

## U.S. Fixed Income

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### Bond Market Review

The Lehman Aggregate Index, a measure of the overall domestic bond market, generated a total rate of return of 3.00% for the fourth quarter and 6.97% for the year. The Lehman Government Corporate Intermediate Index generated a total rate of return of 2.90% for the fourth quarter and 7.39% for the year. Spread sectors in the Lehman Aggregate Index significantly underperformed risk free treasuries during the quarter and for the full year. The repricing of risk began as early as February when the Chinese stock market took a major tumble and investors got their first whiff of a subprime mortgage meltdown. There was a lull for a couple of months but in late July the CEO of Countrywide Financial, a major player in the mortgage lending market, acknowledged that defaults on second mortgages to prime borrowers were rising quickly. His statement triggered a “flight to quality” rally in the U.S. Treasury market. A severe liquidity squeeze ensued due to heightened uncertainty and lack of trust between borrowers and lenders as no one could quantify the magnitude of the subprime problem and no one was sure who held the toxic subprime mortgage-related debt. The most notable squeeze occurred in the asset backed commercial paper market particularly the structured investment vehicles (SIVs) that issued commercial paper to invest in high yield mortgage structures.

Another shock wave hit the market in November when major banks and brokerage firms announced unexpectedly huge write-downs and significant hits to capital associated with the subprime mess. This raised the fear factor another notch and risk aversion returned to the

capital markets with a vengeance. There were brief periods when two and five year swap spreads traded over 100 basis points. According to Lehman, for the first time ever, every spread sector simultaneously underperformed treasuries. No sector went unscathed.

Although the asset backed sector was the worst performing sector for the quarter and for the year, it is the smallest sector with an index weighting of just less than 1.0%. The sector’s underperformance in the fourth quarter was concentrated in home equity, credit card and auto paper. Delinquency rates began to edge higher with further deterioration possible as banks continued to tighten lending standards. The portfolio had some exposure to credit card paper but the majority of the asset backed holdings are comprised of utility rate reduction bonds which were additive to the portfolio’s overall performance.

The corporate sector with a weighting of approximately 19% of the Aggregate was the next worst performing sector. On an excess return basis, the sector returned 1.22% in 2006 as compared to -4.97% last year, a 619 basis point reversal and the worse performance since 2000. The end of the bull market in corporate bonds had its genesis in February when HSBC announced that its problems on second lien and adjustable rate mortgages were even greater than anticipated. This caused increasing concern in a market that had already identified cracks in the subprime market and slowing home price appreciation. A slow leak in credit spreads developed and by mid-August the Lehman Corporate Bond Index had widened 35 basis points on an option adjusted spread basis to 117 from 85 basis points where it began the year. The rate of deterioration worsened as the credit crisis moved through virtually all sectors in the debt

market. Compounding the problem was the leveraged unwind that occurred in the credit derivatives and structured products markets. As a result the Corporate Bond Index ended the year with an option adjusted spread of 181 basis points. The finance component of the Index, and its sub-sectors, was the hardest hit of the corporate bond market, particularly among banks where asset write-downs eroded capital levels and led to ratings downgrades. We believe that risk remains in 2008 from a continuation of the subprime mess. However, this has created some attractive opportunities among the larger, relatively well-capitalized credits in this sector. Away from the finance sector our view of the attractiveness of corporate bonds in general is tempered by the possibility of a mild recession early in 2008. Currently we are inclined to purchase fundamentally sound industrials with some international exposure that could incur spread widening should the probability of a recession increase. Finally, we anticipate increasing our corporate bond exposures toward relevant index weightings from their current underweight positions.

The commercial mortgage backed (CMBS) sector was the next worst performing sector and is approximately 6% of the Aggregate. Much of the underperformance reflects the rout in the structured product market and the broader deterioration in the credit markets. Near term we do not anticipate adding to this sector. However, the holdings in the portfolio are rated AAA with a weighted loan to value ratio of about 59% and we expect the high quality seasoned holdings will be additive in the coming year as swap spreads are expected to narrow.

The mortgage sector has the largest weighting in the Aggregate and is approximately 39% including fixed rate and adjustable rate mortgages. This sector's underperformance is

obvious as the subprime mortgage related debt problems cast a shadow over the agency mortgage market. The concerns for the sector going forward are declining interest rates if recession fears continue and soft demand by banks and the agencies. However, tighter swap spreads would be positive for mortgage performance in 2008. We expect to remain slightly overweighted in this sector.

The agency sector was the best performing sector on a relative basis and is about 11% of the Aggregate. Credit concerns about Freddie Mac and Fannie Mae gripped the market in the fourth quarter amid disappointing earnings and the need to raise capital. The agencies have not been immune to the deterioration in credit quality stemming from the housing recession. Both agencies have reported an increase in the number of prime mortgages that are seriously delinquent in the third quarter. To shore up their balance sheets both agencies have issued preferred stock and cut their dividends. Moreover, they have announced a number of policy changes in an effort to trim potential credit losses. Of all the sectors, we are the most positive as swap spreads are expected to further narrow. We remain overweighted in this sector and expect to reinvest call proceeds in callable structure with longer lock outs.

## Economic and Interest Rate Outlook

Despite the meltdown in housing, soaring energy prices and tightening credit standards imposed by banks during the second half of the year, the U. S. economy continued to expand at a solid pace in 2007. Offsetting the sizeable declines in residential investment was solid spending by the consumer and a narrowing of the trade deficit due to the combination of a weaker dollar and strong global growth. However, some of the recent economic data for the fourth quarter has been weaker than expected, signaling that the housing slump may finally be spilling into the broader economy. The shocker was the December employment data. The unemployment rate surged to 5.0% from 4.7% while the economy added an anemic 18,000 jobs. In addition, the December ISM index that measures manufacturing activity dropped to 47.7 with 50 the dividing line between contraction and expansion. Moreover, the new export order component plunged in December and considering that exports have been an important support for the economy, the drop was far from comforting. Consequently, for the fourth quarter we anticipate a significant slow down in the pace of growth in the economy compared to the 4.9% reported for third quarter real GDP. For 2008 we expect housing will continue to be a drag on economic growth as the sector continues to seek equilibrium between supply and demand through a combination of declining home prices and lower mortgage rates. A key driver to watch will be the trend in employment. Although there has been deterioration in job growth, this will more likely lead to several quarters of weak growth, below 2%, but not a recession. We expect some retrenchment in consumer spending given the

slowdown in job gains, continued weakness in house prices and high energy prices. Importantly, should employment growth turn negative and the economy experience several more months of very weak economic data, the economy could be flirting with a recession.

In 2007 the Federal Reserve responded to the subprime turmoil and the subsequent liquidity freeze by lowering the fed funds rate three times from 5.25% in September to 4.25% by year end. Although the Fed has warned that inflation remains a problem, there is no evidence that a wage price cycle is developing. Moreover, with economic growth slowing, inflationary pressures should ease in the months ahead. This should give the Fed some elbow room to lower the fed funds rate at its January 30 meeting. The market is pricing in several rate cuts with the possibility of a 2.5%-3.0% fed funds rate over the next twelve months. We expect recession worries will remain the driving force for interest rates for at least the first half of the year.

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