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## Investment Review and Outlook April 2009

### Fixed Income Markets

In April, the non-Treasury fixed income spread sectors posted strong performance as investors' became more comfortable with the economic outlook. Better than expected corporate earnings (albeit versus low expectations) led to increased investor risk-appetite. The U.S. Credit Index had its best monthly performance ever in terms of excess return, with lower-quality securities outperforming higher quality issues. Similarly, High Yield and Leverage Loans returns also were record-setting. The Securitized (MBS, CMBS and ABS) Sector also had a stellar month with CMBS posting strong returns over Treasuries on expectations that the Federal Reserve's TALF facility would be expanded to include financing for the CMBS sector. Given this backdrop and the burgeoning supply of Treasury issuance to fund the various stimulus programs, Treasury yields rose. Longer maturity (10+ years) yields were higher by 45-50 bp while shorter maturity yields increased only 10 bp resulting in a steeper Treasury yield curve (difference in yields between short and long maturities). Most sovereign bond markets, notably New Zealand and the United Kingdom, also outperformed the U.S. as foreign central banks continued to cut their target interest rates. After several months of strengthening, the U.S. dollar fell 1% against a basket of six major currencies as riskier assets found favor across most markets.

### Outlook

The U.S. economy contracted further in the first quarter of 2009, resulting in the worst six-month decline since the 1950's as real GDP shrank 6.1% following a decline of 6.3% in the final quarter of last year. Despite the magnitude of the decline, there were some positive takeaways in the report that bode well for the economic outlook. The primary detractors in the quarter were a decline in investment (both residential and non-residential), lower exports and a massive inventory correction (the largest ever reported). These adjustments to inventories should result in increased production in the second half of the year. Another positive note in the report was the 2.2% increase in consumer spending which was the first positive reading in three quarters, likely a result of tax refunds that are up more than 20% year-over-year. Other glimmers of hope can be found in manufacturing as well as in housing. The Institute for Supply Management (ISM) survey, a bellwether for the manufacturing sector, improved for the fourth consecutive month. While still showing contraction, the report indicates that the decline in manufacturing has slowed, and more importantly, some of the forward-looking subcomponents (such as new orders and production) of the survey show that further gains can be expected. Looking at housing and construction, pending sales of existing homes posted back-to-back gains in February and March (for the first time in a year), and anecdotal data in some of the bubble regions (CA, NV and AZ) show prices also increased marginally. Meanwhile, construction spending rose for the first time in six months. As expected, given some of the "green shoots" that are being observed, consumer confidence has improved. Turning to the labor market, non-farm payrolls are expected to lose another 600,000 jobs in April with the unemployment rate rising to 8.9%.



At the most recent Federal Open Market Committee meeting in late April, short-term rates were left unchanged at close to 0%. The FOMC indicated that it “anticipates... exceptionally low levels of the federal funds rate for an extended period.” In the statement released with the policy decision. The Committee did note the economic outlook “has improved modestly since the March meeting” but is “likely to remain weak for some time.” In addition, the FOMC stated that they would continue the quantitative easing (asset purchases) program to “promote economic recovery and to preserve price stability.”

We continue to favor the Securitized Sectors for their quality (AAA) and attractive yields relative to Treasury and Agency securities. The Federal Reserve’s program to stabilize mortgage rates will continue to have a positive impact on MBS performance going forward. In addition, our expectation is that the TALF program and the Treasury’s PPIP program will succeed in re-starting the stalled securitization markets. The portfolios have a modest overweight position in the U.S. Credit Sector, which remains relatively cheap despite improving fundamentals. We will use the new-issue market to add strong and stable names in this space. In the currency markets, rising expectations for an economic recovery should support commodity-levered currencies. As a result, hedged interest rate convergence strategies are near the end of their course. Lastly, we remain underweight in Treasuries and Agencies.

