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Investment Review and Outlook
Fourth Quarter 2007

<u>Fixed Income Markets</u>

The fourth quarter of 2007 was marked by higher volatility and greater illiquidity in the fixed income markets due to continued turmoil related to the problems in the subprime mortgage market. Central banks were forced to step in and address the liquidity situation which grew worse as the year wound down. During the quarter, the Federal Reserve cut the federal funds rate to 4.25%, through 25 bp reductions at both the October and December meetings. In coordination with foreign central banks, the Federal Reserve also put in place a term liquidity facility to further alleviate the credit crunch. For the quarter, Treasury yields dropped sharply with the yield on the 2-year Treasury note declining by 94 bp to 3.05%. Longer maturity yields declined by a smaller magnitude as the yield curve steepened. The yield on the 30-year Treasury bond decreased by 38 bp to 4.45%. As a result, the 2-year/30-year yield spread steepened by 56 bp to end the quarter at 140 bp.

In the fourth quarter, the turmoil in the financial markets resulted in the underperformance of all non-Treasury sectors. The credit sector underperformed by -236 bp which put the underperformance for the full year at -464 bp, the worst ever for the credit sector. The finance sector was the worst hit credit sector posting an excess return of -333 bp, while the industrial and utility sectors held up better with excess returns of -205 bp and -227 bp respectively. Non-cyclical industries such as healthcare and defense were better relative performers with excess returns of -100 bp and -112 bp respectively. The credit curve and the quality curve both steepened due to flight to quality. Long maturity corporate bonds underperformed intermediate issues by -188 bp, while the BBB-rated sector underperformed the single-A sector by -19 bp.

The securitized sector underperformed Treasuries by -54 bp as swap spreads widened and realized volatility climbed higher. The residential mortgage-backed (MBS) sector performed the best with an excess return of -22 bp. Within the MBS sector, the steepening in the Treasury yield curve enabled 15-year passthroughs to outperform their 30-year counterparts by -28 bp. Flight to quality resulted in a strong bid for Ginnie Maes and this sector outperformed conventionals by 11 bp. The commercial mortgage-backed (CMBS) and asset-backed (ABS) sectors underperformed Treasuries significantly and lagged by -217 bp and -408 bp, respectively. The home equity ABS sub-sector was the worst performer in the index with -1223 bp in excess return. Consumer ABS (credit card and autos) were also negatively impacted and underperformed by -122 to -177 bp despite the absence of any clear contagion effect from the problems in subprime mortgages.

Yields in most international developed markets again underperformed the U.S. as interest rates in those regions either rose or declined by less than in the U.S. during the fourth quarter. Notable two-year interest rate differential spread widenings were 136 bp in Australia and 137 bp in New Zealand. The Canadian and British central banks joined the Federal Reserve in cutting rates during the quarter. Interestingly, the Canadian central bank implied that the strengthening Canadian currency may have also been a factor for its actions. The Bank of England (BOE) finally responded to weakening economic data after becoming more comfortable that inflation risks had subsided. Reflecting the widening interest rate differentials, the U.S. dollar remained under pressure against most major currencies with the Euro gaining 2% in the fourth quarter. Although the Canadian dollar was little changed against the U.S. dollar for the quarter, it still strengthened 17.5% for the year. The Japanese yen also gained due to the continuing reversal of carry trades.

Outlook

The coordinated effort by central banks, as well as cash infusions to financial firms from sovereign wealth funds, helped calm the markets going into year end. Spread relationships are beginning to return to more normal levels as liquidity increases. In the U.S., economic growth continues to show signs of slowing, with manufacturing and housing being the major drags. Weekly jobless claims have increased to the 340,000 level, while durable goods orders continue to weaken as businesses try to get a better read on the consumer. However, personal income and spending has remained firm despite a slowing job market. Inflation readings have picked up as oil climbed to $100 a barrel. Going forward, the FOMC will have a difficult time balancing the risks of slowing growth and increased inflation. Therefore, market expectations for several further reductions in the federal funds rate are probably too optimistic.

Despite the turmoil in the credit markets, fixed-rate, investment grade corporate issuance totaled $575 billion during 2007, up from $430 billion in 2006. Spreads for the investment grade sector are now near their 20 year wides, with financial sector spreads at their widest levels ever on an annual basis. The significant widening in credit spreads has presented attractive opportunities, especially in the finance sector. Issue selection, however, remains important. In the mortgage sector, there continue to be relative value opportunities within the Agency-backed segment, despite 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 excessive repricing that took place over the second half of 2007. The CMBS sector should also benefit as near-term supply pressures abate and collateral characteristics improve.

Economic data in other developed markets have held up better than in the United States, although strains are visible in Europe. Conditions are likely to remain difficult for the U.S. dollar as interest rate differential expectations remain unfavorable given that housing related pressures are unlikely to subside quickly. Nevertheless, opportunities for hedged interest rate convergence strategies are likely to emerge in 2008 as the headwinds of 2007 abate.