SMITH GRAHAM
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Cyril M. Theccanat
President
Chief Investment Officer

Market Review and Outlook
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Review

In October, the broad fixed income market as represented by the Barclays Capital Aggregate Index posted a modest 0.11% return. The negative impact from a rise in Treasury yields was offset by significant tightening in non-Treasury sector spreads due to improving U.S. economic data coupled with progress on the sovereign debt crisis in Europe.

A decline in volatility and better yield advantage enabled the residential mortgage-backed sector (MBS) to outperform Treasuries by +29 bp. Despite the broadening of the Federal Housing Finance Agency's (FHFA) criteria (HARP 2.0) to enable more homeowners with underwater mortgages to refinance, higher-coupon MBS outperformed lower-coupon issues by over +10 bp. The commercial mortgage-backed sector (CMBS) was one of the top spread sector performers, earning +144 bp over Treasuries. In a reversal from recent months, lower rated tranches led the way, outpacing the AAA-rated sector by more than +90 bp. The asset-backed sector (ABS) earned just +1 bp relative to Treasuries due to the auto sub-sector which underperformed by -6 bp due to heavy new issuance. The credit sector rebounded nicely with +238 bp of excess return following the dismal performance in the third quarter, as corporate earnings were generally in-line to better-than-expected. The finance sector was the best performer on the month as investors gravitated to the sector's compelling relative value. The Industrials and utilities sectors also posted strong performance of +268 and +221 bp, respectively. Credit quality performance reflected increased risk-taking as lower quality issues outperformed their higher-quality counterparts: Aa +97 bp, A +255 bp, BBB +330 bp and high yield + 630 bp. As investors moved into spread sectors, Treasury yields rose primarily for longer maturities by 12 to 21 bp, while the yield curve, as measured by the 2-year/30-year yield differential, steepened by 22 bp to end the month at +289 bp.

Most developed country bond markets outperformed the U.S. in October driven by reduced fears of a double-dip recession in the U.S., and the perception that a solution to the European debt crisis was at hand. In the United Kingdom, intermediate maturities outperformed the U.S. by 12 to 19 bp and by 38 bp for longer maturities. In Germany, the outperformance was a more muted 2 to 8 bp. Reduced risk aversion weighed on the U.S. dollar which underperformed most currencies by -3% (vs. British pound) to -9% (vs. Australian dollar).

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

Although signs that the European sovereign debt crisis is widening are worrisome, U.S. economic data have continued an encouraging trend. Third quarter real GDP grew by 2.5% with personal consumption accelerating to 2.4%. Additionally, the October employment report was fairly solid when upward revisions to prior months are included. The unemployment rate ticked down to 9.0%, and job openings are at a 3-year high. Given the depth of the recent recession, economic growth is unlikely to be at the pace seen during past recoveries. As a result, the Federal Reserve has committed to keep the interest rate it controls close to zero for the next two years. Despite the firmer tone in recent economic data, the Federal Reserve has lowered its forecast for growth over the next few years and still sees "significant downside risks" to the economy.

Our relative-value framework indicate agency MBS are cheap. While originations have picked up on an increase in refinance activity, net supply is flat. The Federal Reserve's additional sponsorship has tilted the supply/demand balance in favor of MBS, adding to demand from money managers, REITS and banks. Mortgage prices remain at levels empirically associated with considerable negative convexity. Additionally, while HARP 2.0 could have a modest impact on prepayments, prepayment speeds are benign by historical standards as a large part of the mortgage universe is credit-impaired with limited ability to refinance even as rates linger at historical lows. With the Fed on extended hold, carry trades remain in vogue. We generally have a positive allocation bias to securitized products in our portfolios, particularly emphasizing CMBS, as our analysis suggests the potential for material capital gains. We retain our overweight to the corporate sector as valuations remain attractive. The sovereign debt crisis in the eurozone has created stresses not only in the European banking system but also in the U.S. money center banks via sovereign exposures. Despite the recent rally in bank/finance spreads, risk premiums are cheap relative to industrials and utilities. Net exposure to sovereign credit is manageable when measured against tangible common equity for the big U.S. money center banks, coupled with lower leverage and larger capital cushions. In non-financials, fundamentals remain largely intact and balance sheets are strong. Issuer selection, as always, remains critical. The non-dollar markets remain highly volatile and subject to headline risk. The details of any European sovereign debt solution remain to be determined. As a result, the risk of a recession in Europe has appreciably increased. The opportunities in the non-dollar sector will be defined by a preference for liquidity and safety.

Finally we remain underweight Treasuries and Agencies.