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Investment Review and Outlook November 2007

Fixed Income Markets

In November, Treasury yields declined markedly as concerns escalated regarding sub-prime related write-downs and impairments at various financial institutions, most notably at banks. Despite the substantial magnitude of announced write-downs (in excess of \$50 billion, so far), investors are increasingly concerned about the possibility of further impairments. This resulted in a flight to quality of significant proportion. For the month, the yield on the 2-year Treasury note declined by 95 bp to 3.0%, while the 30-year Treasury bond's yield decreased by 37 bp to 4.38%. Consequently, the yield curve steepened by 58 bp with the 2-year/30-year spread widening to 138 bp.

All fixed income spread sectors underperformed in November. The investment grade credit sector was one of the worst performers with -270 bp of excess return. Credit spreads were wider across industries, maturities and credit quality. Intermediate maturities outperformed the long end of the credit curve by 263 bp while industrials outperformed utilities and financials. More specifically, long dated financials, with -654 bp of excess return weighed heaviest on the sector. Spreads were also pushed wider by a flood of new issuance near month-end.

Although August was a tough month for the securitized sectors, November proved to be even more difficult. Fears of further SIV liquidations, disappointing earnings announcements from Freddie Mac and Fannie Mae and the potential need by the bond insurers to raise \$3 to \$7 billion over the next few years to cover losses linked to subprime debt all weighed on the sector. Wider swap spreads and higher volatility resulted in the residential mortgage-backed (MBS) sector posting -66 bp of excess return. The steepening in the Treasury yield curve enabled 15-year passthroughs to outperform their 30-year counterparts by 14 bp. Flight to quality helped limit the Ginnie Mae MBS sector's underperformance to -50 bp. Discount coupons outpaced premiums as servicers moved down in coupon and originators engaged in some convexity selling.

The asset-backed sector (ABS) was the worst performing securitized sector with -378 bp of excess return. This was primarily driven by the 821 bp underperformance by the home equity loan (HEL) sector. Forced liquidations and weak delinquency remittance reports resulted in this dismal performance. After several weeks of tightening, consumer ABS spreads gapped out to the widest levels this year as spreads came under pressure primarily from lack of liquidity due to the ongoing



dealer balance sheet constraints. The auto and credit card ABS sectors posted -168 bp and -217 bp of excess return respectively. Plagued by rising concerns about underwriting quality and a general lack of investor interest, the commercial mortgage-backed (CMBS) sector was also hit hard and ended the month with -250 bp of excess return.

Nominal yields in most international developed markets continued to underperform the U.S. While two-year yields in New Zealand rose by 26 bp, yields declined in the United Kingdom and in Canada by 58 bp and 48 bp respectively. Despite the widening interest rate differentials, the U.S. dollar managed to gain against most foreign currencies mirroring the flight to quality seen in the fixed income markets. Natural resource dependent currencies bore the brunt of this move with the Australian and Canadian currencies down by almost 6%. On the other hand, the Japanese yen gained 5% as the reversal of carry trades continued.

Outlook

With the financial markets again showing signs of heightened stress, Federal Reserve officials, including Chairman Ben Bernanke, have indicated that the downside risks to the economy have increased. The futures markets are fully discounting a 25 bp cut in the federal funds rate at the next central bank meeting in December with a 50% probability for a 50 bp reduction. Although third quarter GDP growth was revised up to 4.9%, spillover effects from the problems related to sub-prime mortgages are likely to be a drag on growth going forward. However, with job and income growth still firm, the likelihood of a recession next year is low.

Year-end considerations are also a key element in the current environment. As a result of the continued pressure on short-term funding costs, the Federal Reserve is likely to take further measures to improve year-end liquidity and enable the financial system to function normally. A combination of interest rate cuts, a reduction in the discount rate and more liquidity injections seem very likely. Additionally, federal government-led solutions to alleviate the crises in the sub-prime mortgage market are also likely to take place.

Given the significant spread widening in the credit sector, relative value opportunities look even more attractive especially in the finance and the utility sectors. However, issue selection remains 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 CMBS sector should also benefit as near-term supply pressures abate and collateral characteristics improve.

Although most foreign central banks are expected to be on hold, conditions seem likely to remain difficult for the U.S. dollar as long as concerns about the fallout from the sub-prime problem persist. However, some central bankers are beginning to comment on the significant appreciation of their respective currencies against the U.S. dollar. This is a change from their previous stance of not commenting on “market determined” exchange rates.

