Fixed Income Insight
Second Quarter 2010

April 21, 2010

- The U.S. economy appears to have started to recover from the longest and deepest recession of the post war era.
  - Payroll employment has recorded several month-to-month gains, although Census-related hiring may have put a slight upward bias in the figures.
  - The official unemployment rate appears to have stabilized, but the broader measures of labor underutilization are still fluctuating and may, as has been the case in the last two recoveries, head higher.
  - Inflation, as measured by the Consumer Price Index, appears to be in check and seems likely to remain so.
  - The steep decline in home prices appears to have ended, but there is little to suggest that housing market conditions will improve to any significant degree in the immediate future.
- The damage to the global financial system has been extensive and is still being repaired.
  - One of the keys to a sustainable expansion will be the speed with which bank lending resumes.
  - The exchange rate continues to be buffeted by international liquidity concerns stemming from the credit market meltdown.
  - Equity prices have rebounded sharply from their 2009 lows and investors are starting to focus on the quality of earnings going forward.
- The Federal Reserve faces a difficult array of problems as it begins to set a new course for monetary policy.
  - The unwinding of the special asset programs put in place immediately following the credit market meltdown has begun, and markets are beginning to adjust to the new regime.
  - The Federal Open Market Committee is expected to start announcing how and when it will begin the process of bringing the level of short term interest rates into a configuration more congruent with sustained economic growth.
- Federal fiscal policy is expected to remain in a broadly stimulative stance and the budget deficit is not expected to narrow beyond the effects that might be seen from a faster pace of economic activity on Federal receipts and outlays.
- State and Local governments will continue to face severe budget problems for the next two budget cycles.
  - Issuance of Treasury securities is expected to remain high for the foreseeable future.
  - Issuance of State and Local securities will be high, but constrained both by credit concerns and statutory limits.
- Barring another flight to quality scenario, interest rates are not likely to decline significantly from their current levels. Depending on how the Federal Reserve decides to address the short-term interest situation, we expect the slope of the yield curve to remain at, or near, its current configuration or to flatten as short rates rise.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on page 2.

Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

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