

**March 20, 2008**

### MARKET LEVELS

	Friday*	Last week	Dec. 31, 2007	One year ago
Dow Jones Industrial Avg	12,195	12,146	13,265	12,448
S&P 500	1,308	1,315	1,468	1,435
NASDAQ	2,223	2,264	2,652	2,456
Russell 2000	671	680	766	807
DJ STOXX Europe 600 (€)	297	307	365	369
Nikkei Index (¥)	12,260	12,433	15,308	17,163
Fed Funds Target	2.25%	3.00%	4.25%	5.25%
2-Year Treasury Yield	1.55%	1.63%	3.05%	4.53%
10-Year Treasury Yield	3.34%	3.53%	4.03%	4.54%
U.S. \$ / Euro	1.54	1.56	1.46	1.33
U.S. \$ / British Pound	1.98	2.03	1.98	1.96
Yen / U.S. \$	98.61	101.10	111.71	117.86
Gold (\$/oz)	\$921.20	\$994.83	\$833.92	\$664.20
Oil	\$101.70	\$110.33	\$95.98	\$58.31

\*Levels reported as of 10:00 am Pacific Daylight Savings Time

### MARKET RETURNS

Year-to-date (1/1/08-03/20/08)

Year-to-date (1/1/08-03/19/08)

Dow Jones Indus Avg.	-8.06%	90 Day T-Bill	1.09%
S&P 500	-10.95%	2-Year Treasury	3.48%
NASDAQ	-16.18%	10-Year Treasury	6.25%
Russell 2000	-12.39%	ML High Yield Index	-3.82%
MSCI World Index	-11.86%	JPM EMBI Global Diversified	0.74%
DJ STOXX Europe 600	-18.56%	JP Morgan Global Hedged	3.04%

### RECAP OF THE WEEK'S ECONOMIC RELEASES

- March 17**      *Industrial Production* - Industrial production dropped by 0.5% in February and capacity utilization slipped to 80.9% from 81.5%.
- March 18**      *Housing Starts, Building Permits* - February housing starts (1.065 million units annualized) and building permits (978k units annualized) declined on the month. Building permits are down 37% versus a year ago, with single-family permits down 42% versus last year.
- Producer Price Index (PPI)* - The February PPI rose 0.3%, in line with expectations. Core PPI, which excludes food and energy prices, jumped 0.5%, on the back of pharmaceutical and car and light truck prices.
- March 19**      *Philly Fed Index* - The Philadelphia Fed survey improved to a -17.4 reading in March, up from

-24.0 previously. However, the index is still pointing to a contraction in manufacturing activity in the region.

March 20

*Leading Indicators* - The February index of leading indicators declined 0.3% after a revised January decline of -0.4%. This marks the fifth consecutive monthly decline and all but confirms a recession is underway.

## OVERVIEW

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- The Federal Reserve slashed its benchmark overnight rate by 0.75% to 2.25% at its March policy meeting this week. The Fed also reduced the discount rate for the second time in the last two days, bringing the rate banks pay to borrow from the Fed to 2.5%. The vote was eight to two with Richard Fisher of the Dallas Fed and Charles Plosser of the Philadelphia Fed favoring less aggressive action. The decision came on the heels of the Fed's Sunday announcement that it was expanding borrowing at the discount window to include non-bank primary dealers for the first time since the Great Depression under the Primary Dealers Credit Facility (PDCF). This is the Fed's latest innovation to target liquidity where it is needed most in the market. The Fed is betting that these actions will ease financial market stress and mitigate the downside risks to economic activity.
- Our concern is that, with the federal funds rate at 2.25% today versus 5.25% just six months ago, the Fed has already used up a significant amount of its traditional policy ammunition to ease strained financial markets. This leaves the central bank less room to maneuver in the months ahead when the economic data is likely to take a turn for the worse and Wall Street's pain impacts Main Street to an even greater degree. The Conference Board's Leading Indicators seems to confirm that financial strains are beginning to impact the real economy. The index fell for the fifth consecutive month in February – the longest string of declines since the 1990-91 recession. Consequently, we expect a further easing of monetary policy by the Fed in the coming months.

## US MARKETS:

### TREASURIES

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- US Treasury yields rallied this week on continued concerns about liquidity constraints and an economic slowdown. The Federal Reserve lowered its overnight rate by 0.75%, less than the consensus of 1.00%. The yield curve reacted by flattening, with the 30-year bond the best performer on the week. Agencies had an eventful week with news that future increases in their securities and home loan portfolios will require \$3 billion of capital reserves per \$100 billion purchased, instead of the old requirement of \$3.25 billion per \$100 billion purchased. Agency spreads tightened dramatically on the week, reversing last week's widening.

### LARGE-CAP EQUITIES

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- Equity markets rebounded this week as a Fed cut and better than expected earnings from broker-dealers helped calm investors. Stocks had their biggest single day rally in five years after the Fed cut rates by 0.75% in an effort to restore liquidity in the market. The Standard & Poor's 500 and Russell 1000 Index gained more than 1.5%. Small cap stocks performed in line with large cap. In terms of style, large cap growth stocks underperformed large cap value stocks. The best performing sector was financials, and the worst performing sector was materials. Bear Stearns (BSC) shares plummeted more than 80% after the company announced an agreement to be purchased by JP Morgan (JPM) for approximately \$2 per share. The purchase price is less than the value of the company's real estate. Shares of Lehman Brothers (LEH) and Goldman Sachs (GS) surged after the companies reported earnings that were better than expected and assured investors that they had more than enough cash to continue operations. Visa (V) jumped nearly 30% on the first day of trading after raising a record \$17.9 billion in its IPO. Nike (NKE) reported profit that beat analysts' estimates on surging sales in China. Shares rose 6% on the news.

## CORPORATE BONDS

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- Investment grade primary activity was at a standstill for most of the week as news over the weekend that JP Morgan is buying Bear Stearns for \$2 per share and the Fed cut the discount rate by 25 basis points dominated the headlines. On Tuesday, however, equity futures were up and overseas markets were strong so corporates rallied. The rally continued after both Goldman and Lehman reported better-than-expected earnings and the Fed cut another 75 basis points, causing the Dow to close up +400 points. Indices were on fire as the IG9 was - at one point - 48 basis points tighter than last Friday's close. As expected though, on Wednesday the new issue spigot exploded with over \$5 billion in new supply, which saturated the market. Equities gave back most of its early week rally by selling off nearly 300 points. Needless to say, it has been a wild week.
- Investment grade corporate spreads widened throughout the week as headlines, earnings and the Fed were the focus of the market this week. For the first time in a while, we witnessed more short covering and slightly better real money buyers of banks and brokers. Focus in the financial space will next shift to the banking sector's earnings, which will likely lead to more disappointments due to write-downs and the unknown value of securities. The Lehman Credit Index Options-Adjusted Spread (OAS) finished the week at +263, eight basis points wider. Telecom/cable/media widened by fourteen; utilities widened by nine; industrials widened by seven; and financials widened by eight basis points.

## MORTGAGE-BACKED SECURITIES

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- This week, the mortgage market shrugged off the usual corporate headline risk and interest rate uncertainty to focus on Federal Reserve monetary policy actions and a change of heart on capital by Fannie Mae and Freddie Mac's primary regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). Both news events were viewed favorably by sidelined investors as hedge funds and money managers raced to buy mortgage in an attempt to front-run potential buying by yield-hungry banks and spread starved Agencies, Fannie Mae and Freddie Mac. With fixed-rate supply expected to be heavy as Agency securitization rates have soared, any demand relief is considered a positive market development. As measured by the current 30-year current coupon, mortgages outperformed Treasuries as spreads contracted by 30 basis points to close the week at 175 basis points versus the 10-year Treasury.
- Turning the focus to the commercial mortgage market, steps by the Federal Reserve to ease broker/dealer liquidity problems helped the tone and pricing within the asset class. With the synthetic market (CMBX) leading the charge, CMBS spreads raced tighter erasing almost all of the underperformance experienced in March. Spreads on AAA-rated CMBS cash bonds from the 2007 vintage narrowed to 240 basis points versus swaps, an approximate 60 basis point improvement from their historic wides experienced one week earlier. The unprecedented tightening move was more pronounced in CMBX with spread crashing 80 basis points to settle at 195 points to the 10-year swap rate. We must caution that this week's spread changes occurred in limited, low volume trading. Spread volatility levels remain elevated with daily swings of 15 to 20 basis points. It's not over...

## MUNICIPAL BONDS

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- The municipal market struggled with supply pressure from both the primary and secondary markets and underperformed the Treasury market. Ten-year and 30-year yields rallied a meager two to four basis points compared to the 12 to 19 basis point rally in comparable Treasury bonds. New issuance totaled about \$4 billion, an impressive number for a holiday week. A variety of issuers brought deals to restructure auction rate products, including the New York State Tobacco Settlement Corporation, Children's Hospital of the District of Columbia and East Alabama Medical Center. Investors and Wall Street traders remain skittish given the amount of expected auction-rate restructuring deals yet to price as well as the threat of selling pressure from leveraged accounts.

## HIGH-YIELD BONDS

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- The high yield market tone has improved after the “rescue” of Bear Stearns by JP Morgan and the various measures the Federal Reserve has implemented to provide liquidity not just to the commercial banks but the investment banks as well. In addition, the 75 basis points cut in the Federal Funds rate to 2.25% and earnings from three of the large investment banks (Goldman Sachs, Lehman, and Morgan Stanley) that beat earnings predictions, helped to stabilize the capital markets. The positive developments of this week might allow the high yield market to gain some traction and for, possibly, the new issue market to re-open after being essentially dormant for much of 2008. The high yield market needs some equity market stability and “relatively” positive economic data to improve its lot as we near the end of a tumultuous first quarter for the financial markets.

## INTERNATIONAL MARKETS:

### EASTERN EUROPEAN EQUITIES

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- Despite a 0.75% cut in interest rates in the US, Eastern European stocks sold off this week. The CECE index of equities traded in Central Europe (Czech Republic, Hungary, and Poland) lost -2.6%, while the Russian stock index RTS closed down -2.3%. In Central Europe, Hungarian mortgage bank FHB (-11.8%) led the downtrade, followed by Polish copper producer KGHM (-10.2%) and Hungarian pharmaceutical company Egis (-8.5%). FHB's shares sold off on a “sell” recommendation and target price decrease at a major brokerage. KGHM sold off after copper prices declined. The company also announced that it expected lower profit for 2008 on lower production. Among the stocks that fared well were Czech drug manufacturer Zentiva (+10.5%), Czech media company Central European Media Enterprises (-6.8%), and Polish bank BZW (+5.5%).
- In Russia, steel producer Severstal (-15.7%) declined the most, followed by energy company Surgutneftegaz (-11.9%) and fertilizer producer Silvinit (-11.5%). Severstal's shares declined after it missed analyst expectations for 2007, as earnings were negatively affected by rising costs. The stock suffered analyst downgrades at a few major brokerages as well. Surgutneftegaz announced it expected to produce less oil in 2008. Among the stocks that fared well were VolgaTelecom (+8.1%), Central Telecommunication Company (+6.7%), and Sibirtelecom (+5.6%). All three companies received stock upgrades at a local brokerage.

### WESTERN EUROPEAN EQUITIES

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- Western European stocks sold off during the week, losing -3.4%. Sectors that did not perform well were basic resources (-11.8%) and technology (-7.7%). In response to sharply falling commodity price, the basic resource sector sold off during the week, and most companies in the sector dropped over -10%. Eramet lost -20.3% and Kazakhmys tumbled -18.2%. In the technology sector, Sony Ericsson (-11.3%) fell sharply this week after a profit warning. Nokia, the world's biggest maker of mobile phones, fell -10.6% following downgrades to “sell” from “buy”.
- The best performing sectors were automobiles & parts (+1.9%) and health care (-0.6%). In the automobiles & parts sector, Volkswagen, Europe's largest carmaker, advanced +13.9% after shareholder Porsche SE announced it may increase its stake to more than 75%. Continental AG climbed +5.8% and Fiat gained +5.3%. Due to recession fears, investors took some defensive positions in health care stocks. Shire's stock jumped +8.2% and Glaxosmithkline added +3.1%.

## GLOBAL BONDS AND CURRENCIES

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- Although the past week was an unprecedented one for global financial markets, its impact on the major, non-US government bond markets was mixed. The UK gilt market made gains, particularly at the short end of the curve, on a flight to bid fuelled by the weekend's events in the US, uncertainty in the aftermath of the Bear Stearn's bail-out and rumours that a major UK bank was in crisis. The Bank of England insisted these rumours were completely unfounded and provided emergency liquidity to the

banking system in an effort to calm anxiety, while the FSA began an investigation into whether the rumours were part of a deliberate effort to manipulate the bank's stock price. The short end of the UK curve also benefited from mounting expectations of an April rate cut after the minutes of the BoE's February board meeting showed increasing support for further easing. Like Gilts, the European and Japanese markets were also firmer early in the week. However, these markets were unable to maintain their gains as stock markets recovered and both bunds and Japanese government bonds closed the week virtually unchanged.

- The Fed's efforts to calm markets, the smaller than expected cut in US rates and the associated recovery in US stock prices provided some solace for the US dollar in the past week. Speculation of central bank intervention to halt the euro's rise also provided support for the dollar and it closed the week firmer against all the major crosses. Against Sterling these gains were assisted by talk of an imminent cut in UK rates and the rumours that a domestic bank was in crisis, while forecasts of a reduction in Japanese rates later this year weighed on the yen. The Australian dollar was also lower against the dollar on the week despite suggestions in the minutes of the RBA's last meeting that there is scope for further tightening.

## EMERGING-MARKET BONDS

- Emerging market dollar-pay debt spreads widened this week on the back of continued market volatility and risk aversion. The Fed rate cut and the announcement of JP Morgan's planned purchase of troubled Bear Stearns provided some comfort to market participants, mitigating some the weakness seen this past week. Broad profit taking in commodities also weighed on emerging market countries that rely heavily on commodities exports. The Turkish Central Bank kept rates unchanged at 15.25% this week, in line with expectations. The MPC leaves the door open for further rate cuts, but remains cautious for now, outlining ongoing uncertainties in the global financial markets
- In South Africa, trade data released this week showed a marginal decrease in the current account deficit, which still stands at a high 7.5% of gross domestic product (GDP). This, together with the softer tone in risk assets, resulted in the South African rand again being one of the weakest currencies this week. In Mexico, industrial production for January surprised to the upside, coming in at 3.1% (YoY) versus forecasts of 2.4% (YoY). Manufacturing led the way in the stronger number, coming at a time when US manufacturing, with which Mexico has close links, has been moving lower. With only two business days in Mexico this week, local rates and currency were roughly unchanged.

## FACTORS SHAPING THE MARKET NEXT WEEK

- Next week, a mix of housing and business investment data will make for a busy data calendar. The US data calendar also includes the final look at fourth quarter gross domestic product.
- The week in Europe features fourth quarter gross domestic product (GDP) in the UK and Bloomberg Purchasing Managers' Index in the Euro-Zone.

## NEXT WEEK'S US ECONOMIC RELEASES

March 24	<i>Existing Home Sales</i>
March 25	<i>Case-Shiller Home Price Index</i>
March 26	<i>Durable Goods, New Home Sales</i>
March 27	<i>Gross Domestic Product, After-Tax Corporate Profits</i>
March 28	<i>Personal Income and Spending</i>