



Fixed Income Insight Second Quarter 2008

May 30, 2008

Review & Outlook of the 2008 Economy and Markets

→ *Market Setting*

- Indicators are signaling an economic slowdown in progress suggesting that we are either in or on the verge of a recession.
- More than normal uncertainty exists throughout the global capital markets.
- Sub-prime loans and leverage losses have contributed to major financial firm write-offs and stricter lending standards going forward. Total banking system losses were around \$231 billion as of April 1, 2008. The potential for much higher losses will depend in part on stimulus packages, housing activity and job stability.
- The credit crunch threatens to pose greater risks to the downside.
- GDP growth rate is likely to remain in the slow growth mode for the year; fourth quarter 2007 growth came in at just 0.6%.
- Federal Reserve, Treasury and Congressional stimulus programs are in the works. The extent of their beneficial impact will be dependent on the scope and timing of their implementation.
- Unemployment rose from 4.8% to 5.1% in March.
- High commodity prices, especially for food and energy, weigh heavily on consumer sentiment and retail sales, and also create a cost push impact toward higher inflation.
- Upside risks to the CPI and core inflation are increasingly evident and raise the risk of stagflation. Inflation is currently running at around 4%, while core inflation is more subdued at 2.4%.
- Fed cuts and the recent economic softening continue to weaken the dollar, thereby helping U.S. exports and raising prices on imports.
- Corporate earnings are expected to wane with the economy with notable exceptions in strong export industries.
- Global growth prospects, albeit still positive, have weakened.
- Geopolitical tensions pose a backdrop risk for the market.

→ *Outlook For Interest Rates and the Markets*

- We expect the Fed to continue to ease albeit at a more cautious pace due to inflationary concerns.
- Despite growing inflation risk, the Fed has indicated “it will do whatever it takes” to assist with the fallout emanating from the sub-prime market and credit crunch
- The Fed may cut by as much as 50 basis points in the second quarter and another 50 basis points through year end, closing 2008 at 1.25%-1.75%.
- We anticipate a continued steepening in the yield curve through the end of the quarter and year.

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 expect 10-year Treasury yields to close the 2nd quarter and year end below 4.0%.
- ❑ 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 remain under pressure compared to most major currencies; there is potential for some near term relief, as G-7 warns that it will not allow the dollar's further deterioration.
- ❑ 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;
 - Sustained support by Foreign Central Banks for the dollar.

Notes and Disclosures

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