SMITH GRAHAM
HOUSTON • NEW YORK

Cyril M. Theccanat
President
Chief Investment Officer

# Market Review and Outlook
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### Review

In May, the fixed income markets as represented by the Barclays Capital Aggregate Index generated a total return of 1.31%. Weaker economic data coupled with renewed concerns about European sovereign default risk resulted in a flight to quality which pushed Treasury yields lower. Risk assets underperformed as all spread sectors lagged duration-equivalent Treasuries for the month.

The securitized sector posted -23 bp of excess return for the month. The agency mortgage-backed sector (MBS) lagged Treasuries by -19 bp due to wider spreads and higher volatility. Higher coupons exhibited greater resilience despite lower interest rates. Reflecting increased investor risk-aversion, the commercial mortgage-backed sector (CMBS) underperformed Treasuries by -85 bp. In a reversal from the past few quarters, higher-rated and shorter-maturity tranches outperformed subordinate and longer issues by more than 110 bp. Despite strong demand, the asset-backed sector (ABS) modestly lagged duration-equivalent Treasuries by -9 bp as swap spreads widened by 2 to 5 bp. Heavy new issuance and weaker economic data weighed on the credit sector resulting in -27 bp of underperformance. Reversing the trend from the prior several months, financials were the worst performer with -60 bp of excess return followed by industrials with -33 bp. The more defensive utilities sector managed to post +4 bp of excess return. Credit quality performance mirrored investor risk aversion with the AA-rated sector underperforming by -14 bp, while the BBB and high yield sectors lagged by -31 and -81 bp respectively. Despite the weakness in economic data, the Treasury yield curve flattened with the 30-year yield declining by 17 bp, while the 2-year Treasury yield decreased by 13 bp. The 2-year/30-year Treasury yield differential ended the month at 376 bp.

Government bonds in most developed markets modestly outperformed the U.S. for the month. The European debt crisis was once again on center stage as concerns resurfaced about a default by Greece. In the currency markets, the U.S. dollar index (measured against a basket of six major currencies) strengthened 2.3%. The euro and the Canadian dollar declined -1.3% and -1.5% respectively, while the New Zealand dollar rallied 3.1%.

600 Travis, Suite 6900 Houston, TX 77002 713. 292.2105 140 Broadway, 45th Floor New York, NY 10005 212.487.5100
www.smithgraham.com

## Outlook

The paltry +54,000 payroll increase in the May U.S. employment report, and an unemployment rate climbing to 9.1% punctuate a string of weak economic data releases which reflect the anemic economic recovery we are in. While factors such as higher gasoline prices, bad weather and the recent disasters in Japan have contributed to the recent weakness, the U.S. economy continues to be weighed down by a housing market that remains at recession lows, and bank lending that is only gradually increasing from a low level. With the economy growing at levels well below potential and core inflation remaining benign, we continue to believe that the Federal Reserve will not begin to raise interest rates until early 2012, at the earliest.

Although MBS look fairly valued, originations remain very light. Consequently, strong demand from banks and foreign investors creates a favorable supply/demand technical for the sector. Furthermore, with the Federal Reserve on extended hold and dwindling outstanding volume in MBS, this creates an environment that is conducive 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 the potential for material capital gains. Healthy fundamentals continue to underpin corporate spread valuations, and we retain our overweight to this sector. We continue to favor financials as spreads remain attractive from a historical basis relative to both industrial and utility spreads. Issuer selection across all sectors, however, is becoming more critical as an increasing number of companies are shifting their focus from protecting their balance sheet and credit metrics to re-leveraging activities through M&A, share repurchases and increasing dividends.

In the non-dollar markets, the shift in debate over the European peripheral debt crisis from default to the terms of intervention will continue to drive volatility in specific sovereign names. Lastly, we remain underweight Treasuries and Agencies.