

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



Cyril M. Theccanat
Executive Vice President
Managing Director – Investment Management

Investment Review and Outlook First Quarter 2008

Fixed Income Markets

The first quarter of 2008 was marked by wide-spread concerns about the Federal Reserve's ability to manage the liquidity and credit crises in the financial markets. Investors fled to the safety of Treasury securities. Margin calls and forced sales of suddenly illiquid assets further exacerbated the situation. The Federal Reserve was forced to step in and facilitate a takeover of Bear Stearns by JPMorgan Chase after the 85-year old firm experienced a run on its capital. Taking extraordinary steps, the Federal Reserve also set up a liquidity facility for primary broker/dealers in order to improve liquidity and to diminish the likelihood of another investment bank being forced out of business. During the quarter, the Federal Reserve cut the federal funds rate by 200 bp, from 4.25% to 2.25%, and continued to emphasize that credit conditions remained tight with further downside risks to the economy. For the quarter, Treasury yields dropped sharply across most maturities with the yield on the 2-year Treasury note declining by 146 bp to 1.58%. Longer maturity yields decreased by less causing the yield curve to steepen. The yield on the 30-year Treasury bond decreased by 16 bp to 4.29%. As a result, the 2-year/30-year spread increased by 130 bp to end the quarter at 271 bp.

First quarter spread performance was similar to what took place in the last two quarters of 2007. Every non-Treasury sector underperformed as spreads across the entire fixed income spectrum widened. There was unprecedented volatility in the credit sector as fears about systemic risks in the financial system overwhelmed fundamentals. For the quarter, the overall credit index widened in spread by 77 bp. As a result, the credit sector underperformed for the third consecutive quarter posting an excess return of -427 bp. This marked the worst ever quarterly performance for the credit sector. Within credits, the financial sector was the laggard with an excess return of -530 bp, while the industrial and utility sectors underperformed by -466 bp and -393 bp respectively. The credit curve and the quality curve both steepened during the quarter as long maturity corporate bonds underperformed intermediate issues by 260 bp, while the BBB-rated sector underperformed the single-A rated sector by 119 bp. The credit sector's underperformance was broad-based, with even defensive sectors such as healthcare and telecommunications experiencing a significant widening in spreads.

The securitized sector underperformed Treasuries by -174 bp as swap spreads widened, realized volatility rose and investors reduced their risk profiles during the quarter. The residential mortgage-backed (MBS) sector experienced extreme volatility during the quarter due to margin calls and forced liquidations resulting in the sector underperforming by -77 bp. The steepening in the Treasury yield curve enabled premiums to outperform discounts by a wide margin, but the 15-year sector underperformed its 30-year counterpart by 59



bp due to lack of sponsorship. The conventional mortgage sector outperformed the GNMA sector following news that the mortgage regulatory agency had loosened restrictions on Fannie Mae and Freddie Mac's ability to grow their mortgage portfolios. Across all of the consumer asset-backed (ABS) sectors, risk aversion and tiering became more pronounced as concerns grew about rising delinquencies and losses amid the housing downturn and a weakening labor market. Excess returns for the auto and credit card sectors were -266 and -316 bp respectively. The Home Equity (HEL) sector was the worst performer in the Lehman Aggregate Index for the quarter with an excess return of -1682 bp. The significant underperformance in the commercial mortgage-backed (CMBS) sector (-777 bp) was primarily driven by the selling that took place in the CMBS derivatives index which has been heavily used as a proxy hedging vehicle for exposures in other segments of the fixed income market.

Yields in most international developed markets continued to underperform the U.S. as interest rates in those regions either rose or declined by less than in the U.S. during the first quarter. Notable changes in two-year interest rate differentials were -132 bp for Japan and -86 bp for New Zealand. The Canadian and British central banks continued to ease monetary policy, lowering interest rates by 75 bp and 25 bp respectively. In contrast, the Australian central bank increased interest rates by 50 bp over two central bank meetings as inflation data remained elevated. The European Central Bank (ECB) and the Reserve Bank of New Zealand (RBNZ) maintained their target rates despite softer economic data as economic indicators continued to point to an upside risk for inflation. Although some European banks and financial institutions have experienced problems similar to their U.S. counterparts, policy actions by the ECB and the Bank of England (BOE) have been relatively limited largely because the magnitude of the problems has been less than in the U.S. Reflecting widening interest rate differentials, the U.S. dollar remained under pressure against most major currencies with the yen and euro gaining 12% and 8% respectively. The big gain in the yen also reflects the risk reduction seen in other asset classes as carry trades were reversed. Interestingly, in previous flights to quality, the U.S. dollar has tended to benefit; however, the concerns about systemic risks have out-weighted the safe-haven perception of the U.S. dollar. Consequently, commodity-levered currencies such as the Australian dollar and the New Zealand dollar have gained.

Outlook

Recent economic data continue to point to deceleration in growth and possibly a mild recession in the first half of 2008. Non-farm employment showed losses of 232,000 jobs during the quarter as the unemployment rate rose to 5.1%. While still low by historical standards, the unemployment rate has moved well off its cycle low of 4.4% to levels not seen since late 2005. Consumer confidence measures plunged as continued decreases in home prices, a softening labor market, and price inflation are weighing heavily on the consumer. Chain store sales have fallen to the lowest levels since 2003 as consumers use disposable income to pay down debt. Inflation readings remain elevated due to high food and energy prices, as worldwide demand has pressured prices higher. The Federal Reserve continues to emphasize that credit conditions are tight while downside risks to growth remain. The central bank has also reemphasized its concerns about inflation. Further interest rate reductions could weaken the dollar more, thereby, causing inflation pressures to rise. The Federal Reserve is likely to focus more on managing market liquidity to help facilitate an orderly unwinding of the leverage in the system.



Spreads for the investment grade sector are near all-time wides. While most credit sectors have experienced significant cheapening, there are compelling opportunities in the finance and telecom sectors. New issues are also being priced at significant concessions to existing securities. This has helped absorb supply which has been running 55% higher than the corresponding quarter in 2007. Despite the overall cheapness of the credit sector, 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. Prepayments should decline because of home price declines and tighter lending standards. Thus, 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 during the first quarter. Though volatile, the CMBS sector, especially AAA-rated tranches, should also benefit as liquidity pressures abate.

Economic data from other developed markets indicate that these economies are holding up better than the U.S. However, contagion from U.S. weakness remains a risk. In Europe, the ECB remains fixated on inflation risks and continues to resist call for interest rate cuts. In New Zealand, high interest rates have helped let air out of the inflated housing market. With commodity prices, especially dairy prices, expected to stabilize this year, it is likely that inflationary pressures will ease. This should enable the central bank to cut interest rates from the currently elevated level of 8.25%. In the currency markets, the U.S. dollar is likely to find support at current levels as systemic risk fears abate, and the market anticipates fewer interest rate cuts. However, with substantial interest rate differentials, any U.S. dollar strength is likely to evolve slowly as housing related pressures are unlikely to subside quickly. Opportunities for hedged interest rate convergence strategies look very attractive in the current environment with New Zealand offering the most compelling opportunity.

