

# ECONOMIC & BOND MARKET QUARTERLY UPDATE

FIRST QUARTER 2008

## MARKET CONDITIONS & DWIGHT PORTFOLIOS

The credit crisis that has been unfolding over the past year or so has had profound and broadening impact on our world, reaching far beyond the financial markets and the securities industry to touch the lives of everyday Americans. Esoteric sectors of the bond markets have become the subject of conversation in homes and businesses across the country, and people who had never even heard of a CDO or a SIV now find themselves struggling to understand why their lives are being adversely affected by these acronyms.

The extreme price volatility witnessed in many parts of the bond market, even in those sectors traditionally considered safe and stable investment classes, has been nothing short of extraordinary. Not even agency-guaranteed mortgage-backed securities have been spared the volatility. Exposure to these sectors has resulted in substantial underperformance relative to the safe haven of U.S. Treasury debt for fixed income investors during the first quarter. However, while the mark-to-market pain has been acute, more of it is attributable to supply/demand imbalances in a liquidity-constrained market than to a massive shift in fundamental credit risk, and long-term investors will ultimately benefit from the

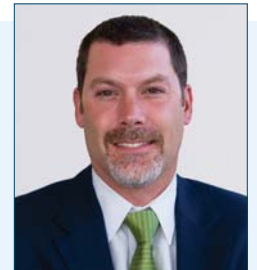
delevering currently underway in the capital markets.

We have been overweight structured product, primarily high-grade asset-backed and commercial mortgage-backed securities, in all of our investment strategies for a number of years now. Structural protections built into these securities, such as overcollateralization and subordination, are designed to insulate the senior bond classes from even severe declines in collateral performance. Our overweight to structured product has allowed us to reduce certain types of idiosyncratic risks in the corporate bond market, while in many cases enhancing the yield of our portfolios.

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David Thompson, CFA  
*President and Co-Chief  
Investment Officer*



David Kilborn, CFA  
*Co-Chief Investment  
Officer*

## CREDIT CRISIS LEAVES NO SECTOR UNSCATHED

### Fixed Income Sector Review

#### Corporates

During the first quarter, the corporate bond market continued the negative trend that started last year as credit market turmoil reached historic levels. Corporates underperformed duration-matched Treasuries by 487 basis points, posting a negative 0.15% total return. Spreads widened by 90 basis points during the quarter, which was not far from the 111 basis points of widening experienced during the full year 2007.

Negative themes that plagued the second half of last year continued in earnest through the first quarter of this year, culminating in the collapse of Bear Stearns. Broad-based fear of financial systemic failure left no corporate sector unharmed. Financials of all kinds performed poorly as the bottom of the housing market has yet to be determined. Industrial, communications, and consumer cyclical credits underperformed as the

market continued to grapple with the prospects of a full-blown recession. This problem called into question the willingness and ability of the great American consumer to maintain spending habits. Energy, while still posting negative excess returns, was a relative bright spot as oil traded in a range around \$100 per barrel.

While there is much to be concerned about, all is not lost. Through its unprecedented actions, the Federal Reserve has seemingly drawn a line in the sand and signaled that it will not

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Market Conditions & Dwight Portfolios, continued from front cover

- ▶ As the credit crisis has deepened in recent months, banks and brokers have come under tremendous pressure by shareholders to hedge balance sheet risk. Brokers have executed those hedges primarily in the credit default swap (CDS) markets, buying default protection on indices such as the ABX and CMBX. These large hedging programs had the impact of pushing spreads wider, and therefore prices lower, relative to Treasury bonds during the first quarter, as there were few “natural” sellers of protection in the CDS markets. Ironically, the hedging of potential mark-to-market risk increased actual mark-to-market risk, as the widening in CDS spreads and the rapidly increasing hedging costs created further strain on asset valuations, exacerbating the liquidity crisis. Declining asset prices and increased volatility scared off potential buyers and led to a wave of margin calls on levered investors in all mortgage-related asset classes, including even agency-guaranteed mortgage-backed securities.

The attendant delevering in the financial markets led to forced liquidations by hedge funds, mortgage REITs, and other levered players. The pace of the leverage unwind became frenetic in February and March, causing several high-profile hedge funds to collapse, and ultimately leading to the downfall of Bear Stearns. With brokers unable to provide adequate liquidity because of their own balance sheet constraints, asset prices plummeted even further, causing valuations to become completely divorced from credit fundamentals. Entire segments of the bond markets have suffered significant price declines, even while structural protections remained intact and collateral quality remained sound.

Returns in our various investment strategies have been mixed during this period. Stable value portfolios have held fairly consistent yields, even with market volatility, due to the book-value guarantees embedded in the portfolios. Insurance portfolios have also held up well. Total-return fixed income portfolios, which mark their securities to market on a daily basis, have fared worse. Our

expertise in structured product has allowed us to avoid many of the worst-performing sectors, such as CDOs, CLOs, and second-lien subprime mortgages, but our overweights in asset-backed and commercial mortgage-backed securities have led to considerable underperformance relative to our benchmarks. Of course we are disappointed with our performance in the first quarter of 2008. Our investment decisions are, as they have always been, guided by fundamental analysis and a classic risk/return approach, and we believe that our portfolios are well positioned to outperform their benchmarks over time.

As the delevering process winds down and asset prices find a new equilibrium, spreads on high-quality mortgage-related securities should tighten from their current extremes. The accumulation of interest income and the reinvestment of maturing principal at elevated yield spreads will also allow portfolios to recover mark-to-market losses over time. Further, amid slowing economic growth in 2008, we expect that high-grade structured product should outperform unsecured corporate debt, particularly that issued by companies exposed to more cyclical sectors. We believe that we are better positioned today than we have ever been and that our investment process was, and will continue to be, the hallmark of the firm. ■

*Written by David Thompson, CFA  
President and Co-Chief Investment Officer, and  
David Kilborn, CFA  
Co-Chief Investment Officer*

## ECONOMIC UPDATE

Nothing is certain but death, taxes, and financial crises. Periods of relative stability encourage complacency, which can lead to loose lending standards and negligible risk premiums. Some sort of an economic shock then occurs, which exposes the accumulated risks and starts a deleveraging process that can culminate in a crisis. The crisis purges the system and exposes risk management and regulatory flaws. Legislators then point fingers and demand change. While this catharsis will eventually result in a healthier system, financial crises are painful for almost everyone involved, including those who have been prudent in their actions.

We hope that the apex of our newest crisis was reached last quarter, when panic blanketed all sectors of the fixed income markets, sending bond prices to levels so divorced from fundamentals that it paralyzed rational investors with irrational fear (see Figure 1, below). Confidence is an essential ingredient in market-based financial systems; without it, capital will not flow. Indeed, it was fear that caused Bear Stearns counterparties to recall their repo lines with Bear Stearns, nearly depleting its liquid capital base of \$18 billion in just a few days and making it insolvent.

A bankruptcy, had it occurred, could have triggered systemic failure and crippled the financial system. Had that happened, economists would be talking about a depression rather than a recession. This is

why the Fed not only agreed to provide JPMorgan Chase with financing to purchase Bear Stearns, but also extended liquidity to all its primary dealers, despite the obvious risk this represents for the Fed's balance sheet. Indeed, if something goes wrong, and the Fed experiences substantial losses, the Fed risks losing its independence.

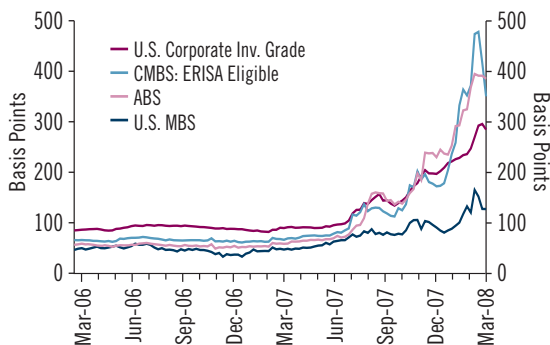
The Fed has clearly demonstrated its willingness to act as lender of last resort. Lending facilities now in place offer depository institutions and primary dealers a number of ways to improve liquidity. Depository institutions can tap the discount window, or they can participate in regular auctions that price longer-term funding. Primary dealers can now access facilities that offer daily funding at the discount rate and term funding at an auction-determined rate. A variety of collateral can be posted by both depository and primary dealers in exchange for this funding. The Fed has also initiated a series of 28-day repos with primary dealers, and it has extended swap lines with foreign central banks to provide dollar liquidity abroad. To encourage borrowing, the Fed reduced the discount rate last quarter by 225 basis points to just 2.50%. Last summer, this rate was 6.25%. These actions have appreciably reduced the level of stress, but the system is still impaired.



Jane Caron, CFA  
Chief Economic Strategist

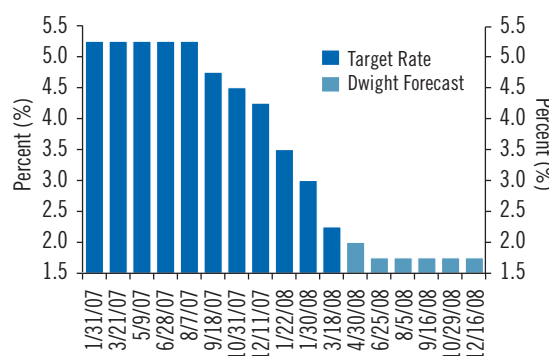
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Figure 1: Option-Adjusted Spreads



Source: Global Insight and Mortgage Bankers Association

Figure 2: Federal Funds Target Rate



Source: Global Insight

Economic Update, continued from page 3

- ▶ In addition to shoring up the financial system, the Fed has sought to stimulate the general economy by lowering the federal funds rate by 200 basis points to 2.25% (see Figure 2, previous page) The impact of this stimulus was muted, however, by financial market stress, which has widened the spread between consumer lending and Treasury rates. The Fed’s goal is to get long-term borrowing rates down, but short of outright purchases of mortgage bonds, the Fed has to do this indirectly by lowering short-term interest rates and offering liquidity facilities.

Other regulators are lending them a helping hand, though. The Office of Federal Housing Enterprise Oversight (OFHEO) lifted portfolio caps on Fannie Mae and Freddie Mac last quarter, which will allow these institutions to expand the number of agency loans they purchase or guarantee. OFHEO also reduced the capital surcharge on Fannie and Freddie from 30% above the regulatory minimum to 20%. This has also freed up capital that can be used to buy or guarantee loans. Furthermore, the Federal Housing Finance Board increased the authority of its member banks to purchase mortgage bonds. These actions have helped reduce conforming mortgage rates (see Figure 3, below), but nonconforming mortgage rates are still elevated.

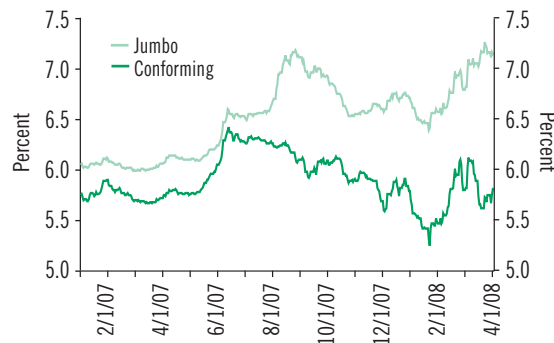
These actions come too late to stave off a recession, but they could be in time to help stabilize

the housing market. A few housing market indicators suggest that conditions are starting to improve: home sales have generally moved sideways for the last four months; the affordability index has jumped; homebuilders’ sentiment and stock prices have risen; and, when asked in surveys, consumers say that now is a good time to buy a house. If home sales stabilize, then the huge overhang of homes available for sale can be worked off at a faster clip, and we might be able to forecast the bottom in home prices with surety. Increased confidence in home-price forecasts could lead to significant improvement in the financial markets because it would help solve two key mysteries: the value of the collateral backing bonds and the cumulative size of write-downs likely to be taken by financial institutions.

The big caveat attached to this optimistic view is that we are now in a recession, and we could experience a substantial decline in payroll and income growth that would undercut housing-market improvement (see Figure 4, below). That scenario, unfortunately, bodes poorly for the financial markets because it would not only reduce clarity about collateral value but also result in still higher estimates about financial market write-downs.

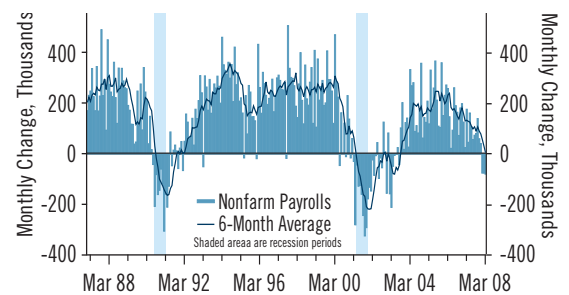
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**Figure 3: 30-Year Fixed Rate Mortgage Rates**



Source: Global Insight

**Figure 4: Nonfarm Payroll Growth**



Source: Global Insight and NBER

Fixed Income Sector Review, continued from front cover

▶ allow any large bank or primary dealer to fail. Additionally, as evidenced by recent equity capital-raising plans set forth by the likes of Lehman Brothers, Citigroup, UBS, Wachovia, Washington Mutual, and Wells Fargo (to name a few), there is ample demand for investment opportunities in financial institutions.

Over the course of the quarter, we increased our exposure to financial institutions as issuers were forced to come to market at very compelling levels. Given the Fed's actions, and market support to help recapitalize the bank and finance industry, we will continue to look for opportunities in that subsector. Within the context of an overweight to finance, we remain cautious on the corporate sector overall. As fears of absolute financial system disaster continue to abate, the market will be left with the real prospect of economic recession. We will try to avoid those names that have outright consumer exposure, as well as those industrial names that are sensitive to broad economic weakness.

## Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned 2.43% for the first quarter of 2008. On a duration-adjusted basis, MBS returned 77 basis points less than U.S. Treasuries during the quarter. MBS continued to outperform other spread sectors during the quarter, and spreads have tightened significantly from the wide levels seen in February.

MBS had drastically underperformed Treasuries heading into the last week in February. Liquidity continued to be a problem during the quarter as balance sheets remained fiercely guarded and risk appetite was nonexistent. Sponsorship for MBS was scarce, and few market participants were willing to commit significant resources to the sector.

Since the beginning of March, both domestic and overseas buyers have emerged and established a prolonged buying program in mortgages. The actions from the Fed reassured investors that the government would be very active in preventing any sort of

systemic crisis. In addition, the Office of Federal Housing Enterprise Oversight (OFHEO) eased the capital restrictions on Fannie Mae and Freddie Mac, reestablishing them as potential large buyers of MBS. Investors' appetites for risk quickly returned, and we have seen remarkable outperformance by mortgages during the latter half of March.

We began 2008 with a neutral position in MBS, and we have been moving toward a slight overweight since the beginning of March. While we believe that the supply of mortgages will remain robust in this low-rate environment, we have seen buyers emerge from all corners of the market. Volatility is still an issue for MBS, and we will continue to try to add to our position at wider spreads.

## Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) posted the worst quarterly excess returns in their history during the first quarter, as commercial banks and brokers embarked on massive loan-hedging programs and opportunistic momentum investors tagged along for the ride. The spread widening was led by the CMBX credit default swap indices, which were the primary hedging vehicles for several large institutions that had come under pressure by shareholders to offset commercial real estate loan exposure on their balance sheets.

Notwithstanding the futility of trying to hedge condo construction loans in overbuilt markets with credit default swaps on super-senior CMBS bonds backed by stabilized properties, demand for default protection in CMBX overwhelmed an already fragile market. With confidence shaken, many real money investors stepped aside to wait for conditions to stabilize. In their absence, spreads hit record wides before hedging activity finally abated and fast money shorts covered their positions.

Despite what the sector's performance may have implied about credit fundamentals, CMBS loan delin-

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*Despite what the sector's performance may have implied about credit fundamentals, CMBS loan delinquencies in the first quarter remained near their historic low of just 0.27% in January.*

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► frequencies in the first quarter remained near their historic low of just 0.27% in January, according to Fitch Ratings. While forecasts of sharp increases in delinquencies are warranted in a slowing economic environment, the current fundamentals stand in stark contrast to the price performance of the sector.

Negative net issuance in the first quarter and a very low new issue pipeline on the horizon leave the market with a very supportive supply outlook. As investors attempt to redeploy interest income and maturing principal, many will find CMBS hard to resist at current valuations. We have maintained our overweight to the sector, concentrating our holdings in the highest tiers of the credit spectrum, and we continue

to feel that super-senior AAAs and conservatively underwritten delevered seasoned bonds offer tremendous value to fixed income investors. We feel that investors in these securities will be rewarded by outsized spread income and also by eventual spread tightening as market conditions normalize and liquidity constraints begin to ease.

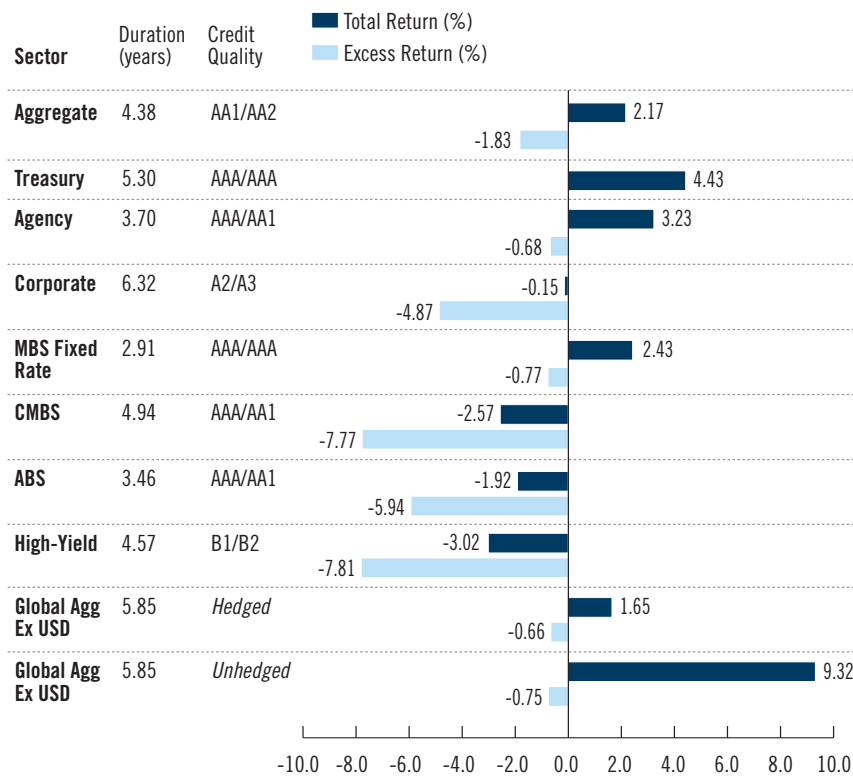
### Asset-Backed Securities

The first quarter of 2008 wasn't all that different from the final quarter of 2007 for asset-backed securities (ABS). ABS underperformed duration-matched Treasuries by 594 basis points, with home equities (HELs) being the largest contributor to negative performance. HELs were down a stunning 1682 basis points, as investors shunned everything mortgage related without regard for collateral, tranche, coupon, or structural protections. As a result of the HEL component, the ABS index also posted a negative 1.92% total rate of return.

Themes were largely unchanged as the market still needs to work its way through of a number of issues before asset prices recover. The economic picture is precarious, with home values falling and consumer confidence waning. The funding mechanism for the student loan market is broken; municipalities are facing higher borrowing costs; there continues to be plenty of headline risk associated with the rating agencies and the monoline bond insurers. Banks and brokers have also had to retain hundreds of billions of dollars worth of hung loans, SIV collateral, and CDOs on their balance sheets, which has vastly reduced their capital.

Despite the mark-to-market underperformance over the last few quarters, we continue to believe that ABS collateral will outperform in the long run. We will maintain our overweight to the highest-quality home equity and equipment lease-backed paper, but we do expect that spreads will remain volatile. We also intend to opportunistically reduce

Figure 5: First Quarter 2008 Sector Statistics\*



\*Source: Lehman Brothers Global Family of Indices. Excess returns represent returns over duration-matched Treasuries. Credit quality represents market-weighted average credit quality for the indicated sector expressed in Moody's nomenclature. The Lehman Brothers U.S. High Yield Index and Global Agg Ex USD are not components of the investment-grade U.S. Aggregate Index.

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our underweight to short high-quality credit cards, autos, and rate reduction bonds.

### High-Yield

The liquidity boom of 2007 has turned into the liquidity bust of 2008. There is a significant supply-demand imbalance, not because of an abundance of supply but rather a dearth of demand.

The high-yield market had remarkably poor performance, with a total return of -3.02% providing -7.81% of excess return. Performance actually did improve throughout the quarter, with March being far less negative than the previous two months.

Spreads widened out to almost 800 basis points. While not approaching all-time wides, spreads are certainly the widest we have seen along with a default rate of less than 1.5%. While this rate is expected to increase throughout the year, most market participants believe it will end the year below 5%. Early in the quarter we did start to see the tangible impact of the credit crunch as companies that would have easily refinanced in 2007 were forced into bankruptcy. We have also seen companies having difficulties exiting bankruptcy because of the lack of exit financing. These factors may contribute to a higher than expected default rate.

New issuance was off over 80% in Q1, with only 11 deals aggregating less than \$3.5 billion. Only two deals came in January, followed by only five in February. The overhang of approximately \$150 billion of unsold LBO debt has effectively frozen the market. Issuers who are constrained by their balance sheets are eager to move this paper, but there is no interest on the part of the buy-side to take the paper down. The CLO market, which had accounted for 70% of loan demand, has dried up entirely. There are buyers of lower tranches, but the dislocations in triple-A markets have made senior financing unavailable. Banks are now looking to new structures to alleviate the backlog, which could free up their balance sheets for new deals.

In spite of the poor Q1 performance and significant

spread widening, downside risks currently outweigh upside potential for most high-yield debt issues. Clearly a significant liquidity premium has been priced into the market, along with expectations of an increasing default rate. It is unclear to what extent a more significant economic slowdown is being priced into the market. In addition, the supply overhang remains a significant risk to the market. Therefore, we intend to maintain our bias toward high-quality credits, and we will remain highly selective with new high-yield purchases. If it appears that the downturn is less protracted than our current view, and the technical overhang is removed, the high-yield market may generate positive excess returns in the second half.

### Municipal Bonds

We end the first quarter of 2008 with municipal bonds trading at historically low prices. Overall, municipals underperformed with the Lehman Brothers Municipal Bond Index having a total return of -0.61% for the quarter compared with +4.43% for the Lehman Brothers U.S. Treasury Index. Prices,

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### Dwight Sector Specialists

The Sector Update was written by the following sector specialists:



John Bisset, CFA  
Corporates



Josh Kruk, CPA, CFA  
Mortgage-Backed Securities



Derrick Wulf, CFA  
Commercial Mortgage-Backed Securities



Peter Milne  
Asset-Backed Securities



Edward Meigs, CFA  
High-Yield



Keith McCarthy  
Municipal Bonds



Peter Vutz  
International, Non-Dollar

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▶ however, were very volatile in the quarter, with a dramatic sell-off in February, when arbitrageurs faced with margin calls were forced to sell into a thin market as their LIBOR-based hedges rallied. In March, municipals snapped back and outperformed Treasuries by 217 basis points.

Interestingly, the underperformance in January and February occurred in the context of a very weak primary market environment. For those two months, issuance declined 35% compared to the same period in 2007. Volumes improved in March as some issuers started to refinance their failed auction rate securities, although volume for March was still down 12% compared to March 2007. Overall, new issue volume for the quarter totaled approximately \$80 billion, down 25% from a year ago.

With the dramatic moves in interest rates in the first quarter, the municipal curve continued to steepen with the 2s/30s AAA spread widening to 267 basis points.

The seemingly endless market contagion continued in the first quarter of 2008. Major issues with subprime, monoline insurance, rating agencies, auction rate securities, and the decline in state revenues led to a major steepening in the tax-exempt yield curve and severe market dislocation. These extreme conditions have led to abundant opportunities in the municipal space and offer investors attractive yields relative to Treasuries.

We believe the Federal Reserve will continue to reduce the federal funds rate through 2008, providing a supportive backdrop for the municipal bond market. At current valuations, we consider municipal bonds a wonderful investment opportunity for the right investors.

### Global Bonds

The Lehman Brothers Global Aggregate Index Ex U.S. dollar returned 9.32% (total return) in the first quarter of 2008 on an unhedged basis versus the U.S. dollar. The same index returned 1.65% (total return) on a hedged basis.

The global bond markets continue to suffer from a severe hangover triggered by a combination of elevated inflation numbers around the globe, the continued delevering of the financial markets, and a lack of risk appetite by market participants, as fallout from the subprime crisis in the United States weighed heavily on financial markets around the world.

Conditions within the interbank lending markets continue to be challenging as well. Three- and six-month LIBOR rates in Euro point to an unwillingness of depository institutions to lend to each other. Repeated liquidity injections by the European Central Bank proved to be only short-term solutions that were not able to notably improve the liquidity crunch within the interbank market.

The dealer community continued to offer liquidity only sparingly and reluctantly, which led to a widening of bid/offer spreads in almost all markets, with the notable exception of the U.S. Treasury market and the Bund (German Government Bond) market. Liquidity and spreads of European peripheral markets versus the German market fluctuated wildly during the quarter. The lack of a functioning futures market (with the exception of the German one) and hence the absence of an ability to appropriately hedge risk positions contributed to this volatility.

The European economies within the Euro zone experienced a tale of two worlds. A select few northern European economies (most notably Germany and France) managed to show an amazing resilience in economic activity, employment growth, and business confidence, despite the deterioration of the U.S. economic environment and the additional burden of the continued strength of the Euro versus the U.S. dollar. The story is a much different one in Ireland and in most of the southern European countries like Portugal, Italy, Spain, and Greece. Those countries (“ex” Euro zone-g geared exporters) suffer greatly from the historic appreciation of the Euro.

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▶ Chairman Bernanke, in a recent appearance before the Joint Economic Committee, danced around a question on whether the economy is in a recession. He admitted that economic growth might contract in the first half of 2008, but he expects economic growth to strengthen in the second half of the year and to grow “at or a little above its sustainable pace in 2009.” We think that the Fed is too optimistic. We believe that economic growth, after contracting in the first half of the year, will enjoy a policy-induced rebound in the second half that fizzles into a sluggish growth rate persisting well into 2009. On the bright side, this period of anemic growth should keep inflation under control.

Our view is more pessimistic than the consensus forecast because we are concerned that real consumption growth will expand at a slow pace for an extended period of time, and that this will keep investment spending in check. We think consumers are on the verge of reducing their propensity to spend as they focus on paying down debt and rebuilding savings accounts (see Figure 6, below). We are also concerned that weak U.S. growth, surging commodities prices, and the credit crunch will weigh heavily on world output and will slow export growth. Two events that could improve our outlook would be a sharp reduction in commodities prices and an end to the credit crunch. Even under those conditions, our revised forecast would probably still

be lower than the Fed’s. For this reason, we think the Fed will continue to ease monetary policy in future meetings, lowering the funds rate to 1.75% or possibly lower.

For investors, it has been a very rough period, as exhibited by Figure 1, but the markets are now discounting a very dire outlook. Some would argue that the markets have priced in the end of the world. Investors with capital and a long-term horizon can selectively take advantage of bargain-basement prices with the knowledge that the basement will, at times, feel like a dungeon. ■

*Written by Jane Caron, CFA  
Chief Economic Strategist*

**Dwight Asset Management Company**  
**Total Assets as of 3/31/08:**  
**\$71.7 Billion**

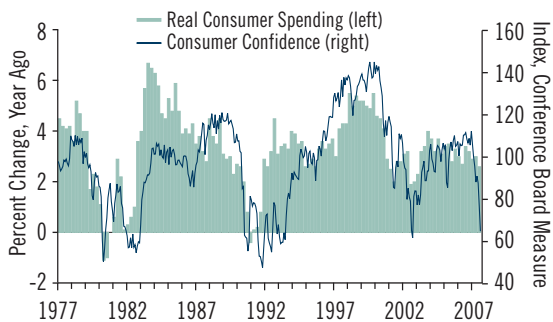
**Assets by Product Strategy (\$ Billions)**

Stable Value	47.8 <sup>1</sup>
Fixed Income	35.8 <sup>2</sup>
Insurance	19.1 <sup>3</sup>

1. Includes assets also included in the fixed income total managed for stable value clients.  
2. Includes assets also included in the stable value and insurance totals.  
3. Includes assets also included in the fixed income total.  
Please Note: Stable value separate account and commingled fund data is as of 2/29/08.

This Quarterly Update is prepared for general informational purposes only, without respect to the investment objectives, financial profile, or risk tolerance of any specific person or entity who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any investment strategy or security discussed or recommended in this update and should understand that statements regarding future performance may not be realized. Investors should note that income, if any, from any investment strategy or security may fluctuate and that underlying principal values may rise or fall. Past performance is not necessarily a guide to future performance.

**Figure 6: Consumer Spending Versus Confidence**



Source: Global Insight and NBER

Fixed Income Sector Review, continued from page 8

- ▶ In addition, the property markets of Ireland and Spain show signs of weakness, which rivals the declines of the U.S. housing market.

Persistently high headline inflation numbers (Euro CPI + 3.3% — the highest reading in 15 years) within the Euro zone are cause for further concern within the European Central Bank. Wage deals in the German steel industry, and in particular the one covering the German public-sector employees, clearly exceed what is tolerable for the ECB. The fear that these excessive wage increases (an average of 8% over the two-year life of the contract) will be passed on to the consumer and will create a secondary inflation push might not be unfounded.

We do not believe in the thesis of a decoupling of global economic activities, and for that reason we maintain that despite the justifiable hawkish rhetoric of the ECB, the general weakening of the global economic environment will cause the Central Bank to shift gears during the later half of the second quarter or early third quarter and cut its key lending rates. Stubbornly high inflation rates might delay a monetary easing, but will not eliminate the eventual need for it. Within this framework, we believe that steepening trades in the Euro zone offer an excellent investment opportunity.

Meanwhile, the U.K. is experiencing continued fallout from a deteriorating housing market and from secondary effects from the near collapse of Northern Rock. U.K. banks continue to hoard liquidity, keeping LIBOR rates at unsustainable high levels. The U.K. Main Street banks tightened consumer access to loans and raised mortgage rates due to liquidity and capital issues, even as the Bank of England attempts to carefully ease its monetary policy. We expect the Bank of England to pursue its high-wire act, trying to pick the right medicine for a contracting economy while facing unacceptably high headline inflation. The BOE faces the unpleasant prospect of falling further behind the curve in its attempt to reanimate the domestic economy. Hence we continue to like U.K. bonds on a fully hedged basis.

On the other side of the globe, the Reserve Bank of Australia decided to march to its own drum in the first quarter. The RBA raised rates twice (25 basis points each in February and March) to a level of 7.25%. The interest rate increases came in the face of strong inflation pressure and a tight labor market coupled with high capacity-utilization figures. By the end of the first quarter the RBA conceded that it had done enough (or maybe too much?), so it left rates unchanged. The RBA effectively removed the tightening bias from its policy statement. During the past couple of months we have witnessed a deterioration of the Australian real estate market, and the strain on the consumer has become a prevalent problem. The market might be a little bit ahead of itself in interpreting the RBA's change in bias as a capitulation and a signal of an imminent reversal of its monetary policy. We do not foresee an easing of the RBA's monetary policy in the near future unless there is a further dramatic deterioration in the domestic and global economic environment. The front end of the Australian market (in particular Eurobonds and issues of the NSWTC and QTC) looks attractive on a currency-hedged basis.

In Japan, sentiment indicators point toward a weakening of the Japanese economy. The market is beginning to discuss the merits of a potential easing by the Bank of Japan in the second half of the year. We must ask what impact a rate cut could have when the Bank of Japan's lending rate is only 0.5% to begin with.

The U.S. dollar started the New Year where it left off in 2007: it weakened versus other major currencies (minus 7% versus the Euro). We continue to believe that a further deterioration of the global economic climate, combined with a cycle of interest rate cuts by the European Central Bank and the Bank of England, might signal a partial correction of the strong appreciation of those currencies

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*We expect the  
Bank of England  
to pursue its  
high-wire act,  
trying to pick  
the right medicine  
for a contracting  
economy while  
facing unaccept-  
ably high headline  
inflation.*

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**For more information:**

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▶ versus the “Greenback.” While we like most non-dollar markets, we advocate a hedge of those exposures, most notably GBP, Euro, and AUD versus the U.S. dollar. ■

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