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Investment Review and Outlook January 2008

Fixed Income Markets

The first month of 2008 was punctuated by a significant sell-off in global equity markets as fears increased that the slowdown in the U.S. would turn into a recession engulfing other regions in the world as well. The Federal Reserve cut the federal funds rate to 3%, through an unexpected 75 bp reduction between meetings and another 50 bp reduction 8 days later at the regularly scheduled meeting in January. Additionally, a fiscal stimulus package consisting of tax rebates, accelerated depreciation credits and a temporary increase in the size of conforming home mortgage loans is expected to be signed into law before mid-year. Uncertainty surrounding the bond insurers, as well as a huge loss by a rogue trader at a foreign bank, added to the volatility in the financial markets. For the month, Treasury yields dropped sharply with the yield on the 2-year Treasury note declining by 95 bp to 2.09%. Longer maturity yields declined by a smaller magnitude as the yield curve steepened. The yield on the 30-year Treasury bond decreased by 13 bp to 4.32%. As a result, the 2-year/30-year spread increased by 82 bp to end the quarter at 233 bp.

Following a respite in December, the investment grade credit sector's underperformance continued in January with -151 bp of excess return. Credit spreads widened across industries, maturities, and credit quality making the underperformance broad-based. Intermediate maturities outperformed long maturities by 182 bp while single-A credits outperformed BBB-credits by 84 bp. As a result, the credit curve and the quality curve steepened. The industrial sector was the worst performing credit sector with excess returns of -198 bp followed by the financial and utility sectors which underperformed by -151 bp and -135 bp respectively. Even, defensive industries like telecommunications and consumer non-cyclicals underperformed significantly by -305 bp and -138 bp respectively.

The securitized sector underperformed Treasuries by -72 bp due to negative rating actions, uncertainty surrounding the bond insurers, and expectations for more writedowns and liquidations. The best performing securitized sector was the residential mortgage-backed (MBS) sector with an excess return of -14 bp. Down-in-coupon flows dominated activity in the MBS sector. As a result, discounts outperformed premiums by 25 bp. Conventional 30-year passthroughs outperformed their 15-year counterparts by 16 bp despite the steepening in the Treasury yield curve. The commercial mortgage-backed (CMBS) was one of the worst performing securitized sectors with -440 bp of excess return. Growing concerns about the consumer's financial health spilled over into the asset-backed sector (ABS) which posted -208 bp of excess return. The Home Equity Loan (HEL) sector posted -583 bp of excess return, making it the worst performer in the Lehman Aggregate Index.



Yields in major developed markets continued to underperform the U.S. as interest rates in these regions declined less compared to the U.S. Notable two-year interest rate differential spread widenings were 88 bp in the United Kingdom and 80 bp in Japan. The Bank of Canada cut interest rates for the second month in a row bringing its target rate to 4% citing among other factors a softening U.S. outlook. Despite calls from some participants for rate cuts, the Bank of England and the European Central Bank both kept their official rates unchanged. Reflecting widening interest rate differentials, the U.S. dollar continued to decline. Despite weaker economic data from the U.K. including a rapidly deteriorating real estate market, the British pound remained almost unchanged for the month. The New Zealand central bank maintained its 8.25% official rate as there were few signs of moderating economic growth.

Outlook

Economic growth in the U.S. slowed to a 0.6% pace in the fourth quarter of 2007. While non-farm employment for the month of December posted an unexpected drop of -17,000, personal incomes and hourly earnings have held steady. With the extremely low levels of inventories, even a modest pick-up in demand could set the stage for an increase in production. Inflation readings remain elevated due to high food and energy prices. The Federal Reserve may have a difficult time balancing the risks of slower economic growth and increasing inflation. However, the central bank is likely to put more emphasis on ensuring that the economy does not tip into a recession.

Spreads in the investment grade credit sector are near 20-year wides. Compelling valuations together with supportive fundamentals provide several attractive opportunities, especially in the finance and telecommunications sectors. Issue selection, however, remains important. In the mortgage sector, there continue to be relative value opportunities within the Agency-backed sector, despite greater supply, as borrowers cross over from the various non-agency programs. Program, coupon selection and seasoning will, however, be important factors to consider. Strong demand has re-surfaced for the short-dated consumer asset-backed sector. New issues have been several times oversubscribed as investors take advantage of the excessive repricing that took place over the second half of 2007. The CMBS sector offers significant relative value, but continues to suffer from the negative press surrounding the residential sector.

In the non-dollar markets, interest rate differentials are at risk of reversing the trend of the past two years because significant interest rate cuts in the U.S. are already priced in. Consequently, there are opportunities for hedged convergence strategies. In this respect, New Zealand rates remain a compelling risk-reward proposition as the strong economic growth seen last year is likely to moderate in the face of tight monetary policy.

