

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

### **Fixed Income Markets**

In the third quarter of 2007, the global financial markets experienced a sharp spike in volatility as the problems associated with subprime mortgages caused severe dislocations in the commercial paper markets. With many companies experiencing difficulties in accessing the short-term funding market, central banks around the world responded by injecting large amounts of liquidity to ease the credit crunch. In addition to cutting the discount rate by 50 bp in August, the Federal Reserve cut the more important federal funds rate by an unexpected 50 bp to 4.75% in September. For the quarter, Treasury yields dropped sharply with the yield on the 2-year Treasury note declining by 87 bp to 3.98%. Longer maturity yields declined by a smaller magnitude as the yield curve steepened. The yield on the 30-year Treasury bond decreased by 29 bp to 4.84%. As a result, the 2-year/30-year yield spread steepened by 58 bp to end the quarter at 86 bp.

The turmoil in the financial markets resulted in the underperformance of all non-Treasury sectors in the third quarter. The credit sector was worst hit with an underperformance of -216 bp. This marked the worst quarterly result in 5 years. Within the credit sector, the utility and finance sectors posted excess returns of -300 bp and -281 bp respectively, while the industrial sector held up better with an excess return of -201 bp. The credit curve and the quality curve both steepened due to the flight to quality by investors. Long maturity corporate bonds underperformed intermediate issues by over 100 bp, while the BBB-rated sector underperformed the single-A sector by 26 bp. The mortgage and housing-related credit sectors such as consumer finance, building materials and home construction were hit the hardest. Better performers included defensive sectors such as telecommunications, supermarkets and media.

The securitized sector underperformed Treasuries by 98 bp as swap spreads widened and realized volatility climbed higher. The paring back by dealers of balance sheet positions further pressured the sector. The residential mortgage-backed (MBS) sector posted an excess return of -91 bp. Within the MBS sector, the steepening in the Treasury yield curve enabled 15-year passthroughs with their lower volatility exposure to outperform their 30-year counterparts by 13 bp. The 16 to 18 bp widening in swap spreads caused both the commercial mortgage-backed (CMBS) and asset-backed (ABS) sectors to underperform Treasuries by 137 bp and 176 bp, respectively. The home equity ABS sector was the worst performer with -401 bp in excess return. Consumer ABS (credit card and autos) also suffered primarily due to an overreaction to the subprime meltdown despite the absence of any clear contagion effect.

Yields in most international developed markets underperformed the U.S. as interest rates in those regions declined by less than in the U.S. during the third quarter. Two-year interest rate differentials moved unfavorably in Australia, Japan, New Zealand and the Euro-zone by 85 to 44 bp. Most foreign central banks responded to the liquidity crisis during the quarter by deferring their credit tightening bias and by pumping large amounts of liquidity into the markets. Conditions stabilized in most markets by the end of the quarter. As a result, the U.S. dollar reversed most of its gains during the flight to quality. The Canadian dollar was a major beneficiary of rising crude oil prices and gained 7.4%, while the Japanese yen gained 7.3% due to the unwinding of the carry trade. The euro and the Australian dollar also made significant gains, rising 5.3% and 4.5% respectively against the U.S. dollar.

## **Outlook**

The relaxation of monetary policy in the third quarter was clearly in response to the 'seizing' of the credit markets. The timely actions taken by the central banks have succeeded in calming the financial markets. Spread relationships are returning to normal. After falling by over \$350 billion since early August, the commercial paper market has increased for the first time in 8 weeks. The attention of the monetary policymakers will now return to the economy. While economic growth has slowed, the likelihood of a recession is very low. Weekly jobless claims which have been averaging around 315,000 are consistent with an economy that is growing in the 2% to 2.5% area. Personal income growth also remains sturdy with the latest reading showing a 6.8% year-over-year increase. The markets expectation for further cuts in the federal funds rate is, therefore, probably too optimistic.

Despite the turmoil in the credit markets, new issuance in the third quarter was 31% higher than the corresponding quarter in 2006. The significant widening in credit spreads has cheapened the finance and utility sectors; however, issue selection remains important. Also, AAA-rated commercial mortgage-backed securities are a compelling alternative to corporate bonds on a relative value basis. The agency mortgage-backed sector will be faced with greater supply as borrowers cross over from the various non-agency programs. Program, coupon selection and seasoning will be important factors to consider. Strong demand is likely to re-surface for the short-dated consumer asset-backed sector as investors look for opportunities following the significant repricing that took place over the last few months.

Economic data in other developed markets are likely to be stronger relative to the U.S. As a result, interest rate differentials will remain unfavorable for the U.S. dollar. However, there may be potential opportunities for hedged interest rate convergence strategies in New Zealand and the United Kingdom.