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Investment Review and Outlook
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<u>Fixed Income Markets</u>

During the month of July, fears of systemic risk in the financial markets resurfaced due to concerns about the capital adequacy of the Government Sponsored Entities (GSE's), Fannie Mae and Freddie Mac. In order to help restore investor confidence, the Treasury announced a plan that would strengthen the U.S. government's support of Fannie Mae and Freddie Mac. Oil, which began the month at $140 a barrel, rose as high as $145 before ending the month at a still elevated $124. Demand destruction and signs of slowing global growth are beginning to weigh on the commodity markets. The yield on the 2-year Treasury note fell by 11 bp to 2.51%, while the yield on the 30-year Treasury bond increased by 5 bp to 4.57%. Consequently, the 2-year/30-year yield spread widened by 16 bp to end the month at 206 bp.

Most fixed income spread sectors underperformed in July. The investment grade sector lagged Treasuries by -100 bp due to renewed concerns about write-downs at financial firms. The underperformance was broad-based as credit spreads widened across industries, maturities, and credit quality. However, while the quality curve flattened as the BBB-sector outperformed the single-A sector by 23 bp, the credit curve steepened with long maturities underperforming intermediate maturities by -34 bp. The financial sector was the worst performer with an excess return of -187 bp, while the industrial and utility sectors underperformed by -61 bp and -51 bp respectively. Issuance of fixed-rate investment grade debt in July dropped to a five year low of $26 billion.

The securitized sector underperformed Treasuries by -61 bp. Spreads in the residential mortgage-backed sector (MBS) came in from their wides earlier in the month following the U.S. government's strengthened support for Fannie Mae and Freddie Mac. For the month, the MBS sector pared it's earlier losses by half and posted an excess return of -54 bp. The uncertainty surrounding the GSE's provided a better bid for the Ginnie Mae sector which outperformed conventionals by 10 to 20 bp. The commercial mortgage-backed sector (CMBS) was the worst performer in the securitized sector and underperformed by -115 bp. The CMBS curve steepened significantly as shorter maturity bonds outperformed 7 to 10 year issues by 150 to 250 bp. The asset-backed sector (ABS) was negatively affected by the weakening trends in the auto and credit card segments as auto sales have declined dramatically while credit card delinquencies have been rising. The auto and credit card ABS sectors posted excess returns of -50 and -81 bp respectively.

Short maturity yields in most developed international markets outperformed the U.S. as interest rates in those regions declined by more than in the U.S. Notable changes in two-year interest rate differentials were -32 bp for Australia and -39 bp for the United Kingdom. The housing markets in both Australia and the United Kingdom are weakening rapidly and expectations for interest rate cuts are rising. Japanese yields underperformed by 9 bp on expectations that the Bank of Japan (BOJ) will not lower interest rates despite weakening economic fundamentals. The European Central Bank (ECB), as expected, raised official rates by

25 bp, while the Reserve Bank of New Zealand surprised the markets with a 25 bp interest rate cut. Reflecting narrowing interest rate differentials, the U.S. dollar strengthened 3.7% against the New Zealand dollar and 1.7% versus the Australian dollar. Against a basket of six leading currencies, the U.S. dollar was up 1.3% for the month.

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 month, the unemployment rate rose to 5.7% as the economy lost another 51,000 jobs. Consumer confidence measures stabilized as gasoline prices fell below $4 per gallon for the first time in two months, but prices remain elevated. 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 12.5 million seasonally-adjusted annualized rate at the end of July, 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.

The significant widening of credit spreads during the month has increased the attractiveness of the credit sector. Financials continue to offer a favorable reward to risk profile despite the general skepticism towards this sector. Issue selection remains important. As spread relationships normalize, non-cyclical sectors such as utilities and telecommunications are likely to offer good relative value opportunities. The mortgage sector remains cheap due to convexity fears. Prepayments are expected to decline because of home price depreciation and tighter lending standards. Demand is expected to remain firm 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.

After cutting interest rates for the first time since July 2003, the New Zealand central bank indicated that there is "plenty of room" for further monetary policy adjustment. Meanwhile, the recent economic data from Australia point to a rapid deterioration in the housing and consumer sectors. Given New Zealand's economic reliance on Australia, the current downturn in New Zealand is likely to persist longer than expected. Although, the ECB did raise interest rates last month, weakness in Europe's largest economy, Germany, is finally becoming apparent. This, along with falling energy prices, is likely to force the ECB to hold off on further interest rate increases. Abating inflation expectations are also likely to facilitate the long-anticipated interest rate cuts by the United Kingdom's Monetary Policy Committee (MPC). Consequently, hedged convergence opportunities are attractive, with New Zealand remaining a compelling proposition and the United Kingdom looking increasingly promising. In the currency markets, the U.S. dollar should continue to benefit from a narrowing in interest rate differentials even as the Federal Reserve continues to hold interest rates steady. Commodity-levered currencies continue to look vulnerable as commodities like crude oil decline in response to slower global growth.