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## Investment Review and Outlook February 2009

### Fixed Income Markets

After starting the year on a positive note, the fixed income market struggled to digest heavy Treasury and corporate issuance during the month of February. This caused a modest back-up in Treasury yields with the yield on the 2-year Treasury note rising by 3 bp to 0.97% and the yield on the 30-year Treasury bond increasing by 10 bp to 3.71%. The 2-year/30-year yield spread steepened by 8 bp to end the quarter at 273 bp.

In February, renewed concerns about the banking and finance sectors weighed on the credit sector. After recording its best monthly performance ever in January, the Barclays Capital Credit Index widened by 20 bp resulting in an underperformance of -118 bp versus duration-matched Treasuries. The sector's underperformance was primarily driven by the financial sector which recorded an excess return of -371 bp followed by the industrial sector at -41 bp. On the other hand, the utilities sector outperformed by +155 bp as investors moved to more defensive industries within the credit sector. For the month, the credit curve steepened by 87 bp, as intermediate securities outperformed long-maturity bonds. The quality curve, however, flattened by 157 bp as the finance-heavy single-A sector underperformed the industrial/utility dominated BBB-rated sector.

The securitized sector posted +35 bp of excess return for February. Within the sector, performance was mixed, with the residential mortgage-backed sector (MBS) and the consumer asset-backed sector (ABS) outperforming while the commercial mortgage-backed sector (CMBS) underperformed. Despite the negative implications of President Obama's refinancing plan for MBS, the sector outperformed Treasuries by +70 bp as the government continued to buy MBS. The 15 year sector outperformed the conventional 30-year sector by +37 bp due to the lower loan-to-value profile of 15-year borrowers. The asset-backed sector (ABS) lagged Treasuries by -72 bp after two straight months of outperformance. The home equity sector was the worst performer in the Barclays US Aggregate Index, posting -1369 bp of excess return. Lack of supply and the anticipated asset-backed loan facility (TALF) enabled short duration auto and credit card ABS spreads to tighten between 25-100 bp, despite concerns about the negative effects of rising unemployment. The CMBS sector experienced another difficult month, and underperformed Treasuries by -358 bp. Rapidly weakening economic data, negative headlines and Moody's downgrade of 2006 and 2007 vintage deals weighed on the sector. Shorter-dated bonds outperformed longer maturity bonds on speculation that the TALF program could potentially expand to include CMBS.

For the month of February, sovereign bonds of most international developed countries outperformed U.S. Treasuries on signs of worsening economic conditions outside the U.S. Notable outperformance in two-year



interest rate differentials relative to the U.S. were +27 bp for Canada and +25 bp for Germany. During the month, interest rates were cut by 100 bp and 50 bp in Australia and the United Kingdom respectively. Reflecting narrowing interest rate differentials, the U.S. dollar moved higher against a basket of six major currencies by 2.3% for the month. Notably, the Canadian dollar dropped by 3.6%, the New Zealand dollar fell by 1.6%, and the British pound declined by 1.5%. A surprising development in the foreign exchange markets was the 7.8% decline in the Japanese yen against the U.S. dollar, reversing the risk-aversion trend that had benefitted the Japanese currency. Concerns about the impact of the global slowdown on the export-dependant Japanese economy are now weighing on the yen.

## **Outlook**

Economic data continue to reflect significant weakness in economies around the world. In the United States, the unemployment rate rose to 8.1% in the month of February and is expected to climb further in the months ahead. The 651,000 jobs lost during the month brings the total number of jobs lost since the start of the recession to 4.4 million. Consumer confidence remains 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. Congress has finalized a \$787 billion economic stimulus package that is expected to save or create 3.5 million jobs over two years. Also, the Federal Reserve announced that the Treasury's asset-backed lending facility (TALF) will commence in March, which should help free up bank balance sheets and increase bank lending. Monetary policy, meanwhile, is being kept very accommodative with the federal funds rate at ¼%. All of these actions, in conjunction with the fiscal and monetary stimuli being undertaken world-wide are likely to help stabilize the financial markets and enable the resumption of global economic growth over the next twelve months.

The widening in credit spreads, especially in the finance sector due to expectations for further losses on banks' balance sheets, has made valuations attractive. However, issue selection is important as many finance companies remain vulnerable in this downturn. Other sectors such as utilities, telecommunications, energy, and technology continue to look attractive. Issue selection in non-financials is also an important factor 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 sectors. Due diligence is of the utmost importance, especially in the CMBS sector, as loans that were aggressively underwritten in 2006 and 2007 are likely to experience greater than expected losses. Seasoned CMBS deals are expected to perform better than post-2006 issues.

There are heightened concerns about the fragility of the global financial system. The latest round of worries relate to reports that most western European banks have significant exposures to the rapidly deteriorating economies of eastern Europe. Although there is room for further monetary policy easings, the focus is shifting to other measures that central banks can undertake, such as quantitative easing. In this environment, hedged interest rate convergence strategies remain attractive for now. In the currency markets, the U.S. dollar is likely to be supported by favorable interest rate differentials and the continued flight to quality.

