

Fixed Income Insight

July 15, 2005

Third Quarter 2005 Outlook & Review of the Economy

→ Backdrop of Market Conditions

- Market economists (WSJ poll) are still expecting higher interest rates despite bond yields trending in the opposite direction.
- Business conditions appear mostly favorable with steady employment gains.
- Inflation appears manageable even in the face of higher commodity prices.
- Fed poised to raise short-term rates in line with its less accommodative monetary stance.

→ Geo-Political and Economic Environment

- High and volatile oil/energy prices.
- Growing U.S. trade and budget deficits.
- Strengthening dollar – reversing early year expectations.
- Ongoing terrorist threats and Middle East instability.

→ The Basis of Our Expectations for Modestly Higher Interest Rates and Further Flattening

- Economy appears to be growing at a healthy, but constrained, 3% to 3.5% pace.
- Unemployment is lower (5.0%) than at anytime since 9/11/2001.
- CPI and other barometers of inflation have troughed and seem pointed in the direction of slightly higher prices.
- 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.

→ Outlook for Interest Rates

- The Fed has indicated 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 50 and 75 basis points from 3.25% on July 1.
- We expect 10-year Treasury yields to rise in the range of 20 to 40 basis points from the yield of 3.91% on June 30.
- We expect the yield curve to continue to flatten, albeit at a decelerated pace.
- We are anticipating that long-term rates will rise slightly, 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
 - effects of pension reform

McDonnell Investment Management – Portfolio Management & Research Teams

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