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Market Review and Outlook
July 2011

Review

In July, the broad fixed income market as measured by the Barclays Capital Aggregate Index posted a total return of 1.59%. The protracted and contentious U.S. debt ceiling negotiations and heightened concerns about sovereign default risk coupled with weaker global economic data led to a flight-to-quality. Consequently Treasury yields for most maturities made new lows for the year. Only the credit and asset-backed sectors had positive excess returns versus duration-equivalent Treasuries for the month.

The securitized sector underperformed by -62 bp mainly due to the agency mortgage-backed sector (MBS) which lagged Treasuries by -65 bp. All coupons performed poorly for the month, particularly FNMA 6.5s as higher than expected speeds for a large group of specified pools caused a decline in dealer support for this coupon. The commercial mortgage-backed sector (CMBS) struggled to absorb new supply, forcing issuers to revise spread guidance wider, while investors began demanding higher subordination levels. Additionally, an error in S&P's calculation of a debt service coverage metric in a new CMBS deal that had been priced resulted in the deal being withdrawn. These factors contributed to the -37 bp in underperformance for the sector. The asset-backed sector (ABS) was a standout earning +18 bp of excess return, despite the turmoil in the markets. The U.S. credit sector reversed the trend of the prior two months, and outperformed duration-neutral Treasuries by +25 bp. The safe-haven industrial and utility sectors garnered +71 and +83 bp, respectively, while financials lagged by -39 bp. Performance along the credit quality spectrum was mixed for the month as AA-rated issues posted +9 bp of excess return, BBB +33 bp, while high yield underperformed by -46 bp. Despite all the macro uncertainties, the Treasury yield curve flattened with the 30-year yield declining by 25 bp, while the 2-year decreased by 10 bp. The 2-year/ 30-year Treasury yield differential ended the month at 376 bp.

Government bonds in the developed markets presented a mixed picture. The United Kingdom and Germany outperformed the U.S. by 8 to 35 bp on weaker economic data, while Japan and New Zealand lagged by 30 to 40 bp. On the currency front, the U.S. dollar declined against most major currencies with the exception of the euro which declined 0.7% versus the dollar. The British pound, Japanese yen and New Zealand dollar gained 2.3%, 5.0% and 6.0% respectively.

Outlook

While the recent weakness in the economy may be attributed to temporary factors such as higher gasoline prices, bad weather and the disasters in Japan, the U.S. economy continues to be weighed down by a struggling housing market, a stubbornly high unemployment rate above 9.0%, and bank lending that is only gradually increasing from a low level. These headwinds have resulted in economic growth that is well below potential while helping to restrain core inflation. Concerns over a global economic slowdown and rising fears of a European debt contagion will only reinforce the Federal Reserve's stance on easy monetary policy. As such, we believe the Federal Reserve will not begin to raise interest rates until the second half of 2012, at the earliest.

The MBS sector looks attractive as spreads have reached their widest levels of the year. Demand from banks and REITs should return now that the debt ceiling has been raised. At the same time, the Federal Reserve is on extended hold and dwindling outstanding volume increases the likelihood for most securitized product to earn incremental carry. We, therefore, have a positive allocation bias to these products in our portfolios. We are particularly emphasizing CMBS product, as our analysis still suggests that improving fundamentals combined with a positive technical backdrop can result in material capital gains. Despite the slowdown in economic activity, corporate fundamentals remain intact and balance sheets strong. More than 75% of companies in the S&P 500 which have reported second quarter earnings have exceeded analysts' earnings estimates; furthermore, forward-looking guidance is mostly positive. We retain our overweight to the credit sector as valuations are attractive. In addition, the financial sector remains compelling as the recent sell-off has pushed spreads to their widest levels of the year despite improved capital levels and lower leverage, both of which are positive for bondholders. Issuer selection, however, is becoming more critical as an increasing number of companies are shifting their focus to more shareholder friendly activities through M&A, share repurchases and increasing dividends.

The sovereign debt problems in the peripheral Eurozone regions continue to present investors and policymakers with challenges. The structural nature and complexity of the issues involved make it less likely that a quick fix will be found. This means that volatility will remain in both the foreign exchange and debt markets of the Eurozone until an effective long-term solution is put in place. This will weigh on the euro while providing a bid for safe-haven currencies such as the yen and Swiss franc despite their unattractive interest rate differentials.

Finally, we remain underweight Treasuries and Agencies.

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