

# ECONOMIC & BOND MARKET QUARTERLY UPDATE

THIRD QUARTER 2008

## A Year of “What If”

Over the past year or so, a number of events that once seemed unthinkable have come to pass. Huge financial institutions have become insolvent virtually overnight, leaving the financial landscape almost unrecognizable. Uncertainty has grown, volatility has spiked, and losses have mounted. The trauma has been so severe that battered investors now find themselves asking what other unthinkables may be lurking within the ever-growing realm of possibility. Several months ago, it seemed sufficient to describe large market moves as “multi-standard deviation events.” Today, the very notion of standard deviations has become quaint. Historical context no longer applies, and 2008 has become the year of “what if.”

Late last year, credit problems were already beginning to surface as home prices fell and mortgage delinquencies rose. A number of poorly capitalized or over-levered specialty finance companies became insolvent; their assets seized by creditors and auctioned off in the open market. Asset prices

fell further and liquidity slowly got worse. By early 2008, as the housing market continued to worsen and mortgage defaults began to reach alarming levels, even more institutions failed. Subprime mortgage lenders, structured investment vehicles (SIVs), and hedge funds saw the value of their assets fall below their outstanding liabilities, and more liquidations ensued. The cycle continued until eventually just about every company that owned mortgage-related assets was facing losses. Many fears were becoming reality, and investors wondered what would come next. The what-if scenarios seemed to grow with each passing day and it



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## Credit Crisis Claims More Victims in Third Quarter

### Fixed Income Sector Review

#### CORPORATES

The corporate bond market’s negative trend accelerated during the third quarter and underperformed duration-adjusted Treasuries by more than 1,000 basis points according to Lehman Brothers index data, leading to a total market-value loss of 7.8%. Absolute spreads widened a whopping 176 basis points during the quarter as some of the largest names in the index fell victim to the credit crisis.

Lehman Brothers, Merrill Lynch, AIG, Washington Mutual, and Wachovia have all succumbed to the crisis of confidence that gripped the financial sector in recent months. Lehman filed for bankruptcy. Merrill was forced into the arms of Bank of America. AIG was propped up by an onerous government loan package. Washington Mutual’s assets were sold to JP Morgan in a fashion

that left little to nothing for stakeholders up and down the capital structure. Wachovia was acquired by Wells Fargo, only after Citigroup lost in the battle for control of the struggling bank. Furthermore, the last two major independent investment banks, Goldman Sachs and Morgan Stanley, were converted into bank holding companies in an attempt to adapt to new market realities—a move that appears to be working as both have been able to raise capital. The market is now anxiously awaiting the effects of the recently passed Emergency Economic Stabilization Act of 2008 and its impact on the credit creation process.

The credit stresses during the quarter were not borne solely

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*A Year of "What If", continued from front cover*

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*The what-ifs started to pervade everyone's thought process, leading to even greater risk aversion among investors. Soon even the most respected institutions were having difficulty not only raising capital, but finding counterparties willing to lend to them.*

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▶ wasn't long before the world's largest owners of mortgages, Fannie Mae and Freddie Mac, were in the market's crosshairs. By early July their stocks were in a freefall.

In response to the market's cries, U.S. Treasury Secretary Henry Paulson announced a plan to provide capital and liquidity to Fannie and Freddie through loans and the direct purchase of equity. On July 15 he testified before the Senate Banking Committee on the plan, and stated unambiguously that "Fannie and Freddie play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies." He also asserted that the Office of Federal Housing Enterprise Oversight (OFHEO), their federal regulator, "has reaffirmed that both GSEs [Government-Sponsored Enterprises] remain adequately capitalized."

Less than two months later, the GSEs' new regulator, the Federal Housing Finance Agency (FHFA) seized both entities and placed them in a conservatorship, halting all dividend payments and essentially wiping out common and preferred shareholders. In a prepared statement, Secretary Paulson stated that he had "concluded that it would not have been in the best interest of the taxpayers for Treasury to simply make an equity investment in these enterprises in their current form." The intent of the action was to ensure a functioning mortgage market and shore up confidence in the trillions of dollars of outstanding GSE unsecured debt and mortgage guarantees, but it also had some unintended consequences.

By canceling dividend payments on GSE preferred stocks, the FHFA handed billions of dollars of losses to the financial institutions that owned them. Worse, the way in which the GSEs were seized set a very dangerous precedent that made it all but impossible for other struggling financial institutions to raise the capital they needed to stay in compliance with federal banking regulations. The complete reversal

of the Treasury Secretary's stated intentions and the seemingly arbitrary nature of the actions taken led investors to conclude that any private capital injection into a federally-regulated financial entity under the current regime would amount to little more than a reckless gamble. After all, if the government could change its position and seize the GSEs, wiping out common and preferred shareholders—even after their own regulator assured them just weeks earlier that their financial position was sound—then no one was safe. Investor confidence was shattered.

Market participants then had to contemplate the implications of a banking system that was in desperate need of capital but unable to raise it in the open market. The what-ifs started to pervade everyone's thought process, leading to even greater risk aversion among investors. Soon even the most respected institutions were having difficulty not only raising capital, but finding counterparties willing to lend to them. Within days Lehman Brothers, AIG, Merrill Lynch, Washington Mutual, and Wachovia tumbled. In their wake, further investment losses ensued, causing even highly regarded money-market funds to break the buck and threatening even greater damage to the financial system.

Governments around the globe have acted forcefully to prevent further damage to the system. The scope of governmental intervention is unlike anything we have ever seen before or will likely see again. A changing regulatory environment is one of many new realities we will face in the months and years to come, and more questions have arisen about the implementation and long-term effects of these government programs.

Amid all the uncertainty and emotion, securities valuations have become the product of factors well beyond the scope of fundamental analysis. Stock market declines, news headlines, and dire proclamations from political leaders have

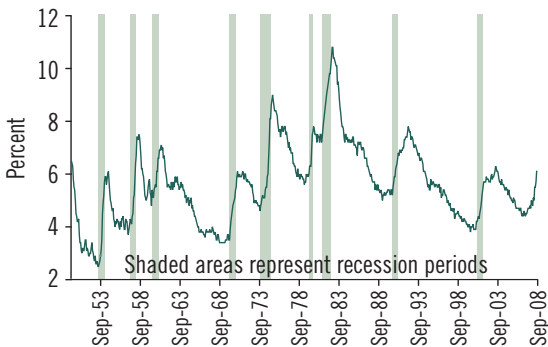
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## Economic Update

The recession is unfolding in a way that portends an even deeper downturn than we had anticipated. We now believe that real GDP will contract by 2.5% in the fourth quarter before declining by another 2% in the first quarter of 2009. Our full-year forecast is still close to 1.5% for 2008, but we have lowered our 2009 GDP forecast by a percentage point to -0.5%. We have revised up our unemployment rate forecast to 7.5% from 7%, and worry that the figure could go higher still. In this environment, we believe that the Fed should lower the funds rate to 0.75% and would not be surprised if the end result is even lower than that. Inflation, meanwhile, is no longer an impediment to Fed easing; we look for core consumer inflation to be back within the Fed's 1% to 2% comfort zone next year.

**Figure 1: Unemployment Rate**

The Unemployment Rate Is Likely to Reach 7.5%



Source: Global Insight and NBER

The risks surrounding our forecast are significant because it is impossible to know the success rate of the numerous government efforts aimed at stabilizing financial markets and loosening credit. It is also difficult to gauge how far consumers, business owners, and investors will retrench in this fearful environment. Moreover, it is hard to know the depth of the downturn abroad and its reverberating effects on the U.S. economy. Washington officials and their foreign counterparts have taken unprecedented steps

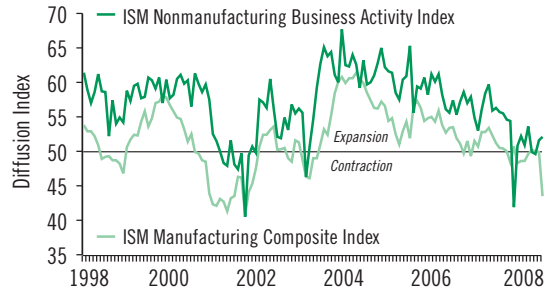
to restore confidence in the financial system and avoid a crippling global recession, but their success rate has so far been limited. Then again, absent these efforts, we might have experienced systemic failure first hand.

The Fed has become a lender-of-last-resort in ways that few economists ever envisioned. Indeed, at the end of the third quarter, the Fed was providing more than \$800 billion of liquidity to the financial system. This is an impressive figure when you think that the Fed's balance sheet remained at approximately \$900 billion between August 2007 and June 2008. Today, the Fed's balance sheet is at \$1.5 trillion and is set to rise above \$2 trillion in the not too distant future.

An important impediment to increasing the size of the Fed's balance sheet was removed when Congress

**Figure 2: ISM Purchasing Manager Indices**

Service Activity Is Also Likely to Contract Soon



Source: Global Insight

granted the Fed authority to pay interest on reserves beginning October 1, 2008. Without this ability, the Fed was constrained by the need to intervene whenever the effective federal funds rate fell too far below the target rate. Now the Fed can set a floor for the funds rate and expand its balance sheet as needed without deviating from the desired monetary policy stance. Indeed, it is the ability to pay interest on reserves that gave the Fed scope to significantly increase the size of the Term Auction Facility (TAF)

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**Jane Caron, CFA**  
Chief Economic Strategist

*Economic Update, continued from page 3*

▶ and currency swap programs. There are long-run risks associated with the enlargement of the Fed's balance sheet, but right now the Fed is desperately seeking to restore order in the financial markets.

In recent months, the Fed has greatly expanded its tool kit; each time there has been a new, serious glitch in the machinery, the Fed has managed to create a new tool to help repair the problem. The latest of these tools, the Commercial Paper Funding Facility (CPFF), will help provide liquidity to the money markets by providing a liquidity backstop for high-quality issuers of commercial paper. Lower-quality issuers are not eligible to participate, so this program only offers a partial fix to the problem. Still, it will allow a large number of commercial paper issuers to roll their paper and avoid potentially devastating cash-flow problems.

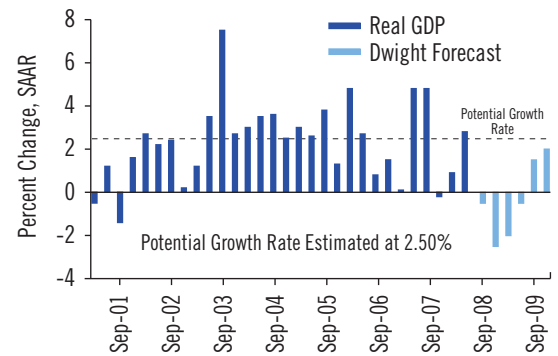
Despite this and other efforts to remove stress in the money markets, LIBOR rates have surged and Treasury bill rates have fallen to fractions of a percent. The spread between three-month LIBOR, the rate at which banks lend unsecured funds to each other, and the Treasury's three-month borrowing rate was still in excess of 350 basis points in early October. This reflects extreme fear about the ability of counterparties to repay loans. Indeed, it is fear that has investors extremely reluctant to bear credit risk even when loans are fully secured. Similarly, fear about principal losses has made private investors very reluctant to help recapitalize financial institutions, which is why the Congress passed the Troubled Asset Relief Program (TARP) on October 2.

The role of the TARP is to restore trust in financial institutions by removing or guaranteeing the troubled assets on their balance sheets. The hope is that banks will then be able to recapitalize in the private markets, but public capital injections may be necessary. Furthermore, the government appears to be readying itself to expand its guarantees of bank

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**Figure 3: Real GDP: Actual versus Forecast**

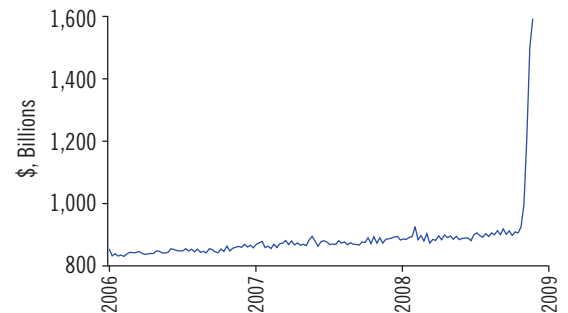
We Have Marked Down Our GDP Forecast



Source: Global Insight and DAMCO

**Figure 4: Federal Reserve Board: Total Assets**

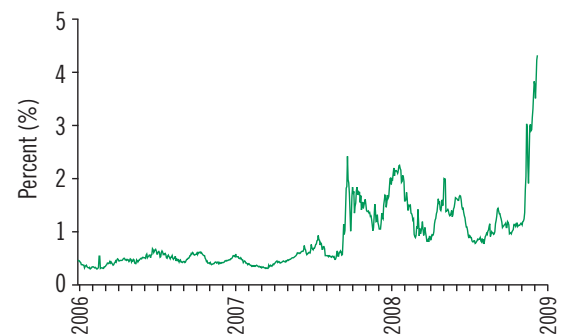
The Fed's Balance Sheet Is on Steroids



Source: Global Insight

**Figure 5: TED Spread: 3M Libor – 3M T-bill**

Money Markets Continue to Show Extreme Signs of Stress



Source: Global Insight

## International Bond Market Update

In the third quarter the financial crisis that originated on American shores finally filtered through to real economies around the globe, rendering decoupling a theory of the past. The Lehman Brothers Global Aggregate Index ex USD returned -5.90% and 1.66% on an un-hedged and U.S. dollar-hedged basis, respectively, for the quarter.

The bankruptcies and rescues of major financial institutions during the quarter were not limited to the United States, as the European continent appears to be the new epicenter for this growing financial crisis. Over the course of only a few days, we witnessed the rescue of financial stalwarts like Fortis and Dexia in Belgium, Bradford & Bingley in the United Kingdom, Glitnir Bank in Iceland, and Roskilde Bank in Denmark. The governments of Ireland and Greece even deemed it necessary to guarantee all bank deposits in an effort to stem the fear of potential bank runs in their countries, and were later joined by a number of other European nations in the process. Meanwhile, just days after Germany's finance minister Peer Steinbrueck pontificated that the financial crisis was an American problem, he found himself engineering a €35 billion rescue loan for Hypo Real Estate—the largest financial rescue in the country's illustrious history.

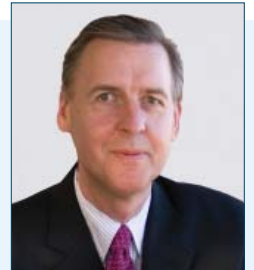
The confidence crisis in the financial system and the sharp deterioration of real economies forced central banks around the globe to reconsider their monetary stance. The crisis has shown a real strain on economies throughout Europe, as former stronghold Germany's economy is sharply deteriorating, France has entered into a recession, and Spain's economic conditions are so dire it is on the edge of entering a depression. While Asia has so far been spared any major collapses, it has not been immune from a dramatic deterioration in economic fundamentals. Japan has already entered into a recession and several other nations are on the brink. Even

emerging economies are feeling the pinch of a severe downturn.

In October, major global governments finally conceded that they had been operating in a state of denial for far too long. With the British government taking the lead, the Europeans and the Americans crafted a globally-coordinated rescue package. On October 8, we witnessed the first globally-coordinated rate cut of the major industrialized nations. While this action was long overdue, we believe it was only the first step in alleviating the pressures on global economies. Now that many major industrialized nations are on the verge of entering deep recessions, we believe that central banks around the globe will revisit their stance on monetary policy. We anticipate at least 100 basis points of quick successive rate cuts from the European Central Bank (ECB) and the Bank of England (BOE), with smaller central banks likely to follow suit.

In the meantime, the dollar had one of its best-performing quarters in recent history. A meaningful reversal of energy prices and a focus on Europe as the new host to the financial crisis have finally opened the pressure valve to enable the dollar's strong performance. The greenback's appreciation relative to major currencies is not without its risks, however, given the price tag on the recent government bailout. We believe that the dollar is still vulnerable to correction if the situation in Europe stabilizes faster than we anticipate. ■

*Written by Peter Vutz  
Sector Portfolio Manager  
International, Non-Dollar*



**Peter Vutz**  
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*Credit Crisis Claims More Victims in Third Quarter, continued from front cover*

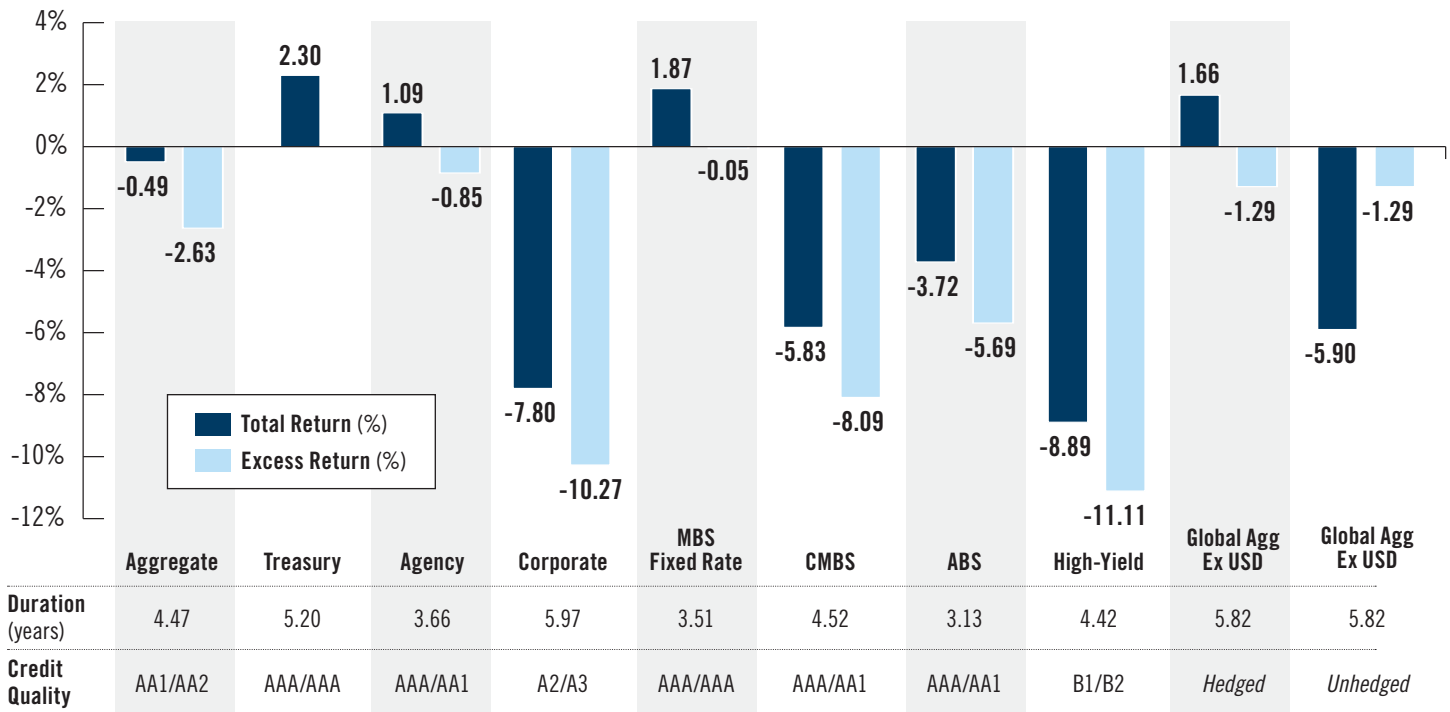
► by financials. New issuance for non-financial sectors came at ever-widening price concessions as the quarter progressed. As the primary market nearly ground to a halt in September, strong high-grade industrial issuers that came to market were forced to pay as much as 100 to 150 basis points above levels indicated by their bonds trading in the secondary markets. Under normal market conditions, the new issue concession for these issuers has tended toward ten to 15 basis points. In addition, many issuers with commercial paper programs came under pressure as the short-term funding and money market environment came under heavy fire. Lastly, a number of industrial and utility issuers have drawn on their bank credit facilities as the state of the term financing market

has left them with few options.

Reflecting our outlook for the overall economy and credit fundamentals, we remain underweight corporate bonds relative to other spread sectors. Within that underweight, we continue to favor financial institutions for their compelling relative value versus industrials. Industrials and utilities are beginning to look attractive from a price perspective, but we expect the weakness in those sectors to continue. Nevertheless, we anticipate opportunities to selectively add corporate exposure through the new issue markets as the credit crisis unduly punishes fundamentally strong credits.

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**Figure 6: Third 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.

*Credit Crisis Claims More Victims in Third Quarter, continued from page 6*

► **MORTGAGE-BACKED SECURITIES**

The mortgage-backed securities (MBS) sector returned 1.87% for the third quarter of 2008. On a duration-adjusted basis, MBS returned just five basis points less than U.S. Treasuries during the quarter—an impressive performance given unprecedented market volatility.

The events of the third quarter added significantly to the volatility and unease already present in the market. By reducing the number of viable counterparties, the bankruptcies and mergers of many of the country’s largest financial institutions reduced the balance sheet capacity available for purchases of all types of securities. As such, the combination of fewer counterparties and the reduction in balance sheets caused institutions to place a higher premium on conserving cash and capital.

In September, the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship in order to stabilize their capital bases and prevent further disruptions in the mortgage market. As a result, the U.S. government is now explicitly backing the agency MBS created by these two organizations. The effect on MBS was extreme as the sector had its best single day following the plan’s announcement. Furthermore, the government made a stated commitment to keep primary mortgage rates low to help support the housing market. In order to accomplish this, the U.S. Treasury authorized a direct purchase program for agency MBS. We believe that this government support should provide a backstop for MBS spreads in coming months.

Prime non-agency MBS struggled through most of the quarter with very little trading as uncertainty increased. Buyers and sellers continued to diverge as neither party was willing to improve. While we expect the Troubled Asset Relief Program (TARP) to help stabilize prices, the ultimate impact will depend heavily on the plan’s details and execution. We plan to maintain our current position in non-agency MBS

until the details of the so-called bailout deal become more apparent. Long-term value is compelling, assuming that there will be some stabilization in housing.

In mid-August, MBS spreads approached the historically wide levels seen in March. We took that opportunity to build a modest overweight to agency MBS. We currently maintain that overweight position, and will look to add to it if there is significant weakness in near-term mortgage performance. The main positive for MBS is that the U.S. Treasury will be directing purchases of mortgages and acting as a backstop for the mortgage rate. The resulting risks are the potential for continued volatility and reduced sponsorship from investors and dealers.

**COMMERCIAL MORTGAGE-BACKED SECURITIES**

The commercial mortgage-backed securities (CMBS) sector reversed course, producing a return of -5.83% for the third quarter and underperforming U.S. Treasuries by 809 basis points on a duration-adjusted basis. The sector has endured extreme performance volatility in 2008; as CMBS endured historic spread widening in the first quarter, exhibited positive returns in the second quarter, and subsequently widened once again in the third quarter. CMBS found itself in the middle of the pack in the third quarter, outperforming investment-grade corporates

*continued on page 8*

**DWIGHT SECTOR SPECIALISTS**

The Sector Review was written by the following sector specialists:



**John Bisset, CFA**  
Corporates



**Josh Kruk, CFA**  
Mortgage-Backed Securities



**Derrick Wulf, CFA**  
Commercial Mortgage-Backed Securities



**Peter Milne**  
Asset-Backed Securities



**Sean Slein, CFA**  
High-Yield



**Keith McCarthy**  
Municipal Bonds

*Credit Crisis Claims More Victims in Third Quarter, continued from page 7*

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- ▶ but lagging the asset-backed and agency mortgage-backed sectors.

In line with the broader financial market, CMBS activity was muted as there has been virtually no new issuance during the last three months. In the secondary market, activity slowed but liquidity was still available. Investors preferred more seasoned bonds with less inherent leverage, so these bonds performed best within the overall sector. On the other hand, deals that were originated within the last two years came under significant selling pressure, reflecting investor concerns about underwriting and rating agency uncertainty. Trades in securities lower on the credit curve were few and far between as investors remained risk averse.

Commercial real estate fundamentals continued to deteriorate during the period as loan delinquencies increased to 0.66% of the CMBS universe. On a historical basis, however, CMBS delinquencies remain well below historical averages and represent just a fraction of the decade's peak delinquency rate of 2.48% in 2003. The CMBS market is directly tied to the health of the financial and retail sectors. Accordingly, we expect further increases in delinquencies as retailers struggle with weak consumer spending and as softer labor markets reduce demand for office space. Nonetheless, most property markets should be well positioned to weather the decline in demand for commercial space as new construction has been far more restrained during this cycle than in previous cycles.

We are maintaining our overweight to the sector because we believe that the highest-quality names continue to offer compelling value for investors. Within our overweight, we continue to favor the highest tiers of the credit spectrum as well as more seasoned securities. Super-senior AAA bonds that have been more conservatively underwritten continue to enjoy excellent loan performance and should continue to perform, even in a recessionary

environment. Furthermore, the sector offers attractive spreads without the heightened idiosyncratic risk present in the corporate bond market or the prepayment risks inherent to the residential mortgage market. While broad market turbulence is likely to keep spreads volatile in the near term, we believe that the sector's current yield advantage combined with the prospect for spread tightening will reward patient investors as markets begin to normalize.

## ASSET-BACKED SECURITIES

Macroeconomic fundamentals continue to deteriorate, reinforcing our long-held view that a consumer-driven recession is upon us. The Federal Senior Loan Officer Survey shows that domestic banks have sharply tightened lending standards for consumer loans. In contrast, according to the survey, as recently as early 2007 banks were not tightening lending standards and some were even loosening standards. Only seven months later, however, a whopping 67% of banks surveyed reported that they were tightening their standards.

Amid economic uncertainty and a breakdown of investor confidence during the third quarter, spreads gapped out to their widest levels in history. Asset-backed securities (ABS) finished the quarter with a total return of -3.72%, underperforming duration-matched Treasuries by 5.69%. Credit cards and autos led the underperformance, posting excess returns of -6.67% and -4.86%, respectively.

During the second quarter spread rally, we moved to an even more defensive posture by selling the majority of our remaining cash flow autos and reinvesting the proceeds in shorter spread duration assets. Going forward we will maintain this defensive stance, favoring top-tier AAA-rated consumer assets with low spread duration. While spreads remain vulnerable to further widening through year end, we continue to take a buy and hold approach to our

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*A Year of "What If", continued from page 2*

▶ meanwhile eroded consumer and business confidence even further, convincing observers that this credit crisis is not a problem confined only to Wall Street. The economy now faces greater weakness in consumer spending and business investment, deepening the recession that is probably already well underway.

The deterioration in the economic landscape has heightened some forms of credit risk, and market dislocations have become amplified by the volatility and illiquidity. The violent de-levering in the

financial markets has also forced the hasty liquidation of many fundamentally sound assets, allowing the discerning investor to find tremendous values amid the debris. We expect volatility to continue as the markets seek a new equilibrium, but also expect the opportunity to be rewarded for investing in undervalued, high-quality assets along the way. ■

*Written by Derrick Wulf, CFA  
Sector Portfolio Manager*

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*Credit Crisis Claims More Victims in Third Quarter, continued from page 8*

▶ purchases and believe that high-quality ABS collateral will outperform Treasuries and agency collateral over the longer term.

## HIGH-YIELD

The high-yield market exhibited record losses in the third quarter as market participants reduced risk in response to heightened systemic fears. What began earlier this year as a relatively orderly process of deleveraging cascaded into wholesale selling. As a result, high yield returned a record loss of 8.89% and underperformed duration-matched Treasuries by 11.11%.

Option-adjusted spreads widened 312 basis points as participants chose safety over yield. Negative drivers of performance included deepening pessimism of near-term economic prospects, the inability of companies to obtain financing on commercially reasonable terms, technical pressure of leveraged credit participants exiting positions, and increasing default pressure. Spreads widened most in the lowest credit tiers as BB-rated issues continued to outperform. No sector produced positive total returns and broadcasting, diversified media, and financials suffered most. Defensive

sectors such as utilities, consumer staples, and health care outperformed on a relative basis. During the quarter, the percentage of distressed securities (those trading at a spread of more than 1,000 basis points over Treasuries) nearly doubled to 35% of the market—a record percentage increase in the relatively-brief history of the high-yield market. This likely portends a higher default rate in coming quarters from the current benign rate of 3.50%. Accordingly, with the Lehman Brothers High Yield index spread north of 1,000 basis points, the market is factoring in default rates approximating 10%, levels last seen during the cyclical default peaks in 1991 and 2002.

Primary market conditions will likely remain challenging for banks and high-yield companies alike. Underwriters are struggling to find the balance sheet capacity to bring deals to the market. Companies that have access to the capital markets face financing costs that continue to spiral upwards. In addition, alternatives like the leveraged loan and convertible bond markets remain largely closed due to technical or structural problems. Many companies

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*Credit Crisis Claims More Victims in Third Quarter, continued from page 9*

▶ simply have little or no access to the debt capital markets at this juncture due to worsening financial performance, heightened risk aversion of market participants, or a combination thereof. Likewise, secondary market liquidity has been poor and is likely to continue deteriorating in coming weeks as defaults increase and banks struggle with capital adequacy issues.

We expect credit conditions to marginally worsen as we progress toward year-end. The credit crunch will likely persist for a few more quarters while the economy is expected to post negative GDP. As a result, spreads and defaults are likely to trend higher as we enter 2009. Nonetheless, BB and higher-

quality B spreads are approaching the bear-market-wide levels last seen in previous credit contractions. In contrast, CCC spreads remain well inside cyclical wides and continue to remain tight relative to BBs and Bs. We therefore believe that fundamental value is beginning to emerge in the higher-quality credit tiers. Given more time for banks to repair their balance sheets and better clarity on prospects for economic growth, we see high yield as fairly valued given known risks. Accordingly, we will maintain our bias in favor of higher-quality defensive names and avoid sectors with no

### MUNICIPAL BONDS

The municipal bond market remained under severe pressure for the majority of the third quarter and continues to trade at historically cheap levels. Municipal yields as a percentage of U.S. Treasury yields continued to gap higher, with ratios reaching historic levels.

The total return for the Lehman Municipal Bond Index for the third quarter of 2008 was -3.21%. Most of the decline came in September, when the index registered its worst monthly and year-to-date total returns in more than 20 years. During the past nine months municipals have underperformed the Lehman U.S. Treasury Index by almost 800 basis points.

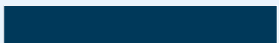
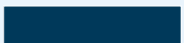

Municipals are suffering due to a weakening economy, illiquidity, money market pressures, deleveraging, the near absence of viable bond insurers, and slowing tax revenues. Combined with an almost non-existent primary new issue market, the municipal market is suffering from an incredible strain. Even so, we see incredible long-term value in this market. With yield spreads at historical highs, there is plenty of opportunity to take advantage of the current volatility and dislocation. We expect to see continued pressure for municipals in the near term, but we do not expect a surge in municipal defaults. Keeping in mind that municipals are a high-quality and low-risk sector second only to U.S. Treasuries, we believe that diversification across the spectrum of high-grade state and local general obligation and essential service revenue bonds will prove favorable in the long run. ■

*Written by Dwight Sector Specialists*

### Dwight Asset Management Company LLC Total Assets as of 9/30/08:

**\$73.5 Billion**

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

Stable Value		\$51.1 <sup>1</sup>
Fixed Income		\$31.0 <sup>2</sup>
Insurance		\$17.6 <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 8/31/08.

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.

**For more information:***Economic Update, continued from page 4***Fixed Income & Stable Value**

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activity. Relief for homeowners who are unable (or unwilling) to meet their loan obligations is also part of the new legislation. While many key details are still unknown (such as which assets will be purchased and at what price), our take is that this program will provide relief to financial institutions and homeowners but will stop well short of restoring credit to the broader economy. Unlike U.S. Treasury Secretary Paulson, we do not believe that this program will “unclog the pipes.”

Current events will profoundly reshape the financial markets and the regulatory bodies that oversee our financial system and economy. The implication is that future markets will operate with a much lower level of leverage and risk and a much higher level of oversight. Thus, when the economy recovers from this recession, the trend rate of growth will likely be much slower than the rate enjoyed in recent years—although at that point, any growth will probably feel relatively good. ■

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