



Fixed Income Insight Third Quarter 2010

July 27, 2010

→ **The U.S. economy appears to be continuing to recover from the longest and deepest recession of the post war era.**

- ❑ Private payroll employment has recorded month-to-month gains in each of the first six months of 2010. As welcome as those gains have been, they scarcely offset the more than 8.3 million jobs that were lost over the course of the recession.
- ❑ The official unemployment rate has dropped from its peak level, 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. At issue now is how long that statistic will continue to benefit from falling shelter costs which account for 32% of the Index.
- ❑ 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.**

- ❑ Domestic bank lending activity remains dormant, but recent reports suggest the pace of decline has decelerated.
- ❑ The exchange rate continues to be buffeted by renewed international liquidity concerns stemming from the credit crisis in Europe.
- ❑ Equity prices, after rebounding sharply from their 2009 lows, have come under pressure as investors assess both the prospects of the economy in general and corporate profitability in particular. Investors are increasingly focused 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 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.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on page 2.



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- ❑ While their June policy pronouncement said that the Federal Open Market Committee is not anticipating any significant changes in their target interest rate, dissenting opinions in that pronouncement suggested that debate has begun on when such changes may take place.
 - ❑ Although the Treasury yield curve has recently flattened slightly, all of the flattening can be traced to the decline in long rates associated with the flight to quality that accompanied the European credit crisis. The spread between long and short rates remains well above the levels we would associate with the onset of a decline in aggregate economic activity.
- ➔ **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 are very likely to 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 overall State and Local securities appears to be headed for an above average volume year, but tax-free munis will likely be constrained by credit concerns and lower volume if refundings diminish with higher rates. We expect that tax-free supply constraints brought about by the Build America Bond Program will help mitigate the anticipated upward rate pressure that develops as the recovery moves forward.

Notes and Disclosures

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