

# ECONOMIC & BOND MARKET QUARTERLY UPDATE

SECOND QUARTER 2006

## INVESTORS PROCEED WITH CAUTION AS UNCERTAINTY GROWS

During the second quarter, uncertainty about the path of U.S. monetary policy, global economic trends, housing markets, and inflation weighed heavily on the minds of market participants. This uncertainty led to increased price volatility and risk premiums across asset classes.

Data released in April and May gave some investors the impression that the economy was beginning to slow and that the Fed would pause or end its tightening policy soon. In response, the dollar lost more than 6% of its value versus other major currencies on a trade-weighted basis. However, concerns about a near-term rise in inflation compelled others to argue that the Fed had more work to do. Treasury yields rose higher, and the yield curve steepened in response. On May 10, the Fed raised rates 25 basis points, to 5%, and it indicated that future rate decisions would be increasingly data dependent.

The lack of clarity about what was to come persuaded many global market participants to reduce their overall exposure to

risk, because to investors, uncertainty is the synonym for risk. Simultaneously, investors began to worry about the lagging effects of 400 basis points worth of cumulative rate hikes, coupled with continued high energy and commodity prices. In mid-May, speculative and high-risk investments, ranging from precious metals to Asian and Latin American

equities, began a rapid downward slide, resulting in a sharp, broad-based market correction.

The risk-reduction trade, as it has come to be called, sent the VIX Index, a widely used measure of stock market volatility, to a three-year high in June. The rapid declines in asset valuations, coupled with a spike in volatility, soon led to fears about



Derrick Wulf, CFA  
Sector Portfolio Manager

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## VOLATILITY INCREASES IN THE SECOND QUARTER

### Fixed Income Sector Review

#### Corporates

Higher interest rates and wider spreads led to negative returns in the corporate bond market during the second quarter, with the corporate component of the Lehman Aggregate Index posting a total return of -0.39% during the period. Corporates underperformed duration-matched Treasuries by 17 basis points as spreads widened by 7 basis points during the quarter. Corporates started off on a strong note in April, tightening by 3 basis points that month, as four straight months of positive excess returns finally forced many short sellers to capitulate and cover their positions. This occurred just in time for a 10 basis point sell-off in May and June that followed a widespread risk-reduction trade, most visible in the equity markets. Uncertainty about the Fed and inflationary pressures caused equity volatility not seen since early 2003, when spreads were significantly wider.

Additionally, event risk returned to the market, with the most notable event being the \$13 billion management-led LBO of a high-beta market favorite, Kinder Morgan. Despite the company's stellar operating performance and already cheap trading levels, the bonds widened by over 100 basis points on the announcement. Another broadly held issuer, Tribune, announced a buyback of 25% of its stock in a leveraged recapitalization. Event risk in the form of mergers and acquisitions

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Investors Proceed With Caution as Uncertainty Grows, continued from front cover

*Many asset prices neither reflect the numerous uncertainties that persist nor adequately compensate investors for assuming such risk.*

► the potential compounding effects of the high degree of leverage built into the financial system. Skittish investors feared that market conditions would deteriorate further.

However, on balance, June data was notably improved from earlier in the quarter, indicating that the Fed would pursue at least one more rate hike and that the economy was weathering the higher interest rates and commodity prices relatively well. Overseas equity markets and commodity prices consolidated and even recovered some of their losses; however, credit spreads did not recover. It seemed that the volatility in other markets provided a jolt to bond traders, reminding them that markets can be unkind, and that recently tight spreads just aren't justified amid the uncertainty.




The Fed raised rates again on June 29, and many forecasters interpreted the accompanying statement to mean that the Fed would soon find reason to pause. Treasuries, as beneficiaries of the selling that had occurred in riskier markets in May, quickly resumed their sell-off as inflation concerns reemerged. The 10-year note hit a four-year high, the 2-year note hit a five-and-a-half-year high, and the curve flattened once again. Spreads in most sectors of the bond markets ended the quarter wider, with much of the spread widening occurring in the corporate bond market. The average option-adjusted spread widened by 5 basis points according to the Lehman Aggregate Index.

As we head into the second half of 2006, valuations of many fixed income securities are priced more attractively than they have been in many months. Despite this recent weakness, however, spreads remain tight relative to their historical averages in this stage of the economic cycle. Many asset prices neither reflect the numerous uncertainties that persist nor adequately compensate investors for assuming such risk. We remain positioned cautiously, with the opinion that the market may reveal some unwanted surprises. ■

*Written by Derrick Wulf, CFA  
Sector Portfolio Manager*

**Dwight Asset Management Company  
Total Assets as of 6/30/06:  
\$56.1 Billion**

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

Stable Value		33.9 <sup>1</sup>
Fixed Income		22.7 <sup>2</sup>
Insurance		18.5 <sup>3</sup>

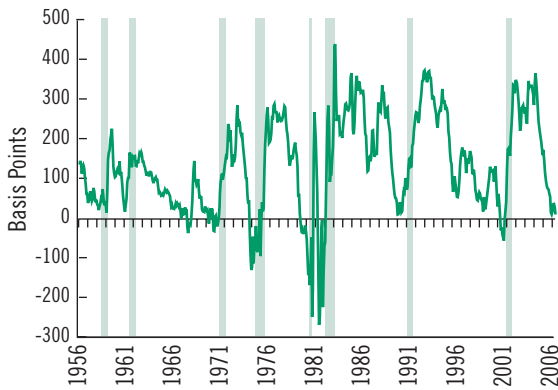
1. Includes assets also included in the fixed income total managed for stable value clients.  
2. Includes assets also included in the stable value and insurance totals.  
3. Includes assets also included in the fixed income total.  
Please Note: Stable value separate account and commingled fund data is as of 5/31/06.

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.

## ECONOMIC UPDATE

The Federal Reserve kept investors on tenterhooks during the second quarter, failing to either pause in policy tightening or give a signal that a pause is near. This has been disconcerting to a number of investors who believe that the Fed is now in danger of tightening too much and of forcing

**Figure 1: Treasury Yield Spread—3-Mo. Bill to 10-Year Note**  
The Yield Curve Typically Becomes Flat/Inverts Prior to Recessions (Shaded areas represent recession periods.)



Source: Global Insight and NBER

the economy into a downturn or even a recession. At the same time, inflation data have been elevated, which makes it appear even more likely that the Fed will err on the side of overtightening. Investor concerns along these lines caused the yield curve to flatten during the second half of the quarter. By June, the curve was inverted, a classic leading indicator that the economy is poised to slow.

While we cannot rule out an economic downturn accompanied by monetary-policy easing in 2007, we have yet to gather enough evidence to forecast one. Instead, we expect GDP growth to average 3% in 2007, following 3.5% growth in 2006. Our optimism is based on the fact that monetary policy is not yet truly restrictive. Credit is still widely available at banks and other financial institutions. Indeed, the competition for lending has kept the cost of borrowing fairly low. Moreover, corporations are generally in excellent financial shape and should continue to bolster economic growth through

increased investment spending and hiring. While it is likely that consumption growth and residential investment will slow, we do not expect either sector to collapse and disrupt the positive tone in the corporate sector.

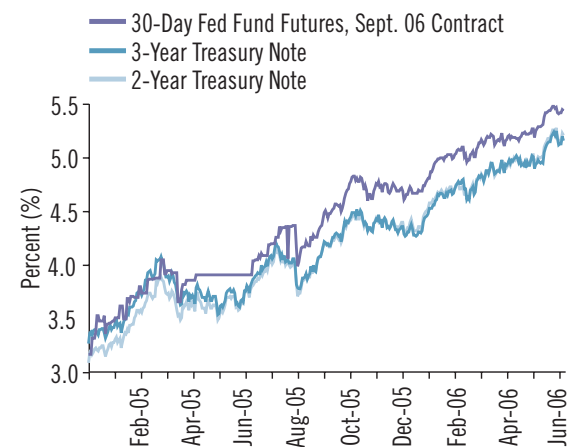
Risks to our positive scenario come in two main forms: (1) the Federal Reserve could make a policy mistake; or (2) an exogenous shock could disrupt the growth cycle through problems such as an energy-price spike or a geopolitical crisis. The good news is that the Federal Reserve can quickly inject a fair amount of liquidity into the system if needed. We expect the Federal Reserve to raise the fed funds rate another 25 basis points to 5.5% and then pause for a period of time. The length of this period depends on the growth and inflation outlook over the next few years. The data indicate that inflation pressure is likely to remain elevated for the next six months but should start to subside in 2007 as economic growth remains moderate. If so, the peak funds rate should be no higher than 5.75%.

A significant problem facing forecasters is that there has been quite a bit of turnover on the Federal Open Market Committee, which is also under new leadership. Thus it is hard to prejudge how this FOMC will react to incoming data. We believe that the Bernanke Fed will function as did the Greenspan Fed; that is, it will stop tightening once it perceives that medium-term inflation risks are under control. This is why we have not raised our funds rate forecast to 6% or higher, as have a number of Wall Street economists. We believe that inflation will remain under control



Jane Caron, CFA  
Chief Economic Strategist

**Figure 2: Short Treasury Notes & Fed Funds Futures**  
Investors Starting to Anticipate a 5.50% Funds Rate in August



Source: Global Insight

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Fixed Income Sector Review, continued from front cover

▶ also impacted the market, as strategic buyers like Anadarko and Phelps Dodge announced purchases of smaller industry players at significant market premiums. While these mergers have not resulted in major ratings downgrades, they are likely to result in increased leverage.

We further reduced our exposure to corporates at the end of April, and we expect to remain underweight the sector. Our goal is to avoid those names most prone to event risk. We will look to add exposure when spreads widen and/or market conditions improve. Meanwhile, we will continue to seek bonds that provide superior carry and price-performance potential.

### Mortgage-Backed Securities

After a strong first quarter, mortgage-backed securities (MBS) struggled to find their footing over the

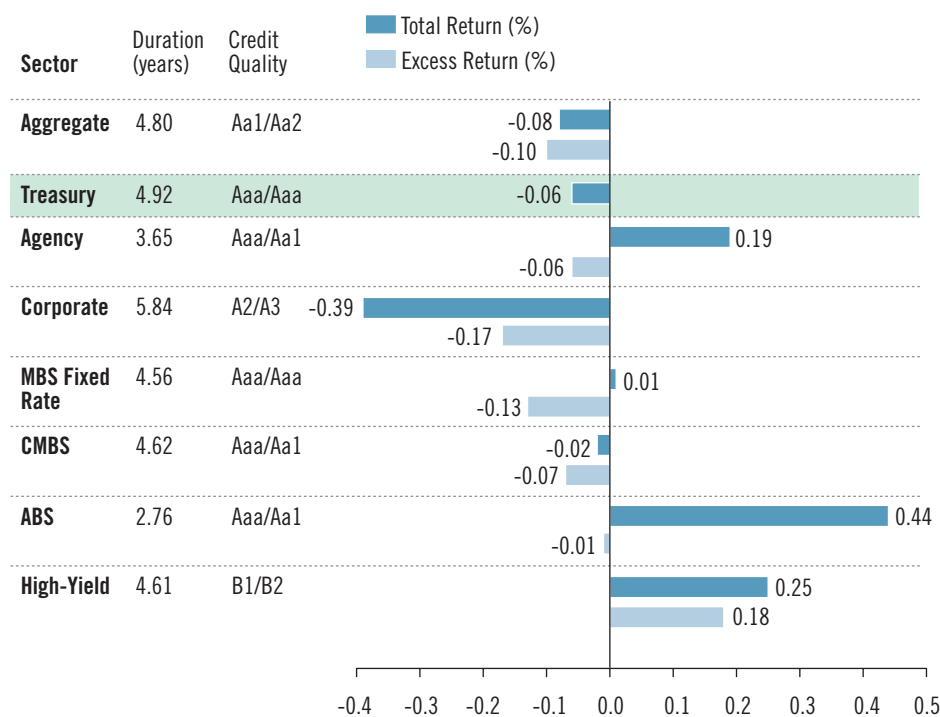
last three months. Several factors kept MBS spreads under pressure. Among these were decreased purchases by overseas investors concerned about a weaker U.S. dollar and also by domestic banks, which continued to face margin pressure brought on by the flat yield curve. On the macro front, investors grappled with a less predictable monetary policy, as the Fed is perceived to be approaching the end of its tightening cycle. Emerging market woes, stock market volatility, and concerns surrounding the domestic housing market also contributed to a general increase in investor unease. The increased volatility led to a rise in the prepayment-extension risk premium in MBS, which caused option-adjusted spreads to widen. By late June, the sector had underperformed duration-matched Treasuries by 13 basis points.

We enter the third quarter with a neutral allocation to MBS versus the benchmark indices. We believe that MBS spreads have become relatively attractive compared to other investment-grade alternatives, but we would prefer to see evidence of returning demand from foreign buyers, and we would like more clarity from the Fed on monetary policy before we add to our position.

### Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) handily outperformed both residential mortgage-backed securities and corporate bonds during the second quarter, but wider swap spreads pushed overall spreads on CMBS wider, leading to negative excess returns versus Treasuries. While concerns about the quality of newly originated loans persisted, fundamentals for the asset class remained strong. A low rate of loan delinquencies and declining vacancy rates in many commercial real estate markets left investors comfortable with the near-term prospects for collateral perfor-

Figure 3: Second Quarter 2006 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.

► mance. Meanwhile, volatility in competing sectors of the fixed income markets—corporate bonds in particular—continued to reinforce the value of senior CMBS tranches as a safe alternative to riskier asset classes.

We like the sector’s overall risk-return profile and continue to believe that it represents good value when compared to many other parts of the high-grade fixed income universe. Therefore, we expect to maintain a significant overweight to the sector. Within our overweight, however, we will continue to favor the senior levels of the capital structure, as we feel that spreads on lower-rated classes do not sufficiently compensate investors for the incremental assumption of risk.

### Asset-Backed Securities

Asset-backed securities (ABS) outperformed all other major spread sectors in the Lehman Aggregate Index during the second quarter. Spreads across all major ABS subsectors were flat or tighter relative to swaps, as overwhelming technicals continued to win the tug-of-war over weaker fundamentals. Wider swap spreads, however, caused overall spreads to drift wider, resulting in one basis point of negative excess returns for the period.

Risks associated with the ABS market have not changed much since the beginning of the year. Spreads in home-equity loan-backed securities remain tight, even as inventories of unsold homes have risen, the rate of home-price appreciation has slowed, and loan performance on recent deals has deteriorated. The consumer, however, remains on relatively solid footing, with the unemployment rate holding well below 5% and consumer confidence intact. There is also plenty of cash on the sidelines and a widespread perception that lower supply in the second half of 2006 will keep spreads firm.

For the second half of the year, our outlook remains largely unchanged. We will continue to overweight the sector, emphasizing high-quality triple-A-rated home equities and equipment lease-backed securities. We will also maintain our underweight to autos,

credit cards, utilities, and manufactured housing.

### Agencies

Spreads on agency debentures widened alongside other spread product during the second quarter, resulting in negative 6 basis points of excess returns for the period. Much of the widening in the sector can be attributed to the same broad market pressures that weighed on other sectors of the fixed income markets, but agencies were not without their own doses of bad news. In the latest chapter of Fannie Mae’s accounting woes, the OFHEO and the SEC fined the company \$400 million in May for manipulating earnings in order to meet targets and trigger executive bonuses. Similar action against Freddie Mac is said to be possible as well. While Fannie Mae plans to reform its accounting procedures and controls, investor confidence has suffered. Spreads on 10-year Fannie Mae debentures widened from 35 to 41 basis points over Treasuries in the second quarter.

Technical factors for agency debt remained positive, however, as constraints on the companies’ portfolio growth has limited the amount of new debt

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### Dwight Sector Specialists

The Sector Update was written by the following sector specialists:



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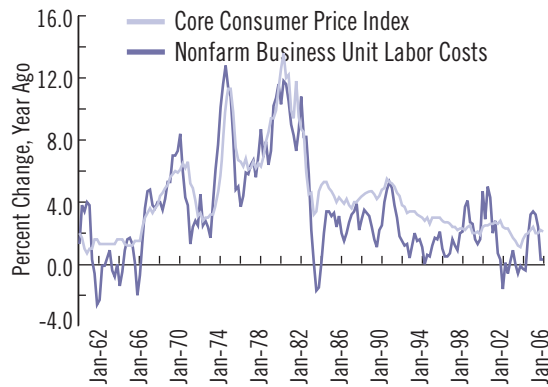
Edward Meigs, CFA  
*High-Yield*

*...if the Bernanke Fed pauses soon, investors will be torn about whether or not they are making good decisions.*

Economic Update, continued from page 3

- ▶ because of low unit-labor costs, contained inflation expectations, and moderate economic growth.

**Figure 4: Unit Labor Costs & Consumer Price Index**  
Barring a Spike in ULC, Inflation Should Remain Under Control



Source: Global Insight

The difficulty for the Bernanke Fed is that it has advertised a 1-to-2% comfort zone for the core

personal consumer expenditure price index, implying that more aggressive action will be taken when inflation exceeds this comfort zone. Our forecast is that the core PCE price index will end 2006 near 2.5%, but moderating inflation pressure should place it back into the comfort zone by the end of 2007. Therefore, if the Bernanke Fed pauses soon, investors will be torn about whether or not they are making good decisions.

While our forecast of sustained GDP growth and contained inflation generally bodes well for investors, there will likely be a fairly high level of uncertainty about the economy, inflation, and monetary policy for the next few quarters. This uncertainty should result in increased volatility and a higher risk premium. Indeed, it is well known that investors do not like uncertainty, which should make for interesting times (and opportunities) in the markets during the coming quarters. ■

*Written by Jane Caron, CFA  
Chief Economic Strategist*

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- ▶ brought to market. Meanwhile, overseas demand for agency debt has remained strong, and some domestic investors have been overweighting agencies versus corporates to reduce their exposure to credit risk. Without these two sources of demand, spread widening could have been much more severe. In light of the sector's continued troubles, and considering what we believe to be much better risk-return profiles in other sectors, we remain significantly underweight agencies and expect to maintain that position for the foreseeable future.

### High-Yield

The high-yield market outperformed both the Lehman Aggregate Index and duration-matched

Treasuries during the second quarter. Performance declined throughout the quarter, however, with a strong April followed by a flat May and a negative June. Lower-credit tiers underperformed, as the market became more risk averse in the face of rising volatility.

Technical factors placed further pressure on the market as new issuance went from \$8 billion in May to over \$14 billion in June, more than \$10 billion of which was in the last two weeks of the month. Meanwhile, high-yield mutual funds experienced net withdrawals, with over \$2 billion in outflows during the quarter.

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▶ Following a strong first quarter, performance for the second quarter was in line with our expectations for 2006. While we might see periods of strength, this late stage of the credit cycle creates an environment in which downside risks begin to outweigh upside potential for high-yield debt. Risks include increased Treasury and equity volatility, growing

default rates, and a deceleration in economic growth. We continue to believe that certain issues offer value, but we intend to maintain our bias toward high-quality credits and remain highly selective with new purchases. ■

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