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Investment Review and Outlook May 2008

Fixed Income Markets

The financial markets continued to stabilize in May following the tumultuous events in the first quarter. As flight to quality eased, Treasury yields increased across all maturities with the yield on the 2-year Treasury note rising by 39 bp to 2.64%. Longer maturity yields increased by less causing the yield curve to flatten. The yield on the 30-year Treasury bond increased by 25 bp to 4.72%. As a result, the 2-year/30-year spread decreased by 14 bp to end the month at 208 bp.

In May, the investment grade credit sector outperformed Treasuries for a second consecutive month by 39 bp. The outperformance was broad-based as credit spreads narrowed across industries, maturities, and credit quality. However, while the quality curve flattened as the BBB sector outperformed the single-A sector by 53 bp, the credit curve steepened with long maturities underperforming intermediate maturities by 16 bp. The utility sector was the best performer in the credit index with excess returns of 53 bp followed by the industrial and financial sectors which outperformed by 46 bp and 31 bp respectively. Issuance of fixed-rate investment grade debt was strong, exceeding the \$100 billion mark for a second straight month despite renewed concerns regarding further writedowns at major investment banks.

The securitized sector posted 36 bp of excess return which marks the third consecutive month of outperformance. Performance was mainly driven by tighter spreads and lower realized volatility. Although the mortgage-backed sector (MBS) had a difficult month, the sector still posted an excess return of 13 bp. The significant rise in yields, tighter lending standards and slower housing turnover extended mortgage durations to their longest levels in six months. As a result, premium coupons outperformed discounts by a wide margin due to convexity selling. For example, 30-year conventional 5% coupons lagged the 6.5% coupons by 70 bp. The Ginnie Mae sector rebounded, posting 16 bp of excess return, 9 bp more than its 30-yr conventional counterpart. The asset-backed sector (ABS) earned 136 bp of excess return during May. Spreads in the credit card and auto sectors narrowed by 25-60 bp as the general tone of the consumer ABS market dramatically improved. Five auto ABS deals (including the first subprime deal since November 2007) and fourteen credit card deals were issued, helping to reprice the secondary market. Faster prepayments and constructive developments on the regulatory and legislative fronts brought demand back to the home equity loan (HEL) market. The HEL sector posted an excess return of 131 bp, the first positive excess return for this sector since September 2007. For the second consecutive month, the commercial mortgage-backed sector (CMBS) was the best performing sector in the Lehman Aggregate Index, posting 190 bp of excess return. The CMBS sector, which continues to be highly correlated with the broader credit markets, benefited from the increase in investor risk tolerance.



Short maturity yields in most developed international markets continued to outperform 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 -38 bp for New Zealand and -26 bp for Japan. However, German and British yields underperformed by 17 bp and 27 bp respectively on declining interest rate cut expectations for the United Kingdom and the Eurozone. Reflecting narrowing interest rate differentials, the U.S. dollar strengthened 0.4% against the euro and 1.5% versus the yen. However, commodity-levered currencies like the Australian dollar and the Canadian dollar gained 1.3% and 1.5% respectively as commodity prices continued their relentless rise.

Outlook

Recent economic data continue to point to slow growth with elevated energy prices a major headwind going forward. First quarter GDP was revised higher to 0.9% due to a lower trade deficit and leaner inventories. Consumer confidence measures weakened further during the month as gasoline prices approached \$4 per gallon. This may mute the stimulus effect from the \$120 billion in tax rebates that households have started receiving. Inflation readings remain elevated due to high food and energy prices, as worldwide demand and a weak 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. As a result, the market is pricing in a hike in the federal funds rate in the fourth quarter of 2008.

Although credit spreads have tightened further in the month of May, corporate bonds still have favorable reward to risk profile. However, as spread relationships normalize, non-cyclical sectors such as pharmaceuticals, utilities and telecommunications will offer better relative value opportunities. Issue selection, however, remains important. The mortgage sector remains attractive with spreads 35 bp cheap to the average spread over the past 10 years. Prepayments are expected to 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 short-dated consumer ABS as evidenced by several new deals coming to the market primarily from investor inquiry. 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 continue to retrace. Consequently, hedged convergence opportunities are attractive, with New Zealand remaining a compelling proposition. Although the federal budget presented by the current government in New Zealand provides for significant tax relief over the next four years, it is unlikely to result in an immediate turnaround of the current weak economic conditions. The New Zealand central bank is still likely to cut interest rates in the second half of 2008. Meanwhile, the European central bank (ECB) and the United Kingdom's Monetary Policy Committee (MPC) are not lowering interest rates despite weakening economic conditions because inflation remains stubbornly high. In foreign exchange markets, the U.S. dollar should benefit from a narrowing in interest rate differentials. Even the commodity-levered currencies now look vulnerable as commodities like crude oil respond to slower global growth.

