obligations (CDOs) tied to sub-prime mortgages. Yields across the entire Treasury yield curve dropped below 5% for the first time in 2 months. The yield on the 2-year Treasury note declined by 34 bp to 4.52%, while the 30-year Treasury bond's yield decreased by 22 bp to 4.9%. The Treasury yield curve steepened as the 2-year/30-year spread widened by 12 bp to end the month at 38 bp.

All fixed income spread sectors were hit hard by the strong bid for safety. The credit sector posted an excess return of -159 bp which was the sector's worst performance in 5 years. As volatility rose, lower quality corporates and longer maturity issues were impacted noticeably. The credit quality curve steepened as the BBB-rated sector underperformed the single-A rated sector by 57 bp. The corporate credit curve also steepened with long maturity corporate bonds underperforming intermediate issues by 184 bp. None of the major credit sectors provided safe-haven. The defensive utility sector was a relatively better performer with an excess return of -149 bp compared to -181 bp for the finance sector and -170 bp for the industrial sector. Even the high-quality securitized sectors underperformed as nominal spreads and swap spreads both widened. The residential mortgage-backed sector (MBS) underperformed Treasuries by 88 bp, and the commercial mortgage-backed sector (CMBS) lagged by 150 bp. While 15-year passthroughs posted an excess return of -56 bp, their shorter duration enabled them to outperform 30-year passthroughs by 41 bp. The short, high quality auto and credit card asset-backed sectors (ABS) did relatively better with excess returns of -12 bp and -41 bp respectively.

Yields in most international developed markets underperformed the U.S. as interest rates in those countries rose more than in the U.S. during July. Two to three-year interest rate differentials moved unfavorably in New Zealand, Australia, Japan and Canada by 84 bp, 31 bp, 30 bp, and 38 bp respectively. The New Zealand central bank stuck to its aggressive tightening stance by raising the official rate by 25 bp to 8.25%. Canadian yields displayed notable relative strength on the back of the 25 bp tightening by the Bank of Canada despite the accompanying subdued commentary regarding future rate increases. Reflecting heightened global risk aversion during the month, the Japanese yen rose 3.85% against the U.S. dollar.

Outlook

The housing market continues to weaken with the sales of new and existing homes down almost 10% in the first half of 2007. The major home builders do not see any improvement in the near term. As a result, this sector will be a drag on economic growth. The problems in the subprime mortgage market together with the large number of adjustable rate mortgages issued since 2001 which will start resetting to much higher interest rates will further dampen spending and growth for the U.S. economy. Even though economic growth is expected to decelerate, 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

Heightened risk aversion has caused a significant widening in spreads across all corporate bond sectors. This has slowed down the issuance pipeline as well as mergers & acquisitions transactions.

While spreads have cheapened from their recent rich levels, caution is still warranted due to the continued turmoil related to the problems in the sub-prime mortgage market. There are relative value opportunities in the Agency-backed MBS as well as short-dated, high-quality asset-backed sectors following the recent bout of spread widening. Treasury inflation protected securities (TIPS) have cheapened further and are attractive as an inflation hedge in the event that the increases in commodity prices become more broad-based.

In the non-dollar markets, there continue to be potential opportunities for hedged interest rate convergence strategies in New Zealand and the United Kingdom. Selective unhedged strategies may also come into focus in the second half of 2007.