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**Investment Review and Outlook**  
**4<sup>th</sup> Quarter 2008**

**Fixed Income Markets**

The final quarter of 2008 was engulfed by the upheaval in the global financial markets as the negative effects from the unexpected bankruptcy of Lehman Brothers rapidly reverberated around the world in an unprecedented manner. Despite the trillions of dollars in direct and indirect support from central banks and governments across the world, financial markets seized up, and the credit intermediation process virtually came to a halt as investor confidence was shattered. The ensuing flight to quality drove U.S. Treasury yields to record lows as the Federal Reserve cut the federal funds rate to just ¼%. Short Treasury bill yields fell close to 0%, and even turned negative on some days in December, which reflects the magnitude of investor risk aversion. For the quarter, the yield on the 2-year Treasury note plunged by 120 bp to end the year at 0.76%. The drop in yield on the 30-year Treasury bond was an even greater 164 bp as investors reached out across the yield curve to obtain yields greater than 1%. By quarter-end, the 30-year bond's yield had fallen to a record low 2.68%. The larger decline in long maturity yields caused the Treasury yield curve to flatten by 44 bp, and the 2-year/30-year Treasury yield spread ended 2008 at 192 bp.

All non-Treasury sectors underperformed as flight-to-quality and lack of liquidity were the dominant themes in the fourth quarter. In the credit sector, the Lehman Brothers Credit Index (now renamed Barclays Capital Credit Index) widened 108 bp resulting in an underperformance versus Treasuries of -543 bp. This follows the greatest quarterly underperformance on record for the credit sector in the third quarter. For the full year, the underperformance was a staggering -1786 bp. The sector's quarterly underperformance was broad-based as all corporate sectors posted negative excess returns led by the utilities sector which recorded an excess return of -1136 bp and the industrial sector which lagged by -863 bp. The financial institutions sector, with an excess return of -40 bp, held up much better as the sector benefited from the U.S. Treasury department's decision to use part of the \$700 billion bailout program (TARP) passed by Congress to make direct capital infusions into financial institutions around the country. For the quarter, the credit and quality curves both steepened as long maturity corporate bonds underperformed intermediate issues by -497 bp and the finance-heavy single-A sector outperformed the industrial/utility dominated BBB-rated sector by 971 bp. Reflecting the depressed market tone, issuance of investment grade fixed rate debt remained subdued at \$86 billion. However, for the first time, \$71 billion of fixed rate FDIC-guaranteed debt was issued by qualifying financial institutions.

Despite its high credit quality, the securitized sector underperformed for the second consecutive quarter, posting an excess return of -396 bp. The sector was dragged down by the commercial mortgage backed (CMBS) and asset backed (ABS) sectors which underperformed Treasuries by -2043 and -1173 bp respectively. The ABS sector was negatively impacted as forced redemptions in an illiquid market caused



spreads to widen sharply. The lack of liquidity and fears regarding the ability of commercial loans coming due in the next few years to be refinanced weighed heavily on the CMBS sector making it the worst performing fixed income sector. For the quarter, the CMBS curve steepened further as shorter maturity bonds outperformed longer-dated issues by over 1800 bp. The Agency mortgage-backed (MBS) sector was aided by the Federal Reserve's announcement that it would be purchasing up to \$500 billion in MBS over the next several quarters to lower mortgage rates. Consequently, although the sector underperformed by -195 bp, it was the best performer in the securitized sector. The better convexity profile of the 15-year MBS sector enabled it to outperform its 30-year counterpart by 200 bp as Treasury yields declined sharply. Discount MBS coupons outperformed premiums by over 100 bp amid fears that lower mortgage rates would unleash a new refinancing wave. The voicing of more government support for Fannie Mae and Freddie Mac cheapened the GNMA sector which underperformed conventionals by 108 bp.

For the fourth quarter, sovereign bond markets in most international developed countries had mixed performance as short maturity yields outperformed and intermediate/long maturity yields underperformed comparable yields in the United States. Notable outperformance in two-year interest rate differentials relative to the U.S. were +177 bp for the United Kingdom and +122 bp for Australia. During the quarter, most central banks continued to cut their target rates as the global economic downturn worsened. The Bank of England, the Reserve Bank of Australia and the Reserve Bank of New Zealand cut rates aggressively by 300 bp, 275 bp and 250 bp respectively. Even the European Central Bank (ECB) cut rates by 175 bp after having raised rates by 25 bp as recently as the third quarter. Reflecting narrowing interest rate differentials, the U.S. dollar moved higher against a basket of six major currencies by 2.3% for the quarter. Most notably, the British pound dropped by 18.1%, the Australian dollar fell by 11.4%, and the New Zealand dollar declined by 13.7%. The Japanese yen posted a small gain on a continuation of carry trade reversals and increased risk aversion.

## **Outlook**

For the first time since World War II, the United States, Europe and Japan are all in simultaneous recessions. Several other emerging-economy countries are also either in a recession or bordering on one. In the United States, the unemployment rate has risen to 7.2% and is expected to rise further to the 8% area. In 2008, 2.6 million jobs were lost, the most since 1945. Consumer confidence has sunk to its lowest level in over 40 years. Consumer spending, business investment and industrial production have all declined sharply. Auto sales in 2008 plunged 36% to a 16-year low. Clearly, the financial and economic crises which are now world-wide are unprecedented. However, it is important to recognize that the global response to this crisis is also without precedent. In the United States alone, total government commitments to energize the economy exceed \$8.5 trillion, which does not include the \$800+ billion stimulus package that is expected when the new administration takes office in Washington in January. In Europe, the corresponding figure is between \$3 and \$4 trillion, while in China, it is approaching \$1 trillion. Additionally, central banks around the globe are slashing interest rates to record lows. The determination of central banks and governments to do whatever is necessary to promote the resumption of sustainable economic growth should not be underestimated. Although the federal funds rate in the United States is now close to 0%, the Federal Reserve has indicated that quantitative easing is another tool at its disposal to bring longer maturity yields down and keep them low. The credit markets were the first areas to reflect stress when the financial crisis began. Several indicators in the credit markets are now showing signs of healing and a better tone. Thirty-day commercial paper, which was yielding 400 bp over Treasuries three months ago, and 130 bp just a month ago, is now at a spread of 15 bp. The TED spread, which measures how much more than the government it



costs banks to borrow for three months, has narrowed from 464 bp in September to 133 bp. Another measure of credit risk, the 2-year interest rate swap spread has narrowed from 165 bp to 56 bp, which is the tightest level since July 2007 just before the credit crisis started. The improved tone in the credit markets is a harbinger for a better environment in other parts of the financial markets over the next year. In our view, the magnitude and scope of the fiscal and monetary stimuli being undertaken world-wide will be successful in enabling the resumption of global economic growth over the next twelve months.

Despite the rally in December, credit spreads remain near record wides, and valuations in many segments of the credit sector are compelling. The financial sector, in particular, has seen appreciable stabilization after Citigroup received direct support from regulators, and the FDIC broadened the terms of the Temporary Liquidity Guarantee Program (TLGP). Other sectors that are attractive include telecommunications, utilities, energy, commodities, technology and machinery. Issue selection, however, remains important as a changed economic environment requires companies to realign their business models to maintain their competitive advantages.

Agency MBS will benefit from government policies that target stabilizing home prices and reducing mortgage rates. Sponsorship for this sector will now come from the Treasury and the Federal Reserve in addition to the Government Sponsored Enterprises (GSE's). The AAA-rated tranches of the consumer asset-backed sector are cheap following the recent extreme widening in spreads. Maturities in the one to three year area for high-quality credit card and auto issuers offer significant value. The ABS sector will also materially benefit from the \$200 billion Term Asset-Backed Securities Loan Facility which will be implemented by the Federal Reserve in February to facilitate the extension of credit to households and small businesses. The CMBS sector, especially AAA-rated tranches, is likely to benefit over the next several months as delinquencies and losses remain low. However, due diligence is of the utmost importance as a severely weakened economy will negatively impact loans that were aggressively underwritten over the last couple of years. Seasoned vintage CMBS deals are preferable to newer ones, especially those underwritten in late 2006 and 2007.

While the U.S. Federal Reserve has brought the federal funds rate close to 0%, foreign central banks have more room to cut rates aggressively. The broad-based and sharp declines in commodity and energy prices provide a constructive foundation for the outlook on inflation. Declining inflation pressures will enable these central banks to maintain accommodative monetary policies. In New Zealand and Australia, further interest rate cuts are expected as the fallout from the decline in commodity prices weakens those economies. Initial indications from Australia-based commodity companies suggest that capital spending will be lower by almost 20% in 2009. Hedged interest rate convergence strategies for currencies with higher yields such as New Zealand continue to remain attractive for U.S.-based investors. In the currency markets, the U.S. dollar is likely to be supported by favorable interest rate differentials, although rising expectations for an economic recovery will also support commodity-levered currencies. The euro is likely to remain weak as uncertainty over the path of the ECB's monetary easing cycle lingers.

