Fixed Income Insight
January 31, 2007

Review & Outlook of the 2007 Economy and Markets

➔ *Market Setting*

- Lower interest rate volatility and stable Fed Policy suggests market may be "range bound".
- GDP growth rate has moderated.
- Lower oil and interest rates in the last quarter appeared to have stabilized the economy at modest growth and inflation levels.
- The housing slowdown continues to be a concern, as lofty price increases subside, inventories remain high and more sub-prime loans fail.
- To date, consumers appear to be taking in stride the housing slowdown. Consumer confidence is still solid. Stock market direction has been positive since summer.
- Employment trends should stay positive with at least 1.5 million jobs created for the full year.
- Core inflation appears to be stabilizing near 2.5%, yet it may be entrenched into the economy due to:
  - Lagging impact of rising commodity prices, employment costs and weakening dollar;
  - Peaking of productivity gains which have caused unit labor costs to go up;
  - Higher import prices affecting consumer goods.
- Credit rating changes showed mostly stable conditions last year with slightly improved upgrade/downgrade ratio.
- Corporate earnings are in solid positive territory, but are anticipated to slow before year-end.
- Global liquidity is strong helping asset values at large and fueling M & A activity.
- Geopolitical tensions pose a backdrop risk for the market.

➔ *Outlook For Interest Rates and the Markets*

- Additional Fed Fund rate hikes are unlikely, although Fed officially remains vigilant about inflation concerns.
- Modest movement in rates across yield curve is expected in first quarter.
- We anticipate a mostly flat yield curve through the year with a bias toward steepening at the next Fed move.
- We expect 10-year Treasury yields to close the first quarter near 4.75% and at year-end near 4.5%.
  - U.S. bond rates are relatively attractive to global investors as they help limit upward pressure in rates.
  - Late stage credit expansion in a healthy economy normally contributes to higher borrowing levels, thus limiting modest rate declines.
- Dollar is expected to continue to lose ground modestly compared to most major currencies.
- Stock market performance of 4%-9% for the entire year is likely to remain below long term historical returns of +10%-11%.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on following page.

Guiding Portfolio Strategies

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- The open issues that could most likely alter the degree or volatility of our upward rate prediction include:
  - the speed of global growth
  - healthy but declining corporate profits
  - upward price pressure on goods and services due to pass-through of commodity price increases
  - energy prices
  - the demand for borrowing in the credit markets
  - the velocity of a housing slowdown, loan delinquencies and impact on credit standards and consumer confidence
  - geo-political tensions, especially in the Middle East
  - sustained support by Foreign Central Banks for the dollar

Notes and Disclosures

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