

Fixed Income Insight

May 2, 2005

Second Quarter 2005 Outlook & Review of the Economy

→ Backdrop of Market Conditions

- Economists are expecting higher interest rates.
- Business conditions appear favorable.
- Fed poised to raise short-term rates in line with its restrictive monetary stand.

→ Geo-Political and Economic Environment

- High and extremely volatile oil/energy prices.
- Growing trade and budget deficits.
- Falling dollar.
- Ongoing terrorist threats and Middle East stabilization.

→ The Basis Of Our Expectations For Modestly Higher Interest Rates

- Economy appears to be growing at a healthy 3% to 4%.
- Unemployment is lower (5.2%) than it was a year ago (5.7%).
- CPI and other barometers of inflation have troughed and seem pointed in the direction of higher prices. Recent inflation pressures coupled with soft patch create possibility of stagflation.
- Growing trade deficit and a more volatile dollar could require higher rates to entice buyers of dollar-denominated securities and fund growing federal budget deficit.
- It may only be a matter of time before credit expands in a healthy economy, leading to higher borrowing levels.

→ Outlook For Interest Rates

- The Fed has telegraphed that it continues to believe short-term rates need to be higher.
- Our expectation is that increases in the federal funds rate are most likely to be between 75 and 100 basis points.
- We expect the market will push 10-year Treasury rates up in the range of 40 to 75 basis points from the yield of 4.19% on May 1.
- We are anticipating that long-term rates will rise, but the degree to which they will rise is far more speculative and depends on multiple variables:
 - the speed of global growth
 - prices of commodities and finished goods, especially oil
 - the demand for borrowing in the credit markets
 - the health of the U.S. housing industry
 - global political tensions
 - sustained support by central banks for the dollar
 - willingness of investors to accept low real rates of returns on bonds

— McDonnell Investment Management Research Team

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