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Investment Review and Outlook
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Fixed Income Markets

October had a rocky start as the negative fall-out from the Lehman Brothers bankruptcy in mid-September rippled world-wide and intensified the deterioration in global financial markets. Many central banks, including the Federal Reserve, cut interest rates aggressively, while the largest ever stimulus/stabilization programs were enacted by governments across many regions around the world, to help stabilize the financial markets. The worsening turmoil in the markets led to a continuation of flight to quality which resulted in a sharp decline in short maturity Treasury yields and a steeper yield curve. The yield on the 2-year Treasury note fell by 41 bp to 1.55%, while the yield on the 30-year Treasury bond increased by 6 bp to 4.37%. Consequently, the 2-year/30-year yield spread steepened by 47 bp to end the month at 282 bp.

Credit spreads continued to widen in October as the global financial crisis worsened. The Lehman Brothers Credit Index widened by 109 bp resulting in an underperformance of -580 bp. The sector's underperformance was broad-based as all corporate sectors posted negative excess returns led by the utilities sector with an excess return of -992 bp followed by the industrial and financial sectors with excess returns of -884 bp and -243 bp respectively. The better relative performance of the financial sector was largely due to the measures taken by the Treasury department to support the banking sector. The flight to quality in October steepened the credit curve as well as the quality curve as long maturity corporate bonds underperformed intermediate issues by -415 bp, while the BBB-rated sector underperformed the single-A sector by -545 bp. Reflecting the continued weak market tone, issuance of investment grade fixed rate debt for the month remained weak at $29 billion.

The securitized sector had its worst-ever monthly performance with an excess return of -248 bp. The residential mortgage-backed sector (MBS) cheapened significantly as deleveraging continued and implied volatility rose sharply. Overall, the MBS sector lagged Treasuries by -152 bp. Across the mortgage sector, premiums outperformed discounts due to the former's lower spread duration. Despite the steeper Treasury yield curve, the15-year MBS sector lagged the 30-year sector by 52 bp. Even the asset-backed sector (ABS) underperformed Treasuries by 665 bp, following spread widening to unprecedented levels as the sector's better liquidity resulted in selling pressures to meet fund liquidations. Credit cards, one of the most liquid sectors, suffered the most posting -928 bp of excess return, while the auto ABS sector lagged Treasuries by -592 bp, the worst month ever for both sectors. Despite continued low delinquency and loss rates, the commercial mortgage sector (CMBS) was the worst performing sector in the Lehman Brothers Aggregate index with an excess return of -1020 bp.

Sovereign bond markets in most international developed countries continued to outperform the United States during the month of October on growing concerns of a global recession. While yields in the United Kingdom (U.K.), Germany, Australia, and Canada declined by more than the decline in U.S. yields, New

Zealand and Japanese yield declines were less. As a result, the U.K. and Germany outperformed by +69 bp and +54 bp respectively, while New Zealand and Japan underperformed by -59 bp and -19 bp respectively. During the month, several foreign banks eased monetary policies with the Reserve Bank of New Zealand (RBNZ) and the Reserve Bank of Australia (RBA) being the most aggressive as both cut interest rates by 100 bp. In a rare instance of coordinated policy action, the Bank of England (BoE), the European Central Bank (ECB), and the Bank of Canada (BoC) in conjunction with the U.S. Federal Reserve cut interest rates by 50 bp. Even the Bank of Japan (BoJ) was compelled to cut interest rates from an already low 0.50% to 0.30%. Reflecting narrowing interest rate differentials, the U.S. dollar was higher against a basket of six major currencies by 7.8%. Most notably, the Australian dollar fell by 15.8%, while the New Zealand dollar declined by 13%. The Canadian dollar, the Euro, and the British pound also dropped by between 10 and 12%. The Japanese yen was the only currency to post a gain (+7.8%) as it benefitted from risk aversion and the reversal of carry trades.

Outlook

The unprecedented stimulus and monetary policy accommodative actions taken world-wide are helping thaw the credit market freeze. For example, the over-night Libor rate, which measures interbank lending, peaked in the middle of October at 5.38%, implying unwillingness by banks to lend to each other. By the end of the month, the rate had declined dramatically to 0.41% by the end of the month, indicating less strain in the credit markets. Also, 30-day yields in the commercial paper market, which companies use for working capital and to finance inventories, declined from a peak of 4.30% to finish the month at 0.88%. Attention has now turned to the effects of the financial crisis on the economy and the depth and length of the recession currently underway. In October, the unemployment rate rose to 6.5%, the highest level since 1994, as the economy lost another 240,000 jobs. Consumer confidence measures declined sharply due to the worsening financial crisis and a weakening employment picture. The dramatic steps taken by central banks across the globe have improved liquidity in the credit markets helping to lower short-term borrowing costs for companies. Stabilization in global financial markets is likely to temper the recessions that are underway in a number of countries around the world. In the United States, the futures markets are now expecting a 3/4% target federal funds rate by the end of this year.

The generalized widening in credit spreads is in response to growing concerns of a global recession. Systemic risk fears, however, have abated as indicated by the outperformance of the financial sector versus the utilities and industrial sectors. At current levels, credit spreads have priced in much of the expected economic downturn. Valuations are very compelling although issue selection remains important because some businesses are unlikely to return to normalcy even if market conditions improve. The mortgage sector remains cheap. 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 very attractive following the record 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 have confirmed a marked economic slowdown in international markets. Central banks are responding with aggressive easing of monetary policies and governments are also putting in place significant fiscal policies to jump-start their economies. Hedged interest rate convergence strategies for currencies with higher yields such as New Zealand and the United Kingdom continue to be attractive for U.S.-based investors. In the currency markets, the U.S. dollar is likely to be supported by favorable interest rate differentials.