# Fixed Income Insight
# January 14, 2005

## *McDonnell Investment Management Market Expectations for 2005*

### *Economy and Interest Rates*

Much like the theme of the now classic movie *"Groundhog Day,"* the backdrop of current market conditions and the outlook for the year ahead look a lot like they did last year at this time. Once again this year, all but one of the prognosticators in the December survey of economists by the Wall Street Journal are expecting higher interest rates. Overall, business conditions also appear favorable once again with gradual job expansion still probable, earnings positive, equity prices up, the global economy growing and the Fed poised to raise short term rates to keep inflationary creep in check. The political and economic global environment is still showing similar surroundings—turbulence in Iraq, extremely volatile oil prices, growing U.S. trade and budget deficits, a weak dollar and the shadow of terrorism lurking as a constant threat.

The *"been there, done that"* feeling hasn't kept the market from thinking that the ultimate impact on long bond rates won't be different than what was thought at the *same time last year*. Based on the similarity of conditions, the nuance of increased intensity in key trends and the logic of those conditions contributing to even greater inflation risk if left unbridled, we renew our expectation for higher interest rates this year at both the short and long ends of the yield curve.

### *Case for Higher Interest Rates*

➔ **Economic Growth**

The economy appears to be growing at a cruise control pace of around 4%. Employment growth was steady throughout 2004: currently unemployment is lower (5.4%) than a year ago (5.7%), payroll growth continues to encourage personal spending, new home sales keep buzzing forward and capacity utilization is going up (albeit from a low base in 2003).

➔ **Rising Inflation**

These factors paint a picture that accents the budding prospects for rising levels of inflation in our economy. The latest Consumer Price Index (CPI) reading in November 2004 registered 3.5% inflation, the highest monthly year over year inflation since the summer of 2001. While the core CPI year-over-year rate of 2.2% was considerably lower, the rate moved up steadily from the 1.1% level at the start of the year. Other inflation barometers also appear pointed in the direction of higher prices. The often dismissed—but still important—commodity price futures index (CRB) hit a 23 year high during 2004, hitting a level of about 290, which was led by soaring oil/fuel prices, a marked increase in metals to supply global growth activity and, to some degree, higher food prices. At the start of 2005, the CRB was hovering around 280, which is still high by historical standards. Oil, an important component of the CRB, took center stage by reaching record prices during the second half of 2004 due to both demand and supply factors. While oil prices receded by the end of the fourth quarter, they remained well above levels normally seen since the Gulf War Crisis. They appear poised for considerable volatility in the foreseeable future. Beyond commodity price risk, finished prices of currency-adjusted imported goods could be escalated by the impact of the falling dollar.

Guiding Portfolio Strategies
McDONNELL INVESTMENT MANAGEMENT, LLC
1515 West 22nd Street • 11th Floor • Oak Brook, IL • 60523 • 630.684.8600

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In the last decade, one factor holding down inflation was the influx of low priced goods from overseas. This factor is likely to diminish on many imported foreign goods. Chinese goods, so far, are immune to this issue since their currency is pegged to ours; however, most other trading partners see their currencies float with their goods becoming more expensive versus a cheaper dollar. While the weaker dollar helps U.S. manufacturers and related jobs, higher prices at home can have a negative cost-push inflationary factor on corporate margins or consumers. Likewise, the imposition of U.S. tariffs on foreign steel had a similar impact by supporting U.S. manufacturers at a cost passed on to others.

**➔ Trade Deficit and the Falling Dollar**

A trend that consistently has moved in the same direction since 1993 and sharpened since 2001 has been the ballooning trade deficit and the decline of the Current Account Balance (exports less imports of goods, services and income). The trade deficit has weakened the support for the dollar, which has been particularly evident in its relationship to the Euro and, to some extent, the Yen. Loss of confidence in the dollar raises concerns and has serious potential implications. It begs the question whether foreign investors will lose faith in dollar-denominated securities and reduce their share of holdings of U.S. bonds and other securities. Consequently, such a condition would likely draw rates higher in order to entice buyers to fund our growing federal budget deficit as well.

While there is an argument that a weaker dollar is a necessary balancing act in order to reduce the trade deficit and generate more advantageous conditions for the U.S., the downside could still be adverse for bonds. Foreign central banks like China and Japan have increased their holdings for U.S. Treasuries; however, they may have done so more to protect their interests relative to the dollar rather than as "best buy" investors. Non-central bank investors face the risk of a double whammy if the U.S. dollar is falling and rising interest rates lower bond prices. Higher interest rates would eventually attract foreign buyers once it appears that conditions are likely to stabilize and readjust for the dollar and interest rate trends.

**➔ Credit Conditions**

We are three years into the economic recovery; money is extremely easy and yet credit expansion remains relatively low, especially for businesses.

In the current credit environment, we believe that the Federal Funds rate is below "neutral" (boundaries undefined) and that the Fed has indicated that it wants to increase rates at a measured pace to bring us from an accommodative stance to a neutral stance. While the Fed has raised the Funds rates by 125 basis points in the past year, the current nominal 2.25% translates to approximately 0% in real terms, which is still low by historical measures. Since 1962, the average real Fed Funds rate (nominal fed funds less core inflation) has been approximately 2%. With core CPI at 2.2%, a neutral Fed Funds rate might be as high as 4%.

In addition, lending standards remain extremely loose due to a falling default rate; it is only a matter of time before a more robust economy starts to entice more corporate borrowing. Without companies borrowing aggressively, the need to raise bank rates is smaller than it would be otherwise. If GDP continues at a 3.5% to 4% growth rate by the second half of the year, chances increase that job growth, higher capacity utilization and increased capital expenditures will be increasingly evident.

## *2005 Outlook*

The recent confluence of trends fosters conditions which are likely to push interest rates higher. With some confidence, the Fed has telegraphed that it continues to believe short term rates need to be higher. Our expectation is that the Fed Funds rate increases are most likely to stay within a 75 to 125 basis point increase over the course of this year. We also expect that the market will push 10-year bond rates up somewhat, probably in the range of 25 to 60 basis points.

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The Fed's direct warning that short term rates are headed up in gradual increments hasn't had a direct impact on long term rates to date. The market seems to accept these increases as a way to slow down the economy so that inflation does not become a more serious issue. We believe that recent inflation indicators have advanced and may prompt investors to require higher real returns to compensate for the higher perceived risk.

Although we are anticipating that long term bond rates will go up, the degree to which they will rise is far more speculative, subject to hundreds of moving variables. In fact, depending on the outcome of some these variables, a case could be made that would call for interest rates to fall once again. In the coming year, we are particularly interested in the following key areas that bear watching:

- the speed of global growth
- prices of commodities and finished goods, especially oil
- the demand for borrowing in the credit markets
- the health of the U.S. housing industry
- global political tensions
- sustained support by central banks for the dollar
- willingness of investors to accept low real rates of returns on bonds

While we currently anticipate that long Treasury bonds are likely to see their yields rise, we wouldn't be surprised to see a quick correction if the Fed signals that it is finished raising short term rates and has reached its "neutral" target earlier than we expect. If the Fed signals that the worst of the inflation risk has passed, a bond rally could ensue. This could alter the outcome for interest rate expectations. We are also concerned about the continued strength of the housing market as reflected in the sharply rising increases in annual home sales and values since 1991. We believe that this component of the economy is vulnerable to a bubble, particularly if interest rates move higher at a swift pace due to the high percentage of loans that have been made as variable rate and "interest only" loans. A significant weakness in the housing market could again rally Treasury bonds as the market would see this change as having a negative impact on GDP growth.

While the forecast for 2005 has similar overtones as last year, the chances that the consensus viewpoint of higher interest rates being realized seems to have better odds for realization given the maturity of the credit cycle, increasing deficits and more evident signs of rising inflation. Bond investors are more likely to ask for appropriate increases in rates in order to cushion themselves from the potential for negative real rates of return.

**— McDonnell Investment Management Research & Portfolio Management Teams**