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Investment Review and Outlook August 2008

Fixed Income Markets

In August, increased risk aversion resulted in most spread sectors underperforming Treasuries. Speculators exited commodity positions as demand destruction and signs of slowing global growth became more evident in foreign economies. As a result, oil fell to \$115, down \$9 for the month and \$30 from its peak. The yield on the 2-year Treasury note fell by 14 bp to 2.37%, while the yield on the 30-year Treasury bond decreased by 15 bp to 4.42%. Consequently, the 2-year/30-year yield spread tightened by 1 bp to end the month at 205 bp.

The Lehman Brothers Credit Index widened by 13 bp in August to 273 bp, the widest level this year. For the month, the investment grade credit sector underperformed duration-matched Treasuries by -63 bp. The underperformance was broad-based as credit spreads widened across industries, maturities, and credit quality. While the credit curve steepened as long maturities underperformed intermediate issues by -83 bp, the quality curve flattened with the BBB-sector outperforming the single-A sector by 5 bp. The financial sector was the worst performer with an excess return of -95 bp, followed by the industrial and utility sectors with excess returns of -60 bp and -37 bp respectively. Issuance of fixed-rate investment grade debt in July remained weak for a second consecutive month at \$30 billion after dropping to a five year low of \$26 billion in July.

The residential mortgage-backed sector (MBS) saw better buying near month end. As a result, carry and spread tightening more than offset convexity losses thereby enabling the MBS sector to outperform Treasuries by 24 bp. After several months of underperformance, discount mortgages outpaced premiums as Treasury yields declined, while the 15-year conventional sector outperformed its 30-year counterpart by 27 bp. The asset-backed sector (ABS) came under pressure during the month due to the negative news surrounding the U.S. auto manufacturers as well as the higher delinquency rates at credit card companies. As a result, the ABS sector posted -200 bp of excess return with the auto and credit card sectors posting excess returns of -178 and -243 bp respectively. The commercial mortgage-backed sector (CMBS) underperformed Treasuries by -195 bp as news about the default of the \$225 million Riverton Apartments weighed on the sector. The CMBS curve steepened significantly as shorter maturity bonds outperformed longer issues by 150 to 250 bp.

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 included the outperformance in Australia and the United Kingdom by -46 bp and -16 bp respectively as well as underperformance in Japan and New Zealand by 8 bp and 7 bp respectively. Official bank rates remained



unchanged as several central bank meetings were slated for September. Reflecting the narrowing interest rate differentials, the U.S. dollar strengthened 5.4% against a basket of six leading currencies with the Australian dollar and the British pound falling sharply by 9% and 8% respectively. The euro and the New Zealand dollar also declined by 6% and 5% respectively.

Outlook

Recent economic data in the United States continue to point to slow growth despite falling energy and commodity prices. During the month, the unemployment rate rose to 6.1%, the highest level of unemployment since 2003, as the economy lost another 84,000 jobs. Consumer confidence measures rose in response to falling gasoline prices which fell another \$0.23 to \$3.66. Automobile sales rose to a 13.1 million seasonally-adjusted annualized rate at the end of August as a result of significant incentives offered by automotive manufacturers. Inflation readings remain elevated but are expected to fall as the weakness in foreign economies puts further downward pressure on energy and commodity prices. While the Federal Reserve expects inflation to moderate, it has acknowledged that the uncertainty surrounding the inflation outlook remains high. The futures markets are now expecting the Federal Funds rate to remain at 2% through the end of 2008.

Credit spreads have widened back to the distressed levels seen in March of this year, thereby, creating several compelling opportunities. Financials, in particular, continue to offer a favorable risk to reward profile despite the general skepticism towards this sector. Although the operating environment for financials remains difficult, well-capitalized companies have the competitive advantage to not only take market share, but to also improve margins. Issue selection, however, remains important. The mortgage sector remains cheap due to convexity fears. Prepayments are expected to decline because of home price depreciation and tighter lending standards. The AAA-rated tranches of the short-dated consumer asset-backed sector are attractive following the recent widening in spreads. 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 most developed markets continue to be weak. While outright contraction in GDP may not happen in the current quarter, expectations for negative growth in the fourth quarter are rising, particularly in the United Kingdom. Despite the economic slowdowns, inflation concerns are preventing most central banks from cutting interest rates. Indeed, the Bank of England (BoE) and the European Central Bank (ECB) again held rates steady at their recent meetings, although the Reserve Bank of Australia did cut interest rates by 25 bp. It seems likely that central banks will eventually embark on a monetary easing cycle, as growth concerns intensify. In addition, the recent sell-off in commodities is likely to help ease inflation concerns. Consequently, hedged interest rate convergence opportunities are attractive, with New Zealand and the United Kingdom remaining the most compelling opportunities. In the currency markets, the U.S. dollar should continue to benefit from a narrowing in interest rate differentials. Commodity-based currencies, such as the Australian and New Zealand dollar look vulnerable, although the Canadian dollar may be supported by its positive correlation to the energy markets, and to U.S. economic growth.

