Fixed Income Insight
Second Quarter 2007
Review & Outlook of the 2007 Economy and Markets

➔ *Market Setting*

- GDP growth rate has moderated to about 2%.
- Crosswind concerns related to a slowing economy and higher core price trends create environment for increased volatility.
- The housing slowdown continues to be a concern, as lofty price increases subside, inventories remain high and more sub-prime loans fail.
- Consumer confidence flattened in the first quarter but remains in healthy territory. Stocks wavered late in the first quarter after a solid 2006; corporate earnings still positive. Consumer spending depend on business conditions and reinvestment.
- Unemployment is holding near a five year low. Service industry job growth is primarily responsible for stable job picture.
- Core inflation inched up again in the first quarter to about 2.7%; upside risks continue to concern Fed, stemming from:
  - 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 implosions involving sub-prime lenders has not spilled over to general economy.
- Corporate earnings expectations remain positive but at diminishing growth rates.
- Global liquidity is strong helping asset values at large and helping M & A activity.
- Geopolitical tensions pose a backdrop risk for the market.

➔ *Outlook For Interest Rates and the Markets*

- Fed appears to be on hold through second quarter; vigilant about inflation concerns and housing spillover.
- Rates are expected to show a modest decline in the second quarter before moving to the lower end (or below) of their trading range.
- We anticipate a modest steepening in the yield curve (except 5s to 30s) through the end of the quarter with a bias toward steepening by year end.
- We expect 10-year Treasury yields to close the year near 4.5%.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on following page.

McDONNELL INVESTMENT
MANAGEMENT, LLC

1515 West 22nd Street • 11th Floor • Oak Brook, IL • 60523 • 630.684.8600

➔ *Outlook For Interest Rates and the Markets (cont'd)*

- Dollar is expected to continue to lose ground modestly compared to most major currencies.
- Stock market performance of 5% below long term historical returns of +10% - 11%.
- The open issues that could most likely alter the degree or volatility of our rate prediction include:
  - the velocity of a housing slowdown, loan delinquencies and impact on credit standards and consumer confidence
  - 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 and commodity prices
  - the demand for borrowing in the credit markets
  - geo-political tensions, especially in the Middle East
  - sustained support by Foreign Central Banks for the dollar

Notes and Disclosures

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