



American Century
Investments®

Investment Viewpoints

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The Credit Crisis and Repricing of Risk, 15 Months Later

**What We Saw, How We Positioned Our Fixed-Income Portfolios,
and What We See Coming Next**

Robert V. Gahagan

Senior Vice President and
Senior Portfolio Manager

G. David MacEwen

Senior Vice President, Portfolio Manager and
Chief Investment Officer, Fixed Income

Spin-off Crises Mark Anniversary

As the investment community marked the anniversary of 2007's stormy "Summer of Subprime" and the damaging credit crisis waves it spawned, we were tossed and turned again by new credit and financial storms that had spread throughout the financial sector during the past 15 months.

Whereas the original tempest blew in suddenly and anonymously over mountains of resetting, defaulting, adjustable-rate subprime mortgage loans, the latest storms arrived with more fanfare and bore familiar names—Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Merrill Lynch, Washington Mutual, Wachovia, and Citigroup.

The familiarity and size of these companies seemed to breed more sympathy (and concern) than contempt—the government and the Federal Reserve (the Fed) resorted, for the most part, to extraordinary measures to limit damage from the downfall of these icons, particularly in the cases of Bear, Fannie, Freddie, Merrill, AIG, and Citigroup.

Financial Collapse Was Averted, But Not Recession

We believe the coordinated efforts of the Fed and the U.S. government helped prevent a complete financial system collapse, but they didn't prevent what appears likely to be a deep recession. Intervention that maintains order on Wall Street doesn't necessarily translate to near-term solutions for Main Street, where credit remains tight and job security and consumer confidence are waning.

Tough times face the average consumer, and we expect them to get worse. What will save Main Street consumers from a continued slow grind downward while Wall Street flameouts attract legislative, financial, and media attention? And when?

Recession Due to Disabled Housing Market

We believe the U.S. economy is in a consumer-led recession that will follow a long, slow, L-shaped pattern of recovery (as opposed to a V-shaped, more rapid rebound). The National Bureau of Economic Research (NBER)—the think tank that identifies key inflection points in the business cycle—defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months. The NBER has already declared that a recession began in December 2007. We think it will include the third and fourth quarters of 2008, as well as the early months of 2009.

How did we fall into this recession? We believe it was the same way the financial crises erupted—beginning with an extended period of easy credit from 2002 to 2004, when the Fed's overnight interest rate target remained at a generational low of 1% for over a year. In fact, inflation-adjusted (real) overnight bank lending rates in the U.S. reached negative levels from roughly the fourth quarter of 2002 through the first quarter of 2005. The Fed was essentially paying investors (and speculators) to borrow money, and they capitalized on that opportunity.

We saw easy credit translate to speculative booms in the housing, credit, and securitization markets, followed by bursting bubbles in those areas after the Fed raised rates, the economy weakened, home values declined, and borrowers defaulted on adjustable-rate loans that reset beyond the borrowers' ability to pay. A vicious credit cycle erupted—credit became increasingly unavailable to financially stretched consumers who had relied upon debt to make ends meet and who needed it more than ever as their expenses increased and incomes remained static or declined.

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Financial-Sector Fuse Was Already Lit in 2006

We anticipated that bursting bubbles would rattle the financial sector, and positioned our fixed-income portfolios accordingly, actively shielding portfolios from credit-sensitive areas in both the mortgage and corporate sectors. For example, as far back as March 2006, we were favoring higher-quality government securities over corporate bonds because we felt that corporate securities offered inadequate compensation for the added risk involved.

More recently, when many market participants seemed to optimistically view the government takeovers of IndyMac, Fannie Mae, and Freddie Mac as signs that the credit crisis was coming to a close, we instead hardened our conviction that more subprime-related shakeouts were yet to come. Indeed, by the fourth quarter of 2008, a host of banking and brokerage institutions were in trouble. The impact of their instability extended far beyond their direct business relationships and securities markets, compromising even the sanctity of money market funds. We still think more financial sector troubles lurk ahead.

No Consumer Sector Signs of a Bottom Yet

It's important to note that while we've positioned our fixed-income portfolios for recession, we're also actively preparing for better credit conditions and an improved risk/reward environment. Our investment teams are watching for both economic and market signs that it's time to seek more aggressive opportunities.

Beyond the attention-grabbing glare of financial-sector fireworks, we still see this recession as consumer- and credit-driven, versus business related. We think the core cause of recent troubles can be traced back to declining home values and consumer-credit repayment issues. Therefore, we still strongly believe the ultimate springboard for economic recovery will be housing price stability, along with improved effective availability of consumer credit.

According to our analysis, neither has happened. We see home prices continuing to decline, and believe the contraction will continue while the employment situation worsens to what we consider more typical recession levels (monthly job losses of 200,000 to 300,000 or more). Meanwhile, we've observed that mortgage interest rates are finally falling after being stuck at the same level from September 2007 to September 2008, but qualifying for those low rates and actually obtaining a loan from financially stressed lenders has become increasingly difficult.

When will home prices stabilize and credit become more readily available? We believe the latter will help drive the former—increasing demand for housing will be the key factor that ultimately puts a floor under falling prices. But demand requires confidence and credit, which we see in short supply right now. We believe the financial sector needs to stabilize to loosen the lending purse strings, but restoring consumer confidence goes beyond that. It will likely require some combination of increasing labor and housing market stability, low interest rates, easier credit availability, falling energy prices, improving corporate credit quality and earnings, and a stock market recovery. We see a couple of those factors already in play, but not enough to make a difference.

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Closing Thoughts

The crux of the matter is that we don't believe we have reached the bottom of this economic cycle; conditions will likely deteriorate in the fourth quarter of 2008 and into 2009 before they improve.

As we sensed would be the case 15 months ago, the credit crisis launched during the "Summer of Subprime" is still with us, housing prices are still declining, home inventories remain high, and consumer spending continues to be constrained. In a paper distributed at the 2007 National Accounts Investment Forum, we said, "We expect that the housing downturn is far from over, and will continue to exert downward pressure on consumer spending and the economy for months to come. The expansion of subprime woes to other real estate lending sectors, combined with the tightening of credit standards, have the potential to undermine housing prices for an extended period." Take away the words "is far from over, and" and we could say pretty much the same thing today.

We think American consumers face hard times ahead that are not addressed directly or immediately by the much-publicized responses to the seemingly accelerating stream of institutional failures in the financial sector. We foresee weak economic growth for the rest of 2008 and well into 2009. Despite that, we remain vigilant for signs that the markets and the economy are turning, and for the opportunities those changes bring.

For now, we favor the securities of large, diversified corporations, U.S. government agency mortgage-backed securities, and municipal bonds. The Fed is boosting market liquidity through various extraordinary activities and facilities designed to mitigate the credit crisis and boost economic growth, but we think it's fighting an extraordinarily uphill battle. We believe the Fed will be forced by ongoing economic weakness to cut rates further in coming months, giving an additional boost to the Treasury sector and other high-quality securities.

Times like these favor bond managers with superior security selection skills, risk/return management discipline, and credit analysis expertise. Our fixed-income portfolio management teams at American Century Investments® possess those traits, as their track record shows. We appreciate having the opportunity to share their thinking and results with you.

The opinions expressed are those of the Fixed Income investment team and are no guarantee of the future performance of any American Century portfolio. Statements regarding specific holdings represent personal views and compensation has not been received in connection with such views. This information is not intended to serve as investment advice. Diversification does not assure a profit or protect against a loss in a declining market.

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P.O. Box 419385
Kansas City, MO 64141-6385
1-800-345-6488
www.americancentury.com/ipro

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