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Investment Review and Outlook October 2007

Fixed Income Markets

In the first two weeks of October, some stability returned to the financial markets following the high volatility seen in the past couple of months. This stability, however, was short-lived as flight-to-quality returned in the second half of the month, although to a lesser degree than earlier this summer. At the end of the month, the Federal Reserve cut the federal funds rate by 25 bp to 4.5%. This follows the 50 bp cut in September. For the month, the yield on the 2-year Treasury note declined by 4 bp to 3.94%, while the 30-year Treasury bond's yield decreased by 9 bp to 4.75%. This resulted in a 5 bp flattening in the yield curve with the 2-year/30-year spread narrowing to 81 bp.

Most fixed income spread sectors recovered in October. The credit sector posted an excess return of 29 bp. The credit curve and the quality curve both flattened as long maturity corporate bonds outperformed intermediate issues by 24 bp, while the BBB-rated sector outperformed the single-A sector by 20 bp. The finance sector was a noticeable laggard as banks and brokers underperformed by 21 bp and 37 bp respectively.

Despite the 1 to 3 bp widening in swap spreads for the month, the securitized sector posted 22 bp of excess return. Lower volatility helped the residential mortgage-backed (MBS) sector outperform by 36 bp. Within the MBS sector, 30-year conventional passthroughs outperformed their 15-year counterparts by 5 bp helped, in part, by the flattening in the Treasury yield curve. The commercial mortgage-backed (CMBS) sector posted -71 bp of excess return, making it the worst performing securitized sector. CMBS spreads widened due to sluggish demand for new issues and the concern that the commercial mortgage market could be vulnerable to a credit crunch. The home equity sector was also one of the worst performers with -61 bp of excess return as the October remittance reports showed worse than expected delinquency performance. On the other hand, the consumer asset backed sector (ABS) performed well with excess returns of 14 bp for both the credit card and auto sectors.

Nominal yields in most international developed markets continued to underperform the U.S. as interest rates in those markets either rose or declined by less than in the U.S. for the month of October. Two-year yields in Australia and New Zealand, for example, rose by 37 and 23 bp respectively in response to stronger than expected economic data. Widening interest rate differentials continued to weigh on the U.S. dollar pushing the currency down by over 5% against the Canadian dollar and the Australian dollar. The Japanese yen, however, was down marginally as the heightened risk aversion seen earlier in the summer ebbed to some extent.



Outlook

When the Federal Reserve cut interest rates in October for the second consecutive month, the central bank signaled that it was likely to now be on hold for the near-term as strains in the financial markets had eased somewhat. Outside of the housing sector, the economy appears to be reasonably firm despite record high energy and commodity prices. Employment and wage growth have not materially softened. A key uncertainty, however, is the potential spillover effects from the problems related to sub-prime mortgages. While the actions taken by the Federal Reserve over the past two months have helped to contain the damage to the rest of the economy, financial institutions continue to write-down holdings in securities related to sub-prime mortgages. This could, in turn, have negative implications for personal and business borrowing.

Despite the modest tightening in credit spreads in October, the finance and utility sectors remain cheap; however, issue selection is important. There are relative value opportunities within the agency-backed MBS market as well as in the short-dated, high-quality asset-backed sectors following the recent bout of spread widening. The commercial mortgage-backed sector should also benefit as near-term supply pressures abate and collateral characteristics improve. Given the continued uncertainty that the financial markets are experiencing, most foreign central banks are expected to hold off on any interest rate increases in the near term. Conditions seem likely to remain difficult for the U.S. dollar as markets assess the fallout from sub-prime related excesses.

