



## Fixed Income Insight Third Quarter 2008

August 12, 2008

### *Review & Outlook of the 2008 Economy and Markets*

#### → *Market Setting*

- ❑ The economy grew by a slow 1.9% during the 2<sup>nd</sup> quarter of 2008, probably propped up a bit by the federal stimulus checks. The economic slowdown has set a market tone that feels more like a recession even if it is not one officially.
- ❑ More than normal uncertainty exists throughout the global capital markets.
- ❑ Sub-prime loans and leverage losses have accelerated, deepening the already substantial write-offs by major financial firms and causing stricter lending standards. The potential for higher losses depends in part on the impact of the recent federal housing bill, job numbers, the availability of credit and the global economy.
- ❑ The credit crunch threatens to pose greater risks to the downside.
- ❑ Housing sales appear to be trending towards a decline of 10% for 2008, and home prices may decline 20% year over year by December 2008. Real estate loans have slowed on a year over year basis to their lowest growth level since 2001.
- ❑ Unemployment has been on an upward course this year with nonfarm payroll employment declining each of the last seven months.
- ❑ 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 remain evident providing a backdrop risk of stagflation for the economy.
- ❑ Overall inflation appears to be headed over 4% in 2008.
- ❑ Low Fed Fund rates and the soft economy continue to reflect a relatively weak dollar, thereby helping U.S. exports and raising prices on imports.
- ❑ Corporate profits as a percentage of GDP have fallen steadily during the past year from their 50 year peak (Sept. 2006) of 13.7% to a still healthy 11.5%. While they are expected to wane with the economy with notable exceptions in strong export industries, overall corporate profits have softened the blow coming from the current credit crunch.
- ❑ Global growth prospects, albeit still positive, have weakened.
- ❑ Geopolitical tensions, especially related to oil, pose a backdrop risk for the market.

#### → *Outlook For Interest Rates and the Markets*

- ❑ The Fed is expected to hold monetary policy steady through year end in order to balance weak growth with inflation risk.
- ❑ We anticipate a continued steepening in the yield curve through the end of the 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 3rd quarter and year end below 4.0%.
- ❑ Rates are expected to be volatile in response to the tension between recession and inflation risk.
- ❑ While the weakened economy and flight to safety have bolstered 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.
- ❑ Stock market performance is likely to be lackluster with negative returns into the double digits 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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