

# *Smith, Graham & Co., Investment Advisors, L.P.*



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## **Investment Review and Outlook February 2008**

### **Fixed Income Markets**

February witnessed a further deterioration in financial conditions due to fear of additional writedowns from financial institutions, and the increasing uncertainty surrounding the bond insurers. Concerns that the ongoing problems in the housing market would spill-over into other areas of the economy led to further apprehension about the commercial mortgage-backed sector. Additionally, the market for auction-rate securities seized up and borrowers were forced to find alternative sources of financing. The Federal Reserve continued to emphasize that credit conditions remained tight with further downside risks to economic growth, signaling future monetary policy easing despite increasing concerns about inflation. For the month, Treasury yields dropped across most maturities with the yield on the 2-year Treasury note declining by 48 bp to 1.62%. Longer maturity yields increased slightly as the yield curve steepened. The yield on the 30-year Treasury bond increased by 8 bp to 4.40%. As a result, the 2-year/30-year spread increased by 56 bp to end the quarter at 279 bp.

The investment grade credit sector continued its underperformance in February with -99 bp of excess return. The underperformance was broad-based as credit spreads widened across industries, maturities, and credit quality resulting in a further steepening of the credit and quality curves. Intermediate maturities outperformed long maturities by 22 bp while single-A credits outperformed BBB-credits by 64 bp. The financial sector performed the worst with excess returns of -115 bp followed by the industrial and utility sectors which underperformed by -103 bp and -81 bp respectively.

The securitized sector posted -133 bp of excess return as spreads widened due to the fear of potential forced liquidations from hedge funds. The residential mortgage-backed (MBS) sector had an excess return of -76 bp as investors scrambled to reduce duration. Premiums outperformed current and discount coupons, while the 15-year sector outperformed the 30-year sector by 22 bp amid continued curve steepening and rising volatility. Risk aversion and illiquidity led to spread widening across all consumer asset-backed (ABS) sectors. Excess returns for the credit card and auto sectors were -130 and -101 bp, respectively. The Home Equity (HEL) sector posted -719 bp of excess return, making it the worst performer in the Lehman Aggregate Index for the second consecutive month. The commercial mortgage-backed sector (CMBS) was the second worst performing securitized sector with -523 bp of excess return as the CMBS derivatives index (CMBX) was heavily used as a proxy hedging vehicle for exposures in other segments of the fixed income market.



Short-term 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 64 bp for New Zealand and 55 bp for Australia. The Reserve Bank of Australia raised interest rates by 25 bp to 7%, after holding rates steady since November 2007, as inflation increased. Reflecting widening interest rate differentials, the U.S. dollar continued to decline with the Australian dollar gaining 3.9% and the euro gaining 2.2%. In a sign of continued risk reduction, the Japanese yen also gained 2.6% despite weaker economic data in Japan.

## **Outlook**

Recent data are painting a slowing economic environment. Non-farm employment for the month of February posted an unexpected drop of 63,000 on the heels of a 22,000 drop in January indicating a softening labor market. Consumer and business confidence measures also fell sharply as continued decreases in home prices, a weaker labor market, and price inflation are weighing on the consumer. However, both chain store sales and new orders for capital goods surprisingly rebounded from the lows of 2007. Inflation readings remain elevated due to high food and energy prices. The Federal Reserve continues to emphasize that credit conditions are tight while downside risks to growth remain signaling further monetary policy easing is in the pipeline.

Spreads in the investment grade credit sector are close to 20-year wides. While the sector offers many attractive opportunities, issue selection 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. There continues to be demand for short, AAA-rated consumer asset-backed securities. The CMBS sector also offers significant relative value, but suffers from the negative press surrounding the woes in the residential sector.

In the non-dollar markets, interest rate differentials are approaching levels not seen for many years. Consequently, there are attractive opportunities for hedged convergence strategies, with New Zealand remaining a compelling risk-reward proposition. Although expectations for rate cuts in the United Kingdom and the Eurozone are building, central banks in those regions have indicated they are reluctant to cut interest rates due to ongoing concerns about inflation. Consequently, the euro and the British pound may find support even in a declining interest rate environment.

