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Investment Review and Outlook
Second Quarter 2008

Fixed Income Markets

In the second quarter of 2008, concerns about the liquidity and credit crises in the financial markets abated following the extraordinary steps taken by the Federal Reserve which culminated in the takeover of Bear Stearns by JP Morgan in March. As a result, Treasury yields rose sharply despite an additional 25 bp cut in the federal funds rate during the quarter which was undertaken in response to weak economic activity. The yield on the 2-year Treasury note climbed by 103 bp to 2.62%, while the yield on the 30-year Treasury bond increased by 23 bp to 4.52%. Consequently, the 2-year/30-year yield spread narrowed by 80 bp to end the quarter at 190 bp.

After the unprecedented volatility witnessed in the first quarter, credit spreads tightened in the second quarter as systemic risk fears abated. As a result, following three consecutive quarters of underperformance, the credit sector posted its first quarterly positive excess return of 134 bp. The sector's outperformance was broad-based as all corporate sectors posted positive excess returns led by the industrial sector which recorded an excess return of 196 bp followed by the utility and financial sectors with excess returns of 182 bp and 112 bp respectively. The credit curve and the quality curve both flattened during the quarter as long maturity corporate bonds outperformed intermediate issues by 56 bp, while the BBB-rated sector outperformed the single-A rated sector by 105 bp. Reflecting the improved market tone, issuance of investment grade fixed rate debt picked up markedly to $272 billion, which was $100 billion higher compared to the first quarter.

The securitized sector outperformed Treasuries by 77 bp during the quarter despite wider swap spreads on the heels of strong investor demand and declining realized volatility. The duration of the residential mortgage-backed (MBS) sector extended to its longest level in over six months due to rising Treasury yields, tighter lending standards and slower turnover. Despite convexity-related selling, the MBS sector had an excess return of 52 bp, with premiums outperforming discounts by 130 bp. The 15-year sector posted an excess return of 90 bp, outpacing the 30-yr sector by 55 bp. For the quarter, the asset-backed sector (ABS) posted 78 bp of excess return. Spreads in the credit card and auto sectors narrowed by 25 to 85 bp as the general tone of the consumer ABS market significantly improved. Over $20 billion in auto ABS deals, including the first subprime deal since November 2007, and several credit card deals were issued, providing a better tone for the secondary market. This enabled the credit card and auto sectors to outperform Treasuries by over 200 bp. The commercial mortgage-backed sector (CMBS) was the best performing sector in the Lehman Aggregate Index with 260 bp of excess return. The only laggard was the home equity loan (HEL) sector, which posted a dismal excess return of -504 bp, making it the worst performer in the Lehman Aggregate Index.

Yields in international developed markets recorded mixed performance relative to the United States in the second quarter. While yields in the United Kingdom and Germany rose by more, yields in Canada, Japan, Australia and New Zealand rose by less. Notable changes in two-year interest rate differentials relative to the U.S. were -108 bp for New Zealand and +36 bp for the United Kingdom. During the quarter, the Canadian and British central banks continued to ease monetary policy, lowering interest rates by 50 bp and 25 bp respectively, while most other central banks left rates unchanged as inflation concerns outweighed the slowdown in economic activity. The Reserve Bank of New Zealand (RBNZ), on the other hand, hinted that rate cuts were possible in the second half of 2008 as the economic slowdown in New Zealand was expected to bring down inflation expectations. Reflecting the mixed performance in interest rate differentials, the U.S. dollar was lower against the British pound, the Canadian dollar, and the Australian dollar but higher against the Euro, the Japanese yen and the New Zealand dollar. In particular, the Japanese yen weakened by 6.1% as risk aversion trades were unwound and carry trades again became attractive.

Outlook

Recent economic data in the United States continue to point to slow growth with elevated energy and commodity prices major headwinds for the economy. During the quarter, the unemployment rate rose to 5.5% as the economy lost an average of 63,000 jobs per month, bringing the year-to-date total job loss to -438,000. Consumer confidence measures weakened further as gasoline prices rose above $4 per gallon. This is likely to temper the stimulus effect from the estimated $120 billion in tax rebates that households have been receiving. Automobile sales fell to a 13.6 million seasonally-adjusted annualized rate at the end of June, the lowest level since September 1993. Inflation readings remain elevated due to high food and energy prices. As a result, the Federal Reserve continues to emphasize its concern about rising inflation expectations. The futures markets are pricing in a 25 bp hike in the federal funds rate by the end of the year.

Despite tighter spreads in the investment grade credit sector, spreads are near their all-time wides and continue to offer compelling opportunities with favorable risk-reward profiles, particularly in the finance and telecom sectors. However, while most credit sectors appear cheap compared to historical levels, some businesses are facing unprecedented stresses in their operating environments. Consequently, issue selection will be critical. 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 are expected to decline because of home price depreciation and tighter lending standards. Thus, program, coupon selection and seasoning are important factors to consider. Strong demand has continued for the short-dated consumer asset-backed sector as investors look for opportunities following the excessive repricing that took place earlier this year. The CMBS sector, especially AAA-rated tranches, are likely to benefit as demand picks up given attractive spreads, very little supply and still low delinquency rates.

Economic data from other developed markets indicate that these economies are beginning to experience a material slowdown. While the central banks in these regions have recognized the downside risks to growth, they remain concerned about inflation and hence are resisting calls for lowering interest rates. The European Central Bank (ECB), in fact, raised interest rates in July. However as recession fears intensify, the ECB may be forced to quickly change its stance. The housing slump in the United Kingdom together with recent data from the manufacturing sector showing an accelerated deterioration in business conditions could force the Bank of England to cut rates. The unfolding economic slowdown in New Zealand, which has now been acknowledged by the Reserve Bank, makes New Zealand a compelling interest rate convergence trade strategy. In the currency markets, the U.S. dollar is likely to find support at current levels; however, any strength is likely to evolve slowly as housing related pressures are unlikely to subside quickly.