



Fixed Income Insight December 15, 2006

Review & Outlook of the 2006 Economy and Markets

→ Market Setting

- ❑ Cross signals cloud a clear direction for the markets.
- ❑ GDP growth rate has moderated.
- ❑ Higher oil and interest rates in the first three quarters appear to have slowed the economy; recent moderation noted.
- ❑ 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. Stock market direction has been positive since summer.
- ❑ Housing appears especially vulnerable to interest 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.
- ❑ Core inflation appears to be creeping up and becoming entrenched into the economy due to:
 - Lagging impact of rising commodity 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 mostly stable conditions this year (to date) with slightly improved upgrade/downgrade ratio.
- ❑ Geopolitical tensions pose a backdrop risk for the market.

→ Outlook for Interest Rates and the Markets

- ❑ Additional Fed Fund rate hikes have become unlikely; although the Fed officially remains vigilant about inflation concerns.
- ❑ Modest movement in rates across yield curve is expected in 4th quarter.
- ❑ We anticipate a mostly flat yield curve through the end of the year.
- ❑ We expect 10-year Treasury yields to close the year slightly below 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 8-12% for the entire year is likely to be close to 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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Notes and Disclosures

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