



Fixed Income Insight Fourth Quarter 2011

November 3, 2011

→ The economic expansion continues in the United States.

- GDP growth rebounded to a 2.5% annual rate in the third quarter from the paltry pace it had sustained in the first half of the year.
- Helped by a rebound in durable goods spending, Personal Consumption Expenditures made a strong contribution to third quarter growth..
- Business Fixed Investment continued to make forward progress, but almost all of the gains are coming from equipment and software spending. Construction-related activity, be it residential or commercial, remains weak.
- Government spending continues to be a drag on overall growth as fiscal conditions at all levels remain dire. The Super Committee, formed as part of the debt ceiling compromise, will announce its spending reduction plans in November.

→ The employment situation continues to perplex.

- Private payroll employment has been making forward progress since early 2010, adding more than 2 million jobs. However, this has hardly made a dent in the more than 6 million jobs lost during the recession and its aftermath.
- State and Local payrolls, meanwhile, continue to shrink with almost 700,000 jobs lost since the trend turned downward in 2008.
- Underemployment continues to be a concern. The broadest measure of unemployment continues to track above 16%. The fact that is still within hailing distance of its cycle-high of 17.4% in a recovery that is now more than two years old is an indication of how difficult it has become to attain any real improvement in employment conditions.
- A further reflection of the changes in the unemployment situation in this recovery is the fact that the long-term unemployed – those out of work for 27 weeks or more – are now the largest cohort in the ranks of the jobless.

→ Inflation remains a concern.

- Despite some abatement in energy prices, both the Consumer Price Index and the Personal Consumption Expenditures Price Index, continue to trend higher.
- Perhaps because of concerns over the stability of world credit markets, as well as the viability of the domestic economic recovery, the Federal Reserve has had little to say about the changing inflation dynamic.
- Shelter costs, which had been helping to restrain the rise of the major price indexes, have accelerated reflecting the strength of the residential rental market.
- Nonetheless, it is difficult to envision sustained demand pull or cost push pressure with sluggish/modest economic growth, weak employment growth, and excess capacity.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on page 2.



MCDONNELL INVESTMENT
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Guiding Portfolio Strategies

→ **Public finances, both here and abroad, come under intense scrutiny.**

- ❑ The United States saw its credit rating lowered to AA+ in the midst of a debate over the debt ceiling. The gridlock and brinkmanship of the budget negotiators sparked concern that there would be no serious consideration of a solution to the current budget imbalance.
- ❑ Debate over the resolution of the Greek debt owned by European banks culminated in a temporary negotiated settlement that is unlikely to provide a fundamental solution to either the Greek or broader Europe debt crisis.
- ❑ State and local finances remain stressed and further austerity measures are likely to be enacted. News of what will be done next at the Federal level will arrive with the announcement by the Super Committee in late November.

→ **Fixed income markets continue to struggle with multiple valuation issues.**

- ❑ The debt crises both here and abroad roiled fixed income markets worldwide as flight-to-quality issues swamped all other considerations.
- ❑ Treasury interest rates moved sharply lower as credit concerns mounted.
- ❑ The Dollar strengthened against its major counterparts because of its safe-haven characteristics.
- ❑ The entire Treasury yield curve moved below the headline rate of inflation, resulting in negative real rates of interest.
- ❑ The question now is when and how these effects are worked out of fixed income prices.
- ❑ Monetary policy remains in stimulative mode, with a low Target Funds rate and rapid money supply growth.
- ❑ There is some evidence of a thaw in commercial and industrial loan activity, suggesting that banks are starting to be less cautious in their credit assessments.
- ❑ Even so, real estate portfolios continue to be trimmed as banks seek to improve their balance sheets.

Notes and Disclosures

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