Fixed Income Insight
Fourth Quarter 2007

October 15, 2007

Review & Outlook of the 2007 Economy and Markets

➔ *Market Setting*

- Fed easing in September mitigated heightened market volatility, which emerged due to fears about potential fallout from sub-prime loans and leverage exposure.
- GDP growth rate is likely to range in a moderate zone between 2% and 2.5% this year.
- Unemployment has inched up from a five year low. Sufficient job growth is likely to keep the jobless rate below 5% through year end. A slowdown in goods producing industry job numbers is being closely watched.
- Concerns about high commodity prices, the slumping housing sector and the vulnerable stock market are present.
- Housing continues to be a source of anxiety, as home sales activity diminishes, lofty price increases subside, inventories remain high and more sub-prime loans fail.
- Consumer confidence ebbed in the third quarter.
- Stocks enjoyed a steep rise in the second and early third quarter due in part to M&A activity and continued positive earnings; however, activity has slowed since the end of July.
- Upside risks to core inflation, which stabilized in the second quarter, continue to concern Fed and stem from:
  - Lagging impact of rising commodity prices, employment costs and continued potential for weakening dollar;
  - Peaking of productivity gains which have caused unit labor costs to rise;
  - Higher import prices affecting consumer goods.
- Credit implosions involving sub-prime lenders has adversely impacted general economy, especially construction and finance.
- Corporate earnings expectations remain positive but at diminishing growth rates.
- Global liquidity has recently tightened significantly although economic growth still appears generally positive.
- Geopolitical tensions pose a backdrop risk for the market.

➔ *Outlook For Interest Rates and the Markets*

- Fed may lower its lending rate by 25 basis points before year end in order to protect growth.
- Rates are expected to be volatile and credit spreads are likely to remain wider than at the start of the year.
- We anticipate a modest steepening in the yield curve through the end of the quarter and year.

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on following page.

➔ *Outlook For Interest Rates and the Markets (Cont'd)*

- We expect 10-year Treasury yields to close the fourth quarter near 4.5%.
  - U.S. bond rates are relatively attractive to global investors as they help limit upward pressure in rates.
- Dollar is expected to continue to lose ground modestly compared to most major currencies.
- Stock market performance appears volatile; could be below long term historical returns of +10%-11%.
- The open issues that could most likely alter the degree or volatility of our rate prediction include:
  - the speed of global growth;
  - domestic job base stability;
  - containment of losses emanating from sub-prime loans and leverage;
  - healthy but declining corporate profits;
  - upward price pressure on goods and services due to pass-through of commodity price increases;
  - energy and commodity prices;
  - the demand for borrowing in the credit markets;
  - the velocity of a housing slowdown, loan delinquencies and impact on credit standards and consumer confidence;
  - geo-political tensions, especially in the Middle East; and
  - sustained support by Foreign Central Banks for the dollar.

Notes and Disclosures