



## Fixed Income Insight July 17, 2006

### *Review & Outlook of the 2006 Economy and Markets*

#### → Market Setting

- ❑ Cross signals have begun to cloud a clear direction for the markets.
- ❑ GDP growth rate has moderated.
- ❑ Higher oil and interest rates are threatening to slow the economy.
- ❑ To date, consumers appear to be taking in stride the housing slowdown, higher gas prices, interest rates and stock market volatility. Consumer confidence is still solid.
- ❑ Housing appears especially vulnerable to higher rates in high price markets as inventories begin to build.
- ❑ Employment trends should stay positive with at least 1.5 million jobs created for the full year.
- ❑ Inflation appears to be creeping up and becoming entrenched into economy due to:
  - Lagging impact of rising commodity prices on prices, employment costs and weakening dollar;
  - Productivity gains may have peaked causing unit labor costs to go up;
  - Higher import prices affecting consumer goods.
- ❑ Credit Rating changes showed stable conditions in the second quarter with slightly improved upgrade/downgrade ratio.
- ❑ Geopolitical tensions pose a backdrop risk for the market.

#### → Outlook for Interest Rates and the Markets

- ❑ The outlook for one more Fed Fund rates hike is built into our 2006 expectations.
- ❑ Modest upward movement in rates across yield curve expected in 3rd quarter followed by a dip in the 4th quarter.
- ❑ We anticipate a mostly flat yield curve through the end of the year (slight inversion in 3rd quarter).
- ❑ We expect 10-year Treasury yields to close the year slightly above 5%.
  - U.S. bond rates are relatively attractive to global investors, helping to limit the expected rise in rates.
  - Late stage credit expansion in a healthy economy normally contributes to higher borrowing levels propping up rates.
- ❑ Dollar is expected to continue to lose ground modestly compared to most major currencies.
- ❑ Stock market performance of 4-8% for the entire year likely to be below long term historical returns (+10-11%).
- ❑ The most likely open issues that could alter the degree or volatility of our upward rate prediction include:
  - 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 prices
  - the demand for borrowing in the credit markets
  - the velocity of a housing slowdown and impact on consumer confidence
  - geo-political tensions
  - sustained support by central banks for the dollar

**McDonnell Investment Management – Portfolio Management & Research Teams**

*Please refer to Notes and Disclosures on following page.*

*Guiding Portfolio Strategies*

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