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Investment Review and Outlook January 2009

Fixed Income Markets

Despite the release of significantly weak economic data, record wide spreads in non-Treasury securities attracted widespread investor interest as 2009 began. As a result, Treasury yields rose while most non-Treasury spreads narrowed. The yield on the 2-year Treasury note increased by 18 bp to 0.94%, while the yield on the 30-year Treasury bond climbed sharply by 93 bp to 3.60%. Consequently, the 2-year/30-year yield spread steepened by 75 bp to end the quarter at 265 bp.

In sharp contrast to the worst January ever for the equity markets, the credit sector had its best monthly performance since the creation of the original Lehman index as investors moved out of Treasuries with record low yields and bought corporate securities. The Barclays Capital Credit Index tightened by 62 bp which brought the index's spread to 431 bp resulting in an outperformance of +319 bp versus duration-matched Treasuries. The sector's outperformance was broad-based as all corporate sectors posted positive excess returns led by the utilities and industrial sectors which recorded excess returns of +675 bp and +513 bp respectively. Although the financial institutions sector lagged, it still provided a positive excess return of +121 bp. For the month, the credit and quality curves both flattened as long maturity corporate bonds outperformed intermediate issues by +172 bp and the industrial/utility dominated BBB-rated sector outperformed the finance-heavy single-A sector by +208 bp. Reflecting the improved market tone, issuance of investment grade fixed-rate, non-guaranteed debt rebounded to \$87 billion. Supply of fixed rate FDIC-guaranteed debt remained strong at \$41 billion.

After two straight quarters of underperformance, the securitized sector ended the month with +43 bp of excess return. Despite higher Treasury yields, the residential mortgage-backed sector (MBS) outperformed Treasuries by +54 bp as the Federal Reserve continued to purchase mortgage-backed securities. Higher coupons outperformed by +35 bp as the market re-evaluated prepayment risk. Despite a sharply steeper Treasury yield curve, the 15-year MBS sector underperformed the 30-year sector by -69 bp due to lack of sponsorship. January was a stellar month for the asset-backed sector (ABS) which outperformed Treasuries by +741 bp as investors anticipated the start of the Treasury's \$200 billion Term Asset-Backed Securities Loan Facility (TALF). This facility will support the issuance of ABS collateralized by a variety of consumer loans such as auto, credit card and student loans. While outperformance was broad-based in the ABS sector, it was primarily driven by the credit card sector which posted +1113 bp of excess return. The worst performing sector in January was the commercial mortgage backed sector (CMBS) which lagged Treasuries by -217 bp due to concerns about deteriorating performance for bonds issued in 2007 and 2008. These concerns have, in turn, resulted in a more pronounced segmentation within the CMBS sector. For instance, spreads for 2005-vintage CMBS tightened by 155 bp, while spreads for 2007 issues widened by 256 bp.

For the month of January, sovereign bonds of most international developed countries outperformed U.S. Treasuries. Notable outperformance in two-year interest rate differentials relative to the U.S. were +101 bp for New Zealand and +53 bp for the United Kingdom. Target rates for most central banks remained unchanged as rate setting meetings were scheduled for February. Reflecting narrowing interest rate differentials, the U.S. dollar moved higher against a basket



of six major currencies by 5.8% for the month. Most notably, the New Zealand dollar dropped by 11.9%, while the Australian dollar fell by 9.3%, and the euro declined by 8.3%. The Japanese yen maintained its uptrend and posted a small gain on continued carry trade reversals.

Outlook

Economic data continue to reflect significant weakness in economies around the world. In the United States, the unemployment rate rose to 7.6% in the month of January, and it is expected to climb further in the months ahead. The close to 600,000 jobs lost during the month brings the total number of jobs lost since the start of the recession to 3.5 million. Consumer confidence is hovering near record lows as the negative effects from the weak employment picture are being compounded by the sharp decrease in household net worth as the housing and equity markets continue to decline. As a result, consumer and business spending have dropped sharply. Despite the unprecedented magnitude of stimulus that has already been provided, the U.S. government continues to look for creative ways to help limit the length and depth of the current economic downturn. Congress is ironing out the final details on an \$800+ billion economic stimulus package, and the Treasury department is finalizing a plan to deploy the second half of the \$700 billion TARP funds. Monetary policy, meanwhile, is being kept very accommodative with the federal funds rate at ¼%. All these actions, in conjunction with the fiscal and monetary stimuli being undertaken world-wide are likely to break the credit logjam and enable the resumption of global economic growth over the next twelve months.

Even after rallying for two consecutive months, valuations in many segments of the credit sector remain compelling. In particular, the telecommunications, utilities, energy/commodities, and technology sectors continue to look attractive. The government's on-going support for banks has provided a favorable risk-reward profile for the financial sector. Issue selection, however, is important as a changed economic environment requires companies to realign their business models to maintain their competitive advantages. In the securitized sector, the Agency-backed MBS sector will benefit from government policies that target home price stabilization and the reduction of mortgage rates. The AAA-rated tranches of the short-dated consumer asset-backed sector remain cheap despite the recent tightening in spreads. However, the weak economy is likely to put further strain on the ABS and CMBS markets. Due diligence is of the utmost importance, especially in the CMBS sector, as loans that were aggressively underwritten in 2006 and 2007 experience greater than expected losses. Seasoned CMBS deals are likely to perform better than post-2006 issues.

Economies across developed and developing regions of the world are weakening. The easing trend in monetary policy is likely to continue even after official rates have been cut to historic lows. For example, the Bank of England cut interest rates by 425 bp over the last 14 months to a record low 1.5% but further reductions are expected. Similarly, expectations have risen for more interest rate cuts in Australia, New Zealand, and the Eurozone as inflation fears have diminished. Consequently, hedged interest rate convergence strategies remain attractive. 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 due to the uncertainty regarding the financial health of some member-nations like Spain and Greece.

