

## **Investment Review and Outlook** **August 2007**

### **Fixed Income Markets**

Flight to quality continued in August as the problems associated with subprime mortgages spilled over into the commercial paper market. This added turmoil in the short-term funding market was viewed to be serious enough for central banks around the world to pump liquidity into the financial markets. The Federal Reserve responded by also cutting the discount rate by 50 bp to 5.75%. The more important federal funds rate, however, was maintained at 5.25%. Treasury yields moved lower in yield as investors sought the safest securities. The yield on 3-month Treasury bills dropped by 83 bp to 4.11%, while the 2-year Treasury note's yield declined by 39 bp to 4.13%. Further out the curve, the decline in yields was more muted with the yield on the 30-year Treasury bond declining by 8 bp to 4.82%. The Treasury yield curve steepened by 31 bp with the 2-year/30-year spread ending the month at 69 bp.

Investor's quest for safety resulted in all non-Treasury sectors underperforming Treasuries for the second consecutive month. The credit sector underperformed by 77 bp. Despite the flight to quality, the credit curve flattened as the long maturity sector outperformed the intermediate sector by 17 bp. The credit quality curve also flattened with the BBB-rated sector outperforming the single-A rated sector by 39 bp. Most of the credit sectors experienced spread widening during August. Some of the better performers, on a relative basis, include the telecom sector and sectors such as lodging, textile and metals & mining that were only a few months ago considered to be prone to event risk.

The asset-backed sector (ABS) was hit hard by the liquidity crunch in the commercial paper market together with the 11 to 18 bp widening in swap spreads at the front-end of the yield curve. As a result, the ABS sector was the worst performing fixed income sector with an excess return of -166 bp for the month. Even the high-quality, short-maturity sectors such as the credit card and auto ABS sectors with no exposure to subprime mortgages experienced significant spread widening and posted excess returns of -142 bp and -100 bp respectively. The fixed rate residential mortgage backed sector (MBS) was the best performer in the securitized sectors with an excess return of -22 bp. The flattening of the swap curve enabled the 30-year MBS sector to outperform the 15-year sector by 28 bp despite the steepening of the Treasury yield curve. This was also a contributor to the outperformance of discount passthroughs over premium coupons. The commercial mortgage backed sector (CMBS) continued to lag and underperformed Treasuries by 49 bp despite having a better credit quality profile than the credit sector.

Yields in most international developed regions underperformed the U.S. as interest rates in those regions declined less during August. New Zealand was a notable exception with two-year yield differentials moving favorably by 35 bp. After continued monetary policy tightening by the New Zealand central bank earlier this year and the subsequent strengthening of the currency, a moderation in economic growth has been seen. Reflecting heightened risk aversion during the month, and the resultant unwinding of carry trades, the Japanese yen gained 2.3% against the U.S. dollar, while the New Zealand kiwi declined by 7.6%.

## **Outlook**

The turbulence in the financial markets is likely to continue in the near-term. Subprime mortgages and related securities are held by a variety of investors including hedge funds, pension funds and yield-plus mutual funds which retail investors were using as substitutes for money market funds. The investor base is also turning out to be domestic as well as international. The problems in the market are unlikely to be “fixed” by a cut in the federal funds rate. The Federal Reserve has been addressing the liquidity issue in the commercial paper market in a variety of ways. For example, the central bank reiterated that banks can pledge asset-backed commercial paper, subprime mortgages and even structured debt obligations that contain subprime mortgages. The Federal Reserve has also provided temporary exemptions from limits on lending between large money center banks and their broker-dealer affiliates. While these moves, together with the cut in the discount rate, have provided some stability to the markets, the significant tiering in the commercial paper market still persists. The problems in the financial markets have not materially impacted the rest of the economy yet. The unemployment rate remains low and income growth is firm; however, these could be at risk if there is further deterioration in the financial markets.

There are good relative value opportunities in the short-maturity, high-quality ABS sector following the significant cheapening of this sector. While the credit sector has cheapened further, issue selection is still important. Defensive names in the utility, healthcare and telecom sectors are attractive. Agency-backed MBS should benefit from the flight out of subprime and related securities. 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.