



RICHTON CAPITAL MANAGEMENT
Experience, Knowledge, Service

Fourth Quarter 2008

Interest Rate Trends

Quarterly Newsletter

Happy New Year to clients and friends! Interest rates fell precipitously in the final quarter of 2008. The Treasury yield curve flattened during the period as the decline in short rates was outpaced by the decline in long rates (the 2 year note fell 120 basis points, the 10 year note fell 143 basis points, and the 30 year bond fell 163 basis points). The resulting increase in fixed income prices has investment grade index returns solidly in positive territory for the year.

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Barclays Aggregate	4.58%	5.24%	5.51%
Barclays Govt/Credit	6.42%	5.70%	5.56%
Barclays Int. Govt/Credit	4.84%	5.08%	5.51%

Source: Barclays Capital

As of December 31, 2008

Federal Reserve Actions

Treasury Market Yields		
	12/31/08	9/30/08
2 Year	0.76%	1.96%
5 Year	1.55%	2.98%
10 Year	2.21%	3.82%
30 Year	2.68%	4.31%

Commodities		
Oil (\$ bal)	\$44.60	\$105.26
Gold (\$/oz.)	\$884.30	\$955.60
CRB Index	\$229.54	\$345.50

Spread Product (Spread to 10 Yr. Treasury)		
10 Yr. "A" Corp	+4.11%	+2.64%
GNMA Current Coupon	+1.84%	+1.74%
10 Yr. "AA" Municipal	+1.44%	+0.54%

In response to the weakening U.S. economy, the Federal Reserve Open Market Committee lowered the Fed Funds Rate three times during the quarter from 2% to near 0% by year end. These aggressive interest rate moves will be accompanied by non-traditional steps to ease monetary policy. Most notable among them is the Federal Reserve's announced \$800 billion program to buy back agency debt, agency mortgage-backed securities, and certain asset-backed securities. These initiatives, designed to keep borrowing rates low, come in addition to the widely debated \$700 billion TARP program put forth by the U.S. Treasury.

Economic Indicators

- The Fed and the marketplace anticipate falling **inflation** in coming years as evidenced by the narrow yield differential between nominal 10 year Treasuries (2.21% at year end) and 10 year Treasury TIPS (2.09% at year end). That small spread is an "implied CPI" rate over the next 10 years of 0.12%. CPI currently is running at 1.1% YOY (as of the December release). Meanwhile, the Core CPI rate is 2.0% YOY and the Core PCE rate is at 1.9% YOY.
- 3Q **GDP** has been reported at -0.5%. Up until that point, the economy had been growing modestly. The financial crisis and stock market collapse of October has had a profound effect on business and consumer spending.
- That effect is also evident in **consumer sentiment** data. The Conference Board release of Consumer Confidence dropped to the level of 38 on

December 30th (that index has steadily declined in 2008 after 100+ readings throughout 2007).

- The market's favorite **housing** indicator, the S&P/Case Shiller Composite, was released on December 30th (as of October) at a new low of -18% YOY. This indicator has been in negative territory since January of 2007.
- Lastly, the **employment** picture continues to look bleak. In December's data release, Non-Farm Payrolls fell -533,000 jobs with an Unemployment Rate of 6.7%. On January 9th, consensus forecast calls for another Non-Farm drop in the amount of -475,000 jobs with the Unemployment Rate rising to 7%.

Conclusion

Looking forward to 2009, the economic "crystal ball" is still quite cloudy. A recession is underway, but the length and the severity of the downturn are unclear. Over a longer term horizon, it is easier to be confident about the success of government actions to stabilize the U.S. economy. Likewise, a longer term perspective makes it easier to perceive relative valuation in fixed income today. Non-Treasury interest rates remain quite high relatively speaking. Regardless of whether the prevailing levels of interest rates rise or fall in early 2009, we expect the gap between Treasuries and other fixed income classes to narrow.

2008 – What a Year!

2008 was a truly remarkable year in fixed income! Throughout the year, events occurred which dramatically changed investors' perceptions of value. **The fear which gripped the financial markets impacted the fixed income sectors differently leading to an unusually wide dispersion in sector returns (see box at right).**

Treasury yields exhibited roller coaster behavior, higher when investors (and the Fed) perceived increased inflation risk, and cascading to all time lows (in the longer maturities) at the end of the year as market participants feared the worst economy since the depression. For the year, **Treasury returns were exceptional, with most of the gains in the fourth quarter.**

2008 Sector Returns	
Treasury Index	13.74%
Agency Index	9.08%
Corporate Bond Index	(4.94%)
Fixed Rate MBS Index	8.52%
CMBS Index	(20.52%)
ABS Index	(12.72%)

Source: Barclays Capital

One consistent theme over the course of the year was concern about the security of financial assets. The year witnessed bankruptcies (Lehman) and distressed takeovers (Bear Stearns, Countrywide, Wachovia, etc.). The government responded with an alphabet soup of programs to assist financial issuers, including taking direct stakes in banks. **Credit spreads on financial issuers peaked in the fourth quarter at levels unseen since the depression before declining somewhat at the end of the year.** In general, the coordinated actions of the Treasury and Fed and the benefits of the TARP program approved by Congress slowly provided confidence to fixed income credit investors in the banking sector and spreads rallied in December.

Non-financial corporate bonds also fared poorly during the year, with spreads gapping out in the fourth quarter as market sentiment on the economic outlook darkened. The declining stock market did not provide comfort as falling stock prices reinforced the gloomy economic outlook. **No credit sector was spared, as corporate bonds posted their worst return relative to Treasuries in thirty years.** Some corporate treasurers, however, took the opportunity to issue debt at relatively low absolute yields in spite of historically wide credit spread to Treasuries.

The fate of mortgage-backed securities (MBS) depended upon whether the underlying credit was government guaranteed (i.e., GNMA, FHLMC, or FNMA) or not. MBS issued by one of the Federal Agencies provided positive returns as the programs put in place to buy these mortgages – with the goal of getting homeowner mortgage payments down – offset the loss as homeowners refinanced at lower rates. Non-government guaranteed MBS fared poorly as investors questioned the quality of the underlying assets. Securities backed by subprime mortgages were hit first, but by the end of the year fear had spread to the Alt-A and commercial mortgage-backed sectors. Notably, these securities declined in value despite high ratings, as investors in some cases sold off solid asset classes indiscriminately.

Finally, agency debt also had a volatile year. Spreads gapped wider as fears about the solvency of Freddie Mac and Fannie Mae heightened, but then narrowed after the agencies were placed into conservancy and the senior debt effectively guaranteed by the government.

What will 2009 bring? **After a tumultuous 2008, investors are likely hoping for a break in the fear pervasive in the capital markets. With the economy apparently slowing dramatically, the verdict is still out on when calm will return.**