



Fixed Income Insight January 17, 2006

McDonnell Investment Management Market Expectations for 2006

Coming out of the gate in 2006, we believe the economy appears to be on solid footing. Economic growth is expected to register near 3.1% for 2005, job development is sufficient to maintain payroll expansion and inflation appears to be in check despite commodity price increases. This is particularly remarkable in light of circumstances that developed in 2005, which had the potential to undermine growth and stability. However, some of these same clouds still threaten to rain on the economic parade this year. The inverted Treasury bond yield curve has emerged as a point of contention among economists in regards to whether an economic slowdown is being signaled, or if the underlying economic strength is sufficient to overcome the pressures of a flatter yield curve. Amidst this backdrop, bond market prognostication calls for a cautious stance.

McDonnell Investment Management's expectations, barring an abnormal shock, move us to expect that bonds will trade in a narrow range during the year with rates tending to move slightly upward. In general, relative market stability is expected; however, potential weak spots—such as the housing slowdown, high energy prices and consumer debt—will require an offset by the strength and muscle of continued corporate capital expansion, technological benefits, wage growth and relatively healthy global conditions.

Specifically, our expectations for key economic outcomes for 2006 include:

- *Fed Funds rate increase to 4.75%*
- *Two year Treasury to close the year near 4.60%*
- *Ten year Treasury to close the year near 4.80%*
- *Slightly steeper 2-year vs. 10-year yield curve (20 basis points) than at the end of 2005*
- *Two-to-three percent weaker dollar compared to major currencies*
- *Stock market performance of 6%-8% will be slightly below long term historical returns (+10-11%)*
- *Inflation for the year closing at about 3.4%*

The Basis for Our Opinion:

→ Fed Funds:

The Federal Open Market Committee (FOMC) is still in a restrictive mode and has been raising the Fed Funds rate by a gradual 25 basis points at each of its regularly scheduled meetings. In light of the inverted yield curve and the handover of the keys of the Fed leadership position from Greenspan to Bernanke at the end of January, the longer term certainty of further rate hikes is dissipating. We are expecting two more 25 basis point increases to 4.75%; however, there is some support for Fed Funds edging up to as much as 5.25% if first half growth remains above 3.5%. The real Fed funds rate has only recently turned positive at a moderate 0.75%, which suggests more tightening. We think that the Fed will become more concerned about "tightening too much, then having to do a quick ease."

Guiding Portfolio Strategies

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→ *Business Conditions:*

Businesses show the greatest strength in corporate profitability and cash reserves. Capital expansion and replacement has been on the uptick. Global interest rates are still relatively low by historical standards, further facilitating company expansion. These same factors are also fueling increased merger and acquisition activity. High profit levels in 2006 will be more difficult to achieve as higher input costs are factored into the equation.

→ *Regional Growth Trends:*

The Fed's *Beige Book* recently reported economic expansion continued across the 12 Federal Reserve Districts through the last several weeks of 2005. However, increases in employment and wages were characterized as moderate. Retail prices and producers' prices for more finished goods were widely reported as rising only moderately or remaining steady. Several districts reported that energy price increases moderated or actually fell. Other non-labor input costs continued to be a concern as intense competition appeared to be holding down the ability to pass through these costs.

→ *Katrina Impact:*

Most of the expected economic impact is expected to be stimulative. The post-Katrina economy looks strong—third quarter 2005 real GDP showed a 3.8% growth rate, with year-over-year at +3.6%. Final retail sales expanded by a vibrant 4.1% in the third quarter (auto incentives contributed). Much of the \$70 billion in hurricane aid approved by Congress is still not spent. While billions are expected to be available for rebuilding, there could be some negative repercussions from potential defaults by local governments and entities related to the fallout on the Gulf Coast.

→ *Manufacturing:*

More than 1/3 of U.S. manufacturers are operating at greater than 82% of capacity (i.e. plastics, petroleum, paper, electrical equipment, food and beverage, machinery). At this stage of business cycle, strong demand, rising rates of capacity utilization and shortages of some skilled labor have created the potential for further price pressures.

→ *Inflation Risk:*

Near term pressures on inflation continue to be high. CPI 3.5% year-over-year is lower than the high of 4.7% in September 2005, but is still higher than in January 2000 when the Fed Funds rate was at 5.5% and the 10-year Treasury was at 6.5%. Even core CPI of 2.1% year-over-year is higher than the January 2000 level of 2.0%. PCE core stands at 1.8%, near the top end of the Fed's tolerance, which is up from 1.1% in June 2003. Commodity prices overall are still running at very high levels given global demand. Offsetting these factors to some degree is the input of lower prices from imported finished goods. Core inflation is drifting higher, albeit at a low rate.

→ *Impact of Oil and Gas:*

Higher energy prices are sticking (the Dec 2008 oil forwards suggest \$60+ for oil). These costs may ultimately be passed on. Higher energy prices are feeding into the distribution chain; shipping and high energy bills give business a compelling case to mark up prices. In providing some offset to the inflationary impact on prices in general, higher energy prices also act like a tax on the economy. We expect them to continue to be felt through the winter and during 2006. Higher energy prices adversely impact disposable income and savings, and it is possible that consumers may reduce their spending on non-energy goods.

→ *Gold:*

Gold's rise from 440 oz to 540 oz (+23%) during the past 12 months may be a clear signal that confidence in the U.S. dollar and inflation control is waning. However, gold may well be an "outdated" measure of inflation pressures. Since many gold mining companies have stopped hedging, the natural sellers have left the market and Asian demand (i.e. jewelry) has outstripped supply.

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→ *Yield Curve:*

The flattening of the yield curve and possible inversion is occurring in a different environment than previous cycles. The curve may continue to remain flat, albeit at higher levels, in order to curb inflationary pressures and in defense of the U.S. dollar. Foreign bank buying of longer Treasury bonds has lifted bond prices on the long end of the curve. However, China's continued purchase of U.S. treasuries is leveling off and is unlikely to increase given their desire to diversify currency reserves.

→ *Dollar Strength:*

We expect the dollar to lose some ground in 2006. Global central bankers are responding with increased restraint. Without continued restraint from the Fed, the U.S. dollar is likely to come under increased pressure leading to higher import inflation.

→ *Trade Deficit:*

The \$700 billion trade deficit is unsustainable. Unless the U.S. continues to keep higher rates than foreign economies, the dollar could head into a tailspin.

→ *Federal Budget Deficit:*

The Fiscal Year 2006 deficit is expected to be well over \$400 billion vs. \$319 billion in 2005. Treasury projects net borrowing of \$170+ billion in the first quarter of 2006 vs. \$96 billion in the fourth quarter of 2005. There does not appear to be enough political will to reduce spending.

→ *The Vulnerability of Housing as a Stimulus:*

The housing boom has been a primary source of economic stimulus. The risks are growing for a leveling off of home price appreciation, which may reduce consumer spending and confidence. Consumers have recognized the wealth effect of homeownership and have shown a willingness to keep their savings rate below zero in order to participate. Thus far, the interest rate increases seem to be impacting the prices of more expensive homes and regional markets that have experienced spectacular growth. One will need to pay particularly close attention to any broader base decline in home prices as it would certainly impact our forecast for modestly rising rates.

→ *Consumer Strength:*

Consumer confidence rapidly rebounded once the Katrina disaster began to heal. A University of Michigan survey moved consumer confidence from 74 in October to 91 in December, the same level experienced before Hurricane Katrina. Any protracted gains in the stock market are likely to reinforce confidence and absorb some of the drawbacks associated with the downturn in housing appreciation. Offsetting the low consumer savings rate is the fact that net worth, as a percent of income, is on its normal historic upward trend. Moreover, the official savings rate is biased lower by the treatment of pensions, capital gains and durable consumption.

McDonnell Investment Management – Portfolio Management & Research Teams

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