

## 2007 REVIEW

In 2007, we were concerned that the economy was out of balance and vulnerable to exogenous shocks.

Early in the year, we publicized a number of forecasts that proved prescient: GDP growth would slow to a rate between 2% and 2.5%; core consumer inflation would remain slightly above 2%; the Fed would ease policy in the latter half of the year; the Lehman Brothers Aggregate Index would post a total return of 7%; and stocks, as measured by the S&P 500, would post a positive but lackluster gain. Internally, we talked about the need to be aware of downward pressure on corporate earnings and the need to continue the high-quality bias adopted in 2006 for our structured product holdings. We were particularly concerned about the subprime sector of the housing market. Extraordinarily poor underwriting standards, erroneous property appraisals, and the sale of inappropriate mortgage products to risky borrowers all pointed to instability.

We could fill pages explaining how the credit market crisis came about in 2007, but here is the condensed version. Expectations of ever-rising home

prices, coupled with lax lending standards (a function of the originate-to-distribute lending model), created an unsustainable dynamic that went into reverse when the housing market bubble started to deflate. As default risk rose, demand for subprime bonds evaporated. This blocked the distribution of already-originated subprime bonds, which in turn sharply reduced new origination and made it harder for subprime borrowers with adjustable rate loans to refinance prior to rate increases. Selling the home was a poor second choice because of the weak housing market. In fact, some mortgage holders found themselves upside-down, with mortgages that exceeded the value of their homes. Defaults surged in this environment, perpetuating the crisis (see Figure 1, page 2).

Surging defaults on subprime mortgages led to contagion in the money markets, where structured investment vehicles (SIVs) had made a big business of issuing commercial paper to purchase subprime and other bonds—a classic “borrow short and lend long” strategy that was very lucrative for a time. Concerns about credit risks caused buyers for this commercial paper to evaporate, resulting in severe funding difficulties for the SIVs. In turn, the SIVs tapped back-up credit facilities with commercial banks in order to avoid forced asset sales. SIV paper was held in a number of money market accounts, leading to performance problems for some and exacerbating investor angst.

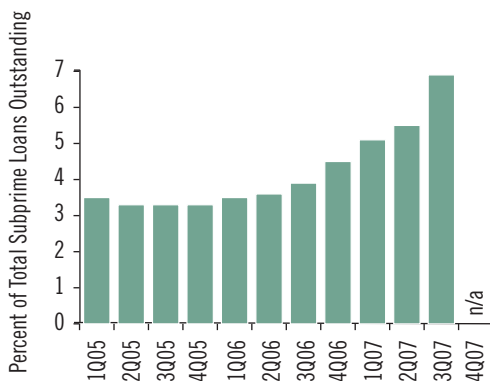
Commercial banks found themselves called on by the SIVs to meet funding needs, while other players were ringing their doorbells to get replacement funding because parts of the bond market were essentially closed. In addition, banks had to cope with a number of deals that were stuck on their books because it had become impossible to bring new



Jane Caron, CFA  
Chief Economic Strategist

**Figure 1: Subprime Foreclosure Rate**

This Rate is Rising at a Rapid Pace



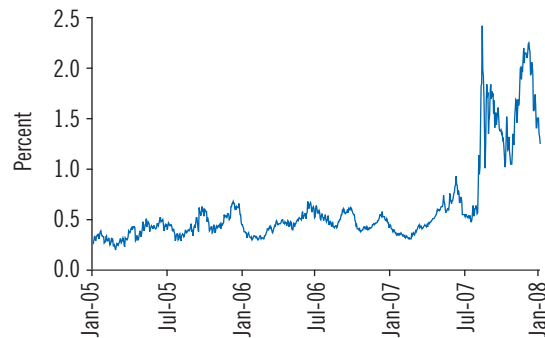
Source: Global Insight and Mortgage Bankers Association

continued on page 2

2007 Review, continued from page 1

► issues to market. Furthermore, market conditions were driving down the prices for other assets on their books, raising the risk that they would have to set aside more capital. In this environment, cash became dear (see Figure 2, below).

**Figure 2: TED Spread, 3-Month LIBOR/3-Month T-Bill**  
Money Markets Under Significant Stress



Source: Global Insight

The hoarding of cash was most evident in surging LIBOR rates, the rate at which banks lend unsecured funds to each other. Banks simply refused to lend their cash. This freeze reverberated through the financial markets and impacted the economy. LIBOR rates serve as key reference rates for many loans and contracts. The economy, already struggling with an accelerating downturn in the housing market, surging food and energy prices, and credit restraint, could not shrug off this additional shock.

We first became concerned about a potential recession in July. Our concern grew in the third quarter because of financial market turmoil and a hawkish Fed. In October, we raised the odds for a recession to 60% from 30% because of continued financial market turmoil, the acceleration in the housing market downturn, and surging food and energy prices—shocks that we feared would tip the

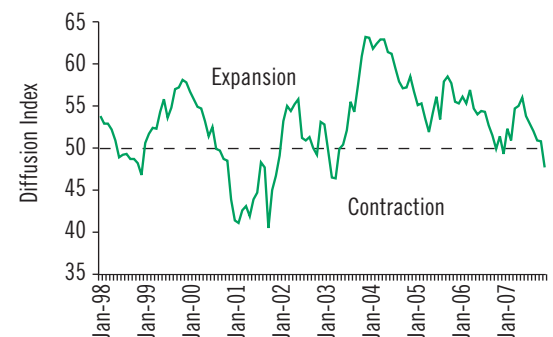
economy into a recession. At that time, we lowered our 2008 forecast for the federal funds rate from 4% to 3%, a 125 basis point decline from the December 2007 rate of 4.25%. We were inclined to forecast an even lower rate, but the persistence of inflation pressure and the hawkish-sounding FOMC suggested that the Fed would cut rates begrudgingly.

Fourth-quarter economic data confirmed our fears that a recession was unfolding. Indeed, we raised the risk of a recession to 90% and reduced our funds rate forecast by 50 basis points as the calendar turned. Particularly concerning was a decline in the Institute for Supply Management’s index for manufacturing purchasing managers’ sentiment to 47.7 in December, a level that indicates contracting manufacturing activity (see Figure 3, below). Also, the Bureau of Labor Statistics reported that the unemployment rate jumped 0.3% in December to 5%, well above its 2007 low of 4.4% (see Figure 4, page 3). Furthermore, housing data for November were dismal, while December retail sales pointed to a hesitant consumer.

continued on page 3

**Figure 3: ISM Manufacturing PMI Index**

This Leading Indicator Has Fallen Into Contraction Territory



Source: Global Insight

**For more information:**

**Fixed Income & Stable Value**

Greg Prisk  
Executive Vice President  
802.383.4104  
gprisk@dwight.com

David Richardson, CFA  
Managing Director  
802.383.4024  
drichardson@dwight.com

**Insurance**

Donald Hill  
Senior Vice President  
802.383.4062  
dhill@dwight.com

John Loud  
Vice President  
802.383.4047  
jloud@dwight.com

**Consultant Relations**

Lisa Trubiano, CFA  
Senior Vice President  
802.383.4066  
ltrubiano@dwight.com

Anicia Mendez  
Vice President  
802.383.4067  
amendez@dwight.com

100 Bank Street  
Suite 800  
Burlington, VT 05401  
802.383.4000

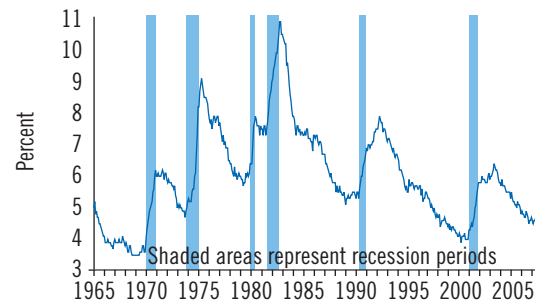
One SW Columbia  
Suite 1720  
Portland, OR 97258  
800.929.4427

www.dwight.com

2007 Review, continued from page 2

▶ As bond managers, our challenge in 2007 was deciding when individual bonds were priced for a recession, making them attractive long-term purchases even if they underperformed Treasuries or other safe-haven assets for a period of time. Our risk-return analyses showed a number of bonds that were attractively priced, but market volatility could

**Figure 4: Unemployment Rate**  
The Latest Increase Foreshadows a Recession



Source: Global Insight and NBER

lead to yet cheaper prices. Thus, timing was particularly important in 2007. More buying opportunities are likely to present themselves in 2008, but we are optimistic that investments we made will lead to good performance in coming years. ■

*Written by Jane Caron, CFA  
Chief Economic Strategist*

This information reflects the viewpoint of Dwight Asset Management Company as of Fourth Quarter 2007 and is subject to change. This article was 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 it. Investors should seek financial advice regarding the appropriateness of investing in any investment strategy or security discussed or recommended in this article 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.