Payden&Rygel

# Weekly Market Update

## MARCH 14, 2003

## MARKET LEVELS

| | Friday* | Last Week | Dec. 31, 2002 | One Year Ago |
|---|---|---|---|---|
| **Dow Jones Industrial Avg** | 7,857 | 7,687 | 8,342 | 10,517 |
| **S&P 500** | 833 | 823 | 880 | 1,153 |
| **NASDAQ 100** | 1,028 | 982 | 984 | 1,477 |
| **Russell 2000** | 355 | 354 | 383 | 498 |
| **DJ STOXX Europe 600** | 186 | 193 | 210 | 257 |
| **Nikkei Index (¥)** | 8,003 | 8,144 | 8,579 | 11,569 |
| **Fed Funds Target** | 1.25% | 1.25% | 1.25% | 1.75% |
| **2-Year Treasury Yield** | 1.55% | 1.19% | 1.60% | 3.60% |
| **10-Year Treasury Yield** | 3.71% | 3.63% | 3.81% | 5.41% |
| **US $ / Euro** | 1.07 | 1.10 | 1.05 | 0.88 |
| **US $ / British Pound** | 1.58 | 1.60 | 1.61 | 1.42 |
| **Yen / US $** | 118.39 | 116.66 | 118.79 | 129.16 |
| **Gold (London)** | $335.50 | $356.60 | $342.75 | $292.70 |
| **Oil** | $34.92 | $37.67 | $31.20 | $24.56 |

**Levels reported as of 10:45 am Pacific Standard Time*

| Market Returns | Year-to-Date (1/1/03-3/14/03) | Market Returns | Year-to-Date (1/1/03-3/13/03) |
|---|---|---|---|
| **Dow Jones Indus Avg.** | -5.81% | **90 Day T-Bill** | 0.26% |
| **S&P 500** | -5.37% | **2-Year Treasury** | 0.49% |
| **NASDAQ 100** | -4.41% | **10-Year Treasury** | 1.60% |
| **Russell 2000** | -7.25% | **ML High Yield Index** | 5.10% |
| **MSCI World Index** | -7.56% | **JPM Emerg Mkts+ Comp** | 7.05% |
| **DJ STOXX Europe 600** | -11.62% | **JP Morgan Global Hedged** | 1.46% |

## RECAP OF THE WEEK'S ECONOMIC RELEASES

*March 12:* *International Trade* - U.S. trade deficit narrowed in January to $41.1 billion from a revised $44.9 billion in the month prior.

*March 13:* *Retail Sales* – Dropped 1.6% last month following a revised 0.3% increase in January.

*March 14:* *Producer Price Index* – Rose 1% in February after gaining 1.6% in the previous month.

*March 14:* *University of Michigan Consumer Confidence* – Preliminary March reading sank to a decade low 75 from 79.9 last month.

## COMMENTARY

### U.S. TREASURY/ECONOMICS

- Stocks and geopolitics took center stage given the light economic calendar. Looming war, high energy prices, a lackluster job market and even inclement weather are being linked to weaker-than-expected retail sales and the University of Michigan consumer sentiment index falling to its ten-year low. On the international front, the weak dollar contributed to the second largest U.S. trade deficit ever.

- Treasuries opened the week higher with 2-year yields reaching new lows as U.N. Security Counsel members sought to delay Iraq's March 17 disarmament deadline. On Tuesday, the bid was reversed as the U.K. signaled a compromise on the deadline. Continued outflows in the short-end put a bid into the intermediate-to-long part of the curve as hedge funds—long/treasuries and short/S&P futures—took some of the flatteners off and covered shorts.

- Japan sold the front end of the curve to repatriate yen as the Nikkei dropped below 8,000. Treasuries also took direction from equities, as U.S. and European stock markets recouped losses of previous sessions.

- There is speculation that if weak economic conditions persist, the FOMC will buy intermediate/long Treasuries thereby lowering interest rates and injecting more cash into the banking system. The market is pricing in a 25 percent chance of a 25 basis point rate cut at the FOMC's March 18 meeting.

### U.S. EQUITIES

- U.S. stocks fell to their lowest level this year before a strong mid-week rally pushed indexes to close slightly up for the week. The S&P 500 dropped below 800, with bad news from airlines and pharmaceuticals leading the declines. Strong sales from Applied Materials and investor speculation that stocks will recover post-Iraq then sparked a healthy advance. Headline news that American Airlines is on the verge of bankruptcy sent its stock tumbling a staggering 50 percent. This indicates further suffering for airline and travel companies. Eli Lilly and Pfizer led a retreat by pharmaceuticals as U.S. regulators expand their probe of drug marketing and pricing. As the duration of the Iraqi standoff extends, downward pressure is depressing the market and consumer confidence, and boosting crude oil prices. Investors are looking for a short and decisive resolution in Iraq.

### EUROPEAN EQUITIES

- The DJ EuroStoxx 600 index gained almost three percent, following two days of massive short-covering. European markets hit 7-year-lows on Wednesday, suggesting that market participants had reached the point of capitulation. Toward week's-end, however, hedge funds began to cover their short positions sending worldwide markets into a broad recovery. The German DAX was the only European bourse to close in negative territory. The euro lost two percent versus the dollar; oil prices were high.

- Technology and insurance sectors led the late-week rally, regaining ground after taking a beating in the recent downward trend. Fortis, the Benelux (Belgium/Luxembourg/Holland) insurance firm, gave relief to the entire European insurance sector after maintaining its dividend policy and its excellent solvency ratios; 81 percent higher than the minimum requirement. Finnish mobile phone maker Nokia gained 16 percent-plus. On the negative side, autos and utilities each declined more than two percent. French engineering firm Alsthom crashed more than 50 percent following the issuance of a profit warning and a cash call to ease financial burdens. German pharmaceutical giant Bayer slipped an additional 15 percent on ongoing litigation concerning its Lipobay and Bycol drugs.

### CORPORATE BONDS

- Investment-grade primary market activity was slow as issuers stayed on the sidelines in an environment in which the threat of an attack on Iraq and rising energy prices are hampering U.S. economic growth.

There were, however, rare appearances from pharmaceutical behemoth Eli Lilly and from Brown-Forman, the manufacturer of Lenox China and Hartmann luggage. Investor demand seems to be focused on higher quality issuers.

- Secondary market activity was sluggish this week with spreads wider across all sectors. Autos were unchanged, but very volatile; finance companies widened 20 basis points. Brokers widened 7 basis points; banks widened 4 basis points; media widened 7 basis points; telecom widened 8 basis points. Industrials widened 5 basis points.

## MORTGAGE-BACKED SECURITIES

- Mortgages lagged Treasuries this week as investors wrestled with both prepayment risk and extension risk. Mortgage investors, faced with record low mortgage rates and a 34 percent jump in the refinance index, sought protection from fast pre-pays by buying lower coupons mortgages. Market affection for lower coupons reversed on Thursday, however. A sharp 20-plus basis point sell-off caught investors off sides as extension fears—quiet for the past few weeks—returned with a vengeance. The result: Mortgage spreads widened across the coupon stack due to heavy originator selling and profit taking by investors long/duration and overweight/mortgages. The current coupon mortgage widened 13 basis points to 132 basis points versus the 10-year Treasury.

## MUNICIPAL BONDS

- Municipals outperformed Treasuries this week due to an imbalance between supply and demand. Several weeks of light primary issuance and increased demand from crossover buyers, insurance companies, and arbitrage accounts drove municipal prices higher over the last two weeks. When Treasuries dramatically dropped in value on Thursday, municipals benefited from residual demand that had not been met. Two-year municipals outperformed Treasuries by 9 basis points, while 5-year and 10-year municipals outperformed by 13 and 7 basis points respectively.

## GLOBAL BONDS

- With the Japanese economy mired in malaise, Japan's ruling coalition is urging the Bank of Japan to be proactive in lending and restoring growth. An 80 percent plunge in Japan's stock market since 1989 has eroded the capital of Japan's banks. The coalition will propose that the Bank of Japan increase purchases of shares from banks to 4 trillion yen ($33.7 billion USD), up from 2 trillion yen already budgeted.

- The European Central Bank is highly concerned about the state of the eurozone economy in the aftermath of last week's 25 basis point cut in lending rates. Attention is now shifting to the April 3 monetary policy meeting. The decline in European equities (DAX at its lowest level in seven years 2,354) is having a negative effect on demand and prices. Although geopolitical concerns are center stage, subdued economic growth and slowing inflation are creating an environment for monetary accommodation.

## EMERGING MARKET BONDS

- Emerging market bond spreads tightened only moderately this week, as the recent strong rally lost some steam. High-yielding credits including Venezuela, Nigeria, Ecuador and Brazil outperformed, as investors search for yield in a low-interest-rate environment. S. Korean bond spreads widened significantly as investors have grown more nervous about tensions with N. Korea; this weakness caused other Asian spreads to widen as well.

- Moody's changed Mexico's rating outlook to positive, citing improvements in the level and composition of the country's debt profile, as well as its adherence to fiscal discipline. Mexico's current rating is Baa2/BBB-.

- Uruguay announced its proposal to conduct a voluntary debt restructuring, through extending maturities to address short-term rollover problems.  Not enough details are yet available about the swap to know whether the incentives offered will be sufficient to attract significant participation from current bondholders.

- Recep Tayyip Erdogan, leader of the Islamic-oriented AK party, will take over as Prime Minister of Turkey after being elected to parliament on Sunday.  Erdogan had been banned from running in the November general elections after reading a poem considered to have religious overtones.  Erdogan is likely to press parliament to approve the deployment of U.S. troops in Turkey.

## HIGH YIELD BONDS

- High yield's cup runneth over. The HY market grinds higher, seemingly oblivious to geopolitical turmoil and soft economic data. The unabated upward march stems from cash pouring into HY mutual funds, where inflows totaled $640 million this week and aggregate year-to-date 2003 inflows stand at $7.2 billion. In just the first two months of 2003, HY has taken in 63 percent of year 2002's total inflows of $11.5 billion.

- The cornucopia of liquidity has led to oversubscription to well-regarded deals. Moore Corporation's $400 million deal was 10 times oversubscribed; Hexcel Corporation's $175 million issue was similarly oversubscribed. The massive liquidity has resulted in investors—hoping to obtain good allocations from underwriters—"gaming" the system by placing significantly larger orders than normal. This gaming distorts the system, as the true interest in a deal cannot be gauged from artificially inflated order books.