



Fixed Income Insight First Quarter 2008

January 28, 2008

Review & Outlook of the 2008 Economy and Markets

→ *Market Setting*

- ❑ “Market turmoil and an evolving economic outlook have produced a volatile situation that has made forecasting the course of the economy even more difficult than usual”—Fed chairman Ben Bernanke 1/10/08.
- ❑ The verdict is still out whether or not the Fed’s aggressive, accommodative responses to the risks of the sub prime market have halted the contagion.
- ❑ Fears about sub-prime loans and leverage exposure are being realized as delinquencies and foreclosures continue to move up sharply.
- ❑ Huge mark to market losses related to eroding investment asset quality at financial companies have created a credit crunch and a growing contagion with a spillover into the general economy.
- ❑ GDP growth rate is likely to fall and remain in the slow growth mode for the first half of the year. Conditions suggest more than a 50% chance of a recession in 2008. Government stimulus programs are being considered, however, any delay would defer their beneficial impact.
- ❑ Job growth tailed off in the second half of 2007 with the jobless rate closing the year at 5%.
- ❑ High commodity prices and a flagging stock market weigh heavily on consumer sentiment and retail sales.
- ❑ Home inventory recently reached a 50 year high, which triggered falling home prices.
- ❑ Upside risks to the CPI and core inflation are increasingly evident and raise the risk of stagflation.
- ❑ Fed cuts and the recent economic softening continue to weaken the dollar.
- ❑ Corporate earnings are expected to be substantially below recent quarters, as margins have come under pressure and losses continue to mount.
- ❑ Global liquidity has tightened although economic growth still appears generally positive.
- ❑ Geopolitical tensions pose a backdrop risk for the market.

→ *Outlook For Interest Rates and the Markets*

- ❑ Fed has accelerated its easing policy in order to offset economic weakness and mitigate the impact of the credit crunch.
- ❑ Despite growing inflation risk, the Fed has indicated “it will do whatever it takes” in responding to the fallout emanating from the sub prime market.
- ❑ The Fed may cut by as much as 125 basis points in the first quarter and another 25 to 75 basis points through year end, closing 2008 at 2.25%-2.75%.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on following page.

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→ *Outlook For Interest Rates and the Markets (cont'd.)*

- ❑ We anticipate a continued steepening in the yield curve through the end of the quarter and year.
- ❑ We expect 10-year Treasury yields to close the 1st quarter at 3.8% and year end near 3.7%.
- ❑ While the weakened economy and flight to safety have driven up Treasury bond prices, prices are high on a historical basis. This presents the risk that these prices will reverse if inflation is not contained and deficit financing increases supply.
- ❑ The dollar is expected to continue to lose ground modestly compared to most major currencies.
- ❑ Stock market performance is likely to be lackluster with negative returns appearing more likely.
- ❑ The most significant risks that could likely alter the degree or volatility of our rate prediction relate to:
 - The speed of global growth, liquidity and credit conditions worldwide
 - Domestic job base growth
 - Rising inflation
 - Containment of losses emanating from residential real estate, consumer debt and overall leverage
 - Declining corporate profits
 - Upward price pressure on goods and services due to pass-through of commodity price increases
 - The demand for borrowing in the credit markets
 - Currency exchange rates
 - Geo-political tensions, especially in the Middle East, and
 - Sustained support by Foreign Central Banks for the dollar

Notes and Disclosures

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