

Market Flash: Capital Markets Update

from CMS BondEdge

Market Environment: Third Quarter 2006

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3rd quarter fixed income performance was dominated by an action that did not occur – the Federal Reserve voted to leave short term rates unchanged at its August meeting, ending a run of 17 consecutive rate increases. The U.S. Treasury curve rallied during the first half of the quarter as this news was anticipated, and then gained momentum after the August Fed meeting.

Ten-year Treasury rates decreased by 50 basis points (bps) during the quarter (from 5.14% to 4.64%), while 2-year yields declined by 46 bps (from 5.16% to 4.70%). While the dominant movement during the quarter was that of a bullish parallel shift, the inversion of the Treasury curve increased slightly, with the spread between 2s and 10s moving to -6 bps from -2 bps at the beginning of the quarter. The 3rd quarter rally more than offset the bearish Treasury curve movement during the 2nd quarter, as rates reverted to levels observed during the 1st quarter of this year. For the year-to-date period, 2- and 10-year Treasury yields ended the 3rd quarter at levels 30 bps and 25 bps higher, respectively.

The rally in the U.S. Treasury curve led to significantly positive returns for fixed income indices during the quarter. The Lehman Brothers Aggregate Index posted a return of 3.81% for the quarter, moving the year-to-date total returns back into positive territory (+3.06%). Broad credit benchmarks such as the Lehman All Credit Index posted an even higher return for the quarter (+4.51%), as longer duration, higher carry, and a slight spread tightening all enhanced performance.

Mortgage rates rallied substantially during the 3rd quarter, especially for 30-year product. 30-year mortgage rates declined by 50 bps during the quarter (from 6.79% to 6.29%), while 15-year mortgage rates finished the quarter at a level 41 basis points lower (moving from 6.33% to 5.92%). Effective durations on mortgage-backed securities decreased markedly as mortgage rates fell, with the effective duration for the CMS BondEdge representation of the Lehman Mortgage Index (SLMI) declining from 4.62 to 3.75 during the quarter.

Swap rates recorded the largest decline in rates during the past 3 months, as 5- and 10-year swap rates rallied by 58 and 57 bps, respectively. 5- and 10-year swap spreads moved 7 bps tighter, as investors seeking to add duration to mortgage dominated portfolios received fixed in the swap market.

Exhibit 1

3rd Quarter 2006 Returns (%)

Index	Income	Paydown	Term Structure	Spread/ Vol	Total
SLAG	1.34	0.03	2.38	0.06	3.81
LBGC	1.31		2.54	0.06	3.91
LBGV	1.20		2.29	0.05	3.54
SLMI	1.38	0.09	2.15	0.01	3.63
SLAC	1.47		2.84	0.20	4.51

Year-to-Date Returns (%)

Index	Income	Paydown	Term Structure	Spread	Total
SLAG	3.88	0.07	-0.94	0.05	3.06
LBGC	3.79		-1.12	0.04	2.71
LBGV	3.47		-0.93	0.07	2.61
SLMI	4.04	0.19	-0.65	-0.01	3.57
SLAC	4.25		-1.37	0.00	2.88

Exhibit 2

OAS Changes, 3rd Quarter 2006 (bps)

	AAA	AA	A	BAA	Total
Industrial		0	-2	6	2
Utility		-6	1	-2	-2
Finance	-3	-2	-3	-2	-2

In January we will revisit the most recent market trends with a review of 4th quarter and full year performance.