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The current recession is providing an opportunity to observe and model risk dimensions that were viewed as extremely low probability events a priori. Those probabilities of severe illiquidity, market failure, default rates, and high unemployment are clearly being revised upwards. In this issue of the Journal of Fixed Income, we begin with an article by Vineer Bhansali, Yonathan Schwarzkopf, and Mark Wise. They derive a model for the term structure of swap spreads and volatilities. Their hazard rate model for swap spreads depends on the level of the yield curve, the steepness of the yield curve, market volatility, and the fraction of risky debt in the economy. The model provides a good fit in normal and stressed environments for the United States, the United Kingdom, and Japan. In the next article, Naohiko Baba provides empirical evidence of a spillover effect from the money market turmoil to the short-term FX swap market and the long-term cross-currency basis swap market. These dynamics are explained by continuous revisions in market expectations of the time length of the turmoil.

The mortgage-backed securities market is essential to a well-functioning housing market. In the next article, Jinyong Kim investigates the liquidity risk of the MBS market relative to U.S. government and agency securities. Jinyong defines a measure of liquidity risk to be a relatively large drop in total transactions during short periods of time. After abstracting from non-liquidity-driven market risk factor transactions, the negative tail of liquidity-driven transactions suggest that MBS securities have greater liquidity risk.

In a high volatility market, it's important to focus on valuation models. In the next article, Choong Chua, Krishna Ramaswamy, and Robert Stine propose a model for forward Eurodollar rates that is a function of long-term, maturity-specific (preferred habitat), and date-specific (shocks to expectations of future spot rates) components. They provide both statistical (out of sample forecasts) and trading strategy justifications for the model. In the next article, Takaaki Ozeki, Yuji Umezawa, Akira Yamazaki, and Daisuke Yoshikawa value residential mortgage-backed securities with a proportional hazard model to describe prepayment risk. The model is extended to price interest-only and principal-only derivatives.

Finally, Michael Stein, Roland Füss, and Wolfgang Drobetz provide insights on optimal portfolio construction when adding fixed income hedge funds to a traditional bond portfolio. In contrast to the problems associated with the multivariate normal distribution assumption, their model employs copula opinion pooling. Both an investor's subjective view and risk tolerance are significant determinants of the hedge fund allocation. Varying the maximum acceptable expected shortfall yields a wide spectrum of hedge fund allocations from 0% to 85%.

We hope you enjoy this issue of *The Journal of Fixed Income*. Your continued support of the Journal is greatly appreciated.

Stanley J. Kon
Editor

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