Smith, Graham & Co.
Investment Advisors, L.P.

Cyril M. Theccanat
Executive Vice President
Managing Director – Investment Management

Investment Review and Outlook
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Fixed Income Markets

In November, the deterioration in the global financial markets continued. The free-fall in Citigroup's stock price led the banking regulators (FDIC) to inject $20 billion of capital and insure $300 billion of troubled assets to help stabilize the bank. Additional steps taken by the Treasury to stabilize the financial markets included the purchase of asset-backed securities (ABS) to unfreeze consumer lending as well as the purchase of Fannie Mae and Freddie Mac debt and mortgage-backed securities (MBS). These additional measures failed to stem the flight to quality, and the yield on the 2-year Treasury note fell by 57 bp to 0.98%. Longer maturity yields dropped by even more as deflation fears increased. The yield on the 30-year Treasury bond decreased by 93 bp to 3.44%. Consequently, the 2-year/30-year yield spread decreased by 36 bp to end the month at 246 bp.

Credit spreads widened for the sixth consecutive month as the global financial and economic crises continued. The 34 bp widening in the credit index resulted in an underperformance of -183 bp. The sector's underperformance was broad-based as all corporate sectors posted negative excess returns led by the industrial sector with an excess return of -218 bp followed by the utility and financial sectors with excess returns of -157 bp and -131 bp respectively. The better relative performance of the finance sector stemmed from the government guarantee on new issuance of unsecured debt by qualifying financial institutions. The credit curve and the quality curve both steepened as long maturity corporate bonds underperformed intermediate issues by -211 bp, while the BBB-rated sector underperformed the single-A sector by -204 bp. Reflecting the continued negative market tone, issuance of investment grade fixed rate debt for the month remained weak at $28 billion.

The securitized sector experienced a second consecutive painful month, posting an excess return of -272 bp. This was primarily driven by the rout in the commercial mortgage backed sector (CMBS) which underperformed by a staggering - 2259 bp. The residential mortgage-backed sector (MBS) lagged Treasuries by -68 bp due to convexity losses and a rise in implied volatility. Mortgages erased some of their earlier losses on the Federal Reserve's announcement that it would purchase up to $500 billion in agency MBS to bring down mortgage rates. As a result, premiums underperformed discounts amid concerns about higher refinancing activity down the road. The better convexity profile of the 15-year MBS sector helped it outperform the 30-year sector by 137 bp. The GNMA sector lagged Treasuries by -181 bp and underperformed conventionals by -100 bp on the heels of greater government support for Fannie Mae and Freddie Mac. The asset-backed sector (ABS) underperformed Treasuries by -316 bp, led by the home equity sector which posted -1865 bp of excess return. In the consumer sector, spreads stabilized with the announcement of the Treasury's Term ABS Lending Facility (TALF). As a result, the auto and credit card ABS sectors posted excess returns of -20 and -4 bp, respectively.

Smith, Graham & Co., Investment Advisors, L.P., 6900 JPMorgan Chase Tower, 600 Travis, Suite 6900, Houston, Texas 77002 Phone (713) 292-2105
www.smithgraham.com

Sovereign bond markets in most international developed countries underperformed the United States in November. Although yields in Australia and New Zealand declined by more than the decline in U.S. yields, British, German, Canadian, and Japanese yield declines were less. Two-year interest rate differentials relative to the U.S. were +52 bp for Australia and +46 bp for New Zealand, while comparable differentials showed underperformance of -63 bp in Japan and -27 bp in Canada. In the United Kingdom, 2-year U.S. Treasuries outperformed by 14 bp. During the month, several foreign central banks eased monetary policy with the Bank of England (BoE) cutting interest rates aggressively by 100 bp and the Reserve Bank of Australia (RBA) cutting rates by another 75 bp on top of the 100 bp cut last month. The European Central Bank (ECB) also cut rates by 50 bp continuing its easing campaign. Reflecting the mixed performance in interest rate differentials, the U.S. dollar was slightly higher against a basket of six major currencies by 1.03%. While the commodities-levered currencies continued to decline, the British pound fell by 4.3% as concerns increased about the bleak prospects for the U.K. economy. As has been the case in recent months, the Japanese yen was the only currency to post a gain (+3.1%) as it benefitted from risk aversion and the reversal of carry trades.

Outlook

Government and central bank interventions world-wide are helping thaw the freeze in the credit markets. These continuing actions should help restore confidence in the global financial system. The spread between the three-month Libor rate and the three-month Treasury yield, which measures risk aversion, fell from 2.59% at the end of October to 2.18% indicating less strain in the credit markets. Also, yields in the commercial paper market, which companies use for working capital and to finance inventories, and yields in the Agency discount note market continue to decline due to measures taken by the Federal Reserve and Treasury. With these money market yields well below 1%, investors will gravitate further on the yield and quality curve spectrums as the credit markets stabilize.

Credit spreads near all-time wides, appear to have priced in much of the expected economic downturn. Valuations are therefore quite compelling. Issue selection, however, remains important because some businesses are unlikely to return to normalcy soon even if market conditions improve. The Agency mortgage-backed sector is cheap due to government policies targeting home price stabilization and reduction in mortgage rates. Sponsorship will now come from the Treasury, the Government Agencies and the Federal Reserve, which over the course of 2009, will benefit the sector. The AAA-rated tranches of the short-dated consumer asset-backed sector are also attractive following the recent widening in spreads. However, deteriorating fundamentals, limited liquidity and lack of clarity on the depth and length of the recession will weigh on the ABS and CMBS sectors. Due diligence is of utmost importance, especially in the CMBS sector, as a deep recession will negatively impact loans that were aggressively underwritten over the last couple of years. Securities from seasoned vintage CMBS transactions are preferable to post-2006 deals.

Economic data from most developed markets confirm a marked global economic slowdown with several countries already in recessions. Central banks are responding with aggressive easing of monetary policy 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. However, as risk aversion abates, higher-beta currencies should find support.