

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



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

Investment Review and Outlook April 2008

Fixed Income Markets

The beginning of the second quarter of 2008 saw a reversal of trends from the first quarter. Investors moved out of Treasuries with yields at historically low levels and embraced riskier assets that were previously shunned. Corporate issuers took advantage of this increased risk appetite and raised a record \$102 billion in fixed rate, investment grade debt during the month. The dollar strengthened slightly, but prices of most commodities still finished the month higher. Oil, which began the month at \$100 a barrel, rose as high as \$119 before ending the month at a still elevated \$113. During April, the Federal Reserve cut the federal funds rate by 25 bp and continued to emphasize that credit conditions remained tight with further downside risks to the economy. For the month, Treasury yields increased across most maturities with the yield on the 2-year Treasury note rising by 67 bp to 2.25%. Longer maturity yields increased by less causing the yield curve to flatten. The yield on the 30-year Treasury bond increased by 18 bp to 4.47%. As a result, the 2-year/30-year spread decreased by 49 bp to end the quarter at 222 bp.

The investment grade credit sector significantly outperformed Treasuries for the month of April by 245 bp reversing a trend of negative excess returns since January 2008. The outperformance was broad-based as credit spreads narrowed across industries, maturities, and credit quality resulting in a flattening of the credit and quality curves. Long maturities outperformed intermediate maturities by 188 bp while BBB-credits outperformed the single-A sector by 44 bp. The financial sector was the best performer with excess returns of 314 bp followed by the industrial and utility sectors which outperformed by 269 bp and 199 bp respectively.

The securitized sector posted 125 bp of excess return as the overall tone of the market improved and investors unwound the previous flight-to-quality trades. Performance was driven by tighter spreads and a reduction in realized volatility. Despite the significant rise in Treasury yields, convexity selling was not a negative factor. As a result, discounts slightly outperformed premiums. The 15-year conventional mortgage-backed sector posted an excess return of 100 bp, outpacing the 30-year sector by 2 bp. Reversal of flight-to-quality trades caused the Ginnie Mae sector to lag its 30-year conventional counterpart by 11 bp. New issuance in the asset-backed sector (ABS) helped reprice the secondary market to tighter levels following strong demand for both credit cards and autos. The Federal Reserve's acceptance of AAA-rated ABS as collateral in its Term Securities Lending Facility also provided much needed liquidity and helped restore confidence in the sector. The credit card and auto sectors outperformed Treasuries by 129 and 90 bp respectively. The home equity (HEL) sector posted -257 bp of excess return, making it again the worst performer in the Lehman Aggregate Index. The commercial mortgage-backed (CMBS), being more credit-sensitive than the other asset-backed sectors, was the best performing securitized sector with 360 bp of excess return.



Short maturity yields in most developed international markets outperformed the U.S. as interest rates in those regions rose by less than in the U.S. Notable changes in two-year interest rate differentials were -55 bp for Canada and -42 bp for New Zealand. During the month, the Bank of Canada and the Bank of England (BOE) cut their target interest rates by 50 bp and 25 bp respectively. Reflecting the narrowing interest rate differentials, the U.S. dollar reversed its recent weakening trend to gain about 1% against the euro and about 4% versus the yen. However, commodity-based currencies like the Australian dollar and the Canadian dollar gained 3% and 2% respectively as commodity prices continued their relentless rise.

Outlook

Recent economic data continue to point to a deceleration in growth although a recession appears unlikely. First quarter GDP advanced by 0.6% helped by a build in inventories and strength in exports. In April, non-farm employment contracted by a less than expected 20,000 jobs during the month, while the unemployment rate fell to 5.0%. Consumer confidence measures continue to weaken as declining home prices, a softening labor market, and price inflation weigh heavily on the consumer. Chain store sales have risen modestly from the low levels seen in March and are expected to benefit from the \$150 billion tax rebate over the next few months. Inflation readings remain elevated due to high food and energy prices, as worldwide demand and a weaker dollar have pressured prices higher. The Federal Reserve continues to emphasize its concern about rising inflation expectations and the uncertainty of the inflation outlook going forward. Further interest rate reductions could weaken the dollar more, thereby, exacerbating the inflation picture. Consequently, the Federal Reserve is likely to focus more on managing market liquidity to help facilitate an orderly unwinding of the leverage in the financial system.

Despite the significant tightening in spreads in the investment grade credit sector, corporate bonds are still cheap. However, as spread relationships normalize, the risk-reward profile of the non-cyclical sectors such as pharmaceuticals, utilities and telecommunications will be more attractive than the finance sector. While the credit sector continues to offer attractive opportunities, issue selection remains important. In the mortgage sector, we continue to see 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 depreciation and tighter lending standards. Thus, program, coupon selection and seasoning will be important factors to consider. Strong demand has re-surfaced for the short-dated consumer asset-backed sector as investors look for opportunities following the excessive repricing that took place during the first quarter. The CMBS sector, especially AAA-rated tranches, should also benefit further from decreased risk aversion and better liquidity.

In the non-dollar markets, interest rate differentials are beginning to retrace from levels not seen in many years. Consequently, hedged convergence opportunities are now very attractive, with New Zealand remaining a compelling proposition. Economic data from New Zealand have recently been particularly weak. This was acknowledged by the Reserve Bank of New Zealand in its latest review. The central bank has now raised expectations that interest rates may be cut in the second half of 2008. Even the European central bank (ECB) has recently softened its hard stance on inflation and may move to a neutral position on monetary policy. If upcoming economic data from the U.S. do not turn to the downside, the dollar rally should continue. However, the Canadian dollar and Australian dollar should be well supported if commodities, particularly crude oil, continue to move higher.

