



## MEMORANDUM

TO: All PCA Clients

DATE: June 29, 2009

FROM: Pension Consulting Alliance, Inc. (PCA)

cc:

**RE: A Review of Interest Rate Spreads – As of May 31, 2009**

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The economic environment of 2008 and 2009 created tremendous headwinds for investors as a global credit crisis, characterized by a complete credit freeze, saw the worst credit market conditions since the Great Depression. The landscape for interest rates and credit spreads since the end of 2008 continues to change dramatically as investors are beginning to see the potential for tremendous profits in credit.

PCA makes the following observations:

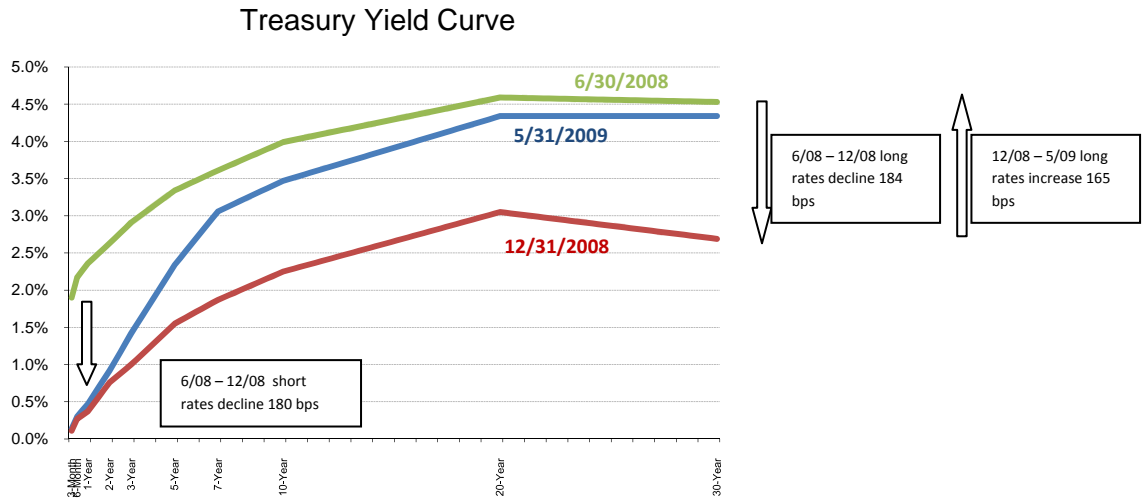
- The Treasury yield curve steepened since mid-2008, as long-term yields have risen
- Corporate spreads have narrowed in recent months from their historic highs as investor sentiment has improved
- High yield spreads have narrowed, but still remain historically wide offering equity-like expected returns
- Securitized spreads have yet to normalize, but have given investors cautious optimism

The market presents opportunities that, by historical standards, appear significant. To take advantage of those opportunities requires the ability to undertake rigorous research, analysis and discipline. Managers that have proven track records in those areas have the potential to add significant value. These opportunities are, in our opinion, short to mid-term and are tactical in nature.



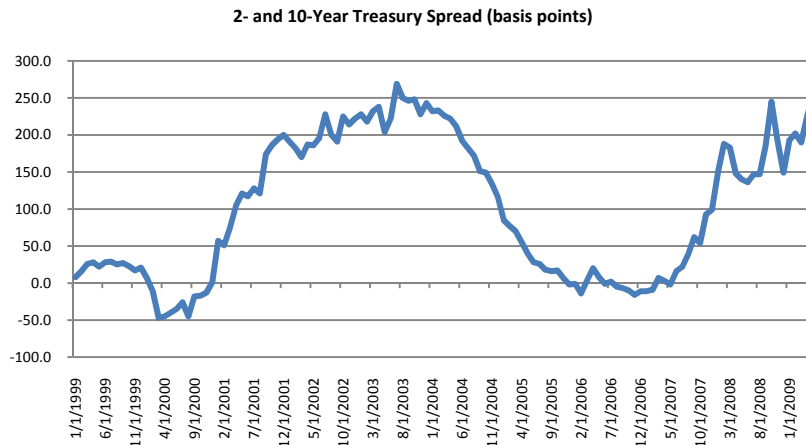
### Treasury Yield Curve

Treasury securities proved to be the safest investments during 2008. From June to December of 2008, the yield curve fell approximately 180 basis points across the entire maturity spectrum. Prices on Treasuries were bid up (causing yields to decline) as investors feared deflation and a continued weakening economy and a re-pricing of risk set off a flight to quality.



Source: Federal Reserve

Historically (see following chart), investors have been compensated for moving out on the yield curve to longer dated maturities. In 2003, the spread between the 10- and 2-year Treasury bonds widened out to above 200 basis points. Following that, during a period of low volatility, spreads narrowed and the yield curve became inverted. Then, in mid 2007, when volatility returned, and investors began bidding up shorter term maturities (causing yields on the 2-year to fall), the 10- and 2-year spread widened beyond 200 basis points.



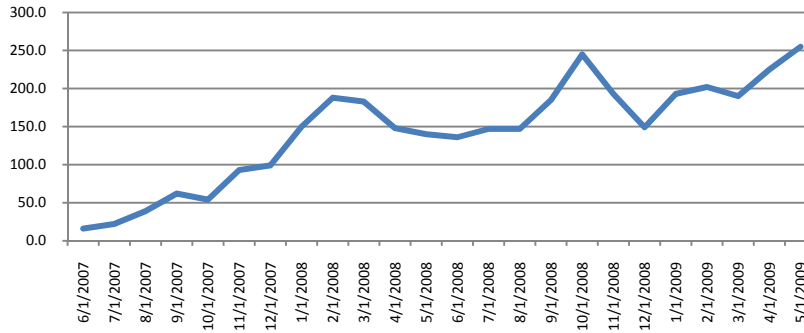
Source: Federal Reserve

A closer look at spreads during the last 24 month period reveals the dramatic widening between the 10- and 2-year Treasuries. Since mid 2007, spreads widened from around 20 basis points



to a height of approximately 255 basis points as the yield curve continued to steepen. While longer-maturity rates have increased, a steeper yield curve is a positive for the U.S. financial system, which tends to lend long-term and finance that lending with short-term debt.

**2- and 10-Year Treasury Spread (basis points)**



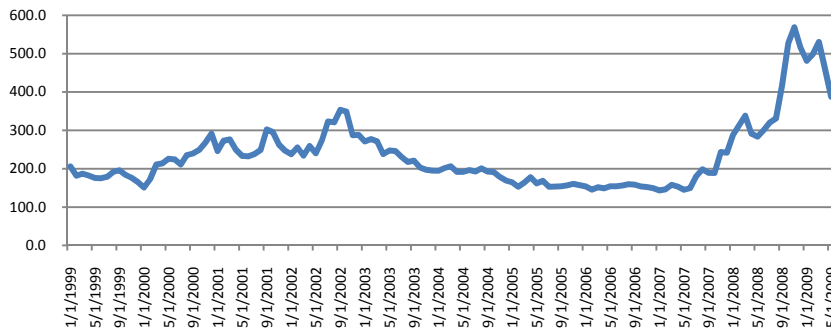
Source: Federal Reserve

This result reveals that a premium is offered once again to investors for moving out on the maturity spectrum as investors are compensated an additional 250 basis points.

### Investment Grade Corporate Credit Spreads

After a dismal 2008, corporate credit has seen a renewed interest from risk-averse investors. Spreads of investment grade corporate bonds to Treasuries (of equivalent maturity) have also come off the highs of November 2008. As seen in the following chart, corporate bonds offered a 150 basis point premium during the low volatility periods of 2005 to 2007. During the crisis period, spreads rose in two phases. First, reflecting events around Bear Stearns's demise, spreads rose to in excess of 300 basis points by early 2008. Then, as the crisis deepened with numerous corporate bailouts and Lehman Brothers' bankruptcy in September 2008, spreads widened to over 550 basis points by November 2008.

**Spread: Corporates v. Treasury (basis points)**

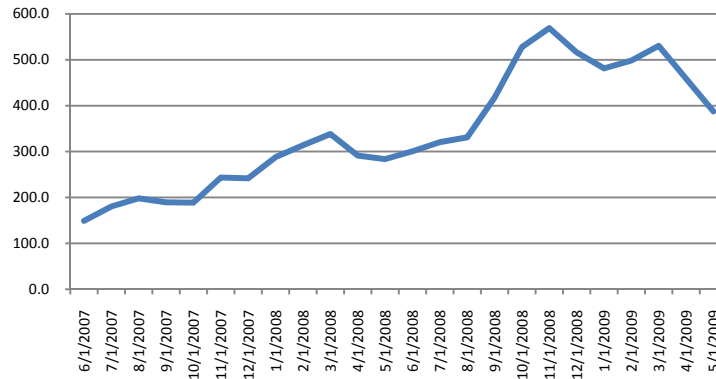


Source: Federal Reserve, Barclays Capital

Since mid 2007, corporate spreads over Treasuries moved from 149 basis points to nearly 570 basis points in November 2008, a near-quadrupling in a period of 17 months. As seen in the chart below, spreads have come down to just below 400 basis points as of the end of May 2009.



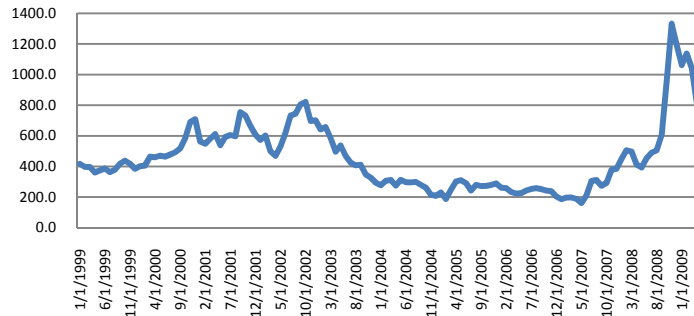
### Spread: Corporates v. Treasury (basis points)



Source: Federal Reserve, Barclays Capital

While investment grade corporate bond spreads over Treasuries remain around 400 bps, there is a distinct difference between investment grade and below-investment grade. Corporate credit spreads followed the same basic pattern during the last 10-year period. In 2004, after dropping from a high of 800 basis points in 2002, investors were compensated 200 – 300 basis points from taking on additional credit risk (in the form of high yield bonds). As the credit crisis unfolded, and investors fled to higher quality assets, spreads widened to around 500 basis points by the end of 2007. However, high yield spreads then ratcheted up to set new historically high limits in excess of 1300 basis points in November 2008.

### High Yield Spread Over Investment Grade Corporates (basis points)

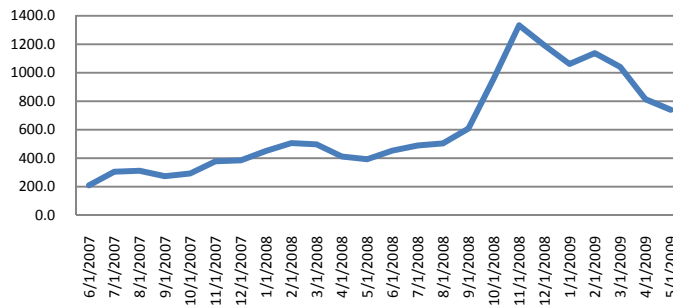


Source: Barclays Capital

The chart below shows how high yield credit spreads have tightened to below 800 basis points in the last 7 months. As investor sentiment has calmed, and volatility backed off its highs of late 2008, investors have begun to bid up high yield bond prices, bringing yields back down to historically recognizable levels. As measured by the Barclay's Capital High Yield Index, high yield bonds have returned 22.5% year to date (as of May 31, 2009).



High Yield Spread Over Investment Grade Corporate (basis points)

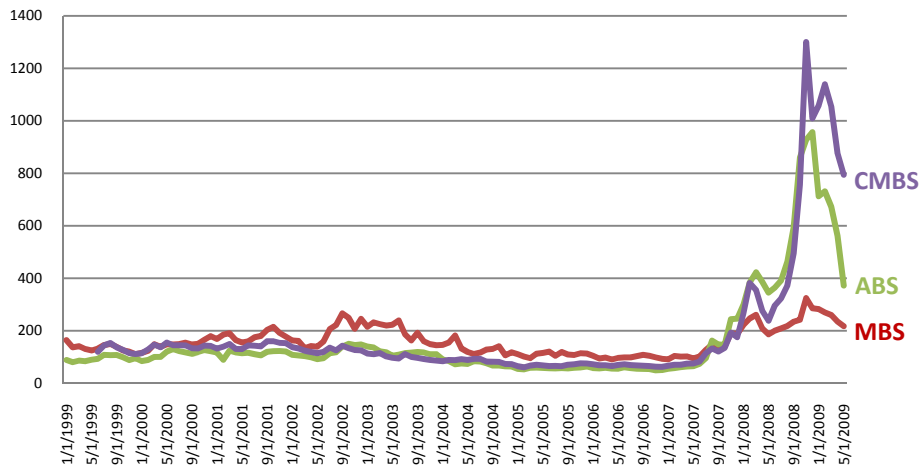


Source: Barclays Capital

### Securitized Bonds

With the new Government programs in place such as TALF and PPIP, securitized bonds have received much attention. Historically, the spreads on mortgage and other asset backed securities were below the 200 basis point range. Strains on the bond market hit the securitized market particularly hard as mark-to-market requirements meant that these bonds were getting priced well below what many investors felt were their intrinsic values. The demand for asset-backed securities ground to a halt as investors feared holding otherwise good assets that were forced to be marked down. The following chart details the main components of the securitized market (not including non-agency asset backed securities). While mortgage backed securities (MBS) rose to heights of 300 basis points, asset-backed (ABS) and commercial mortgage backed securities (CMBS) rose to unthinkable heights of 957 basis points and 1300 basis points, respectively.

Securitized Spreads (basis points)

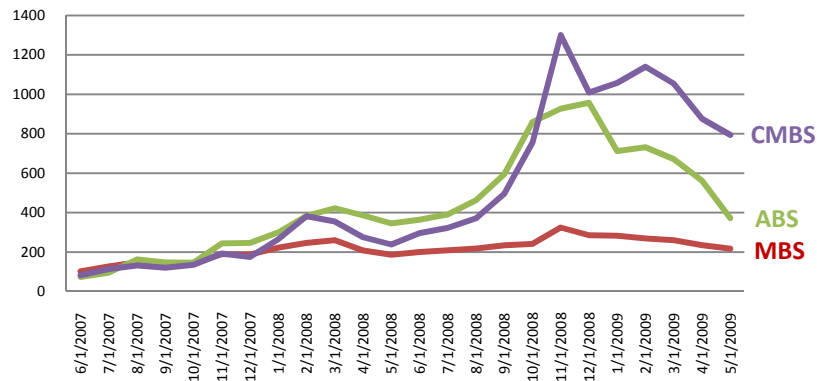


Source: Barclays Capital



A closer look of recent periods shows that since reaching the heightened spreads of late 2008, spreads have narrowed to around 800 basis points for CMBS and 400 basis points for ABS, but are still considered substantial. In addition, MBS (agency) spreads have fallen to around 200 basis points. With the Federal Reserve's purchases of mortgage backed securities from Fannie Mae and Freddie Mac, this segment of the securitized market has rallied. In addition, the inclusion of other asset backed securities in programs such as TALF and PPIP program, including CMBS and RMBS, has given investors renewed, but cautious optimism in this space which has fueled a recent rally.

Securitized Spreads (basis points)



Source: Barclays Capital



## APPENDIX

### Interest Rate Spreads (bps) (1/1/1999 to 5/29/2009)

	<b>29-May-09</b>	<b>Average Spread</b>	<b>Period Low - Date</b>		<b>Period High - Date</b>	
<b>2- and 10-Year Spread</b>	255	102	-47	Mar-00	269	Jul-03
<b>Corporate - Treasury Spread</b>	387	234	143	Jan-07	569	Nov-08
<b>High Yield - Inv Grade Credit Spread</b>	740	454	161	May-07	1332	Nov-08
<b>MBS Spread</b>	217	159	90	Apr-06	325	Nov-08
<b>ABS Spread</b>	372	159	49	Nov-06	957	Dec-08
<b>CMBS Spread</b>	794	183	60	Feb-05	1301	Nov-08