

## Fixed Income Insight October 7, 2004

### *It Should be an Interesting 4<sup>th</sup> Quarter*

At the onset of this year, the bond market heavily anticipated higher interest rates by year-end. During the third quarter though, only the short end of the yield curve made good on that prediction. Short rates are up thanks to the Fed doing its part; however, long term rates are now lower than they were on January 1. Will the economy regain its footing in the fourth quarter and fulfill expectations of moderate growth without overall inflation marking the end of 2004? Or will high oil prices steal the show?

In the backdrop of the apparent summer slowdown, steadily rising oil prices clearly emerged on the radar screen. Pushed up by a host of conditions created by geopolitical concerns (Iraq and Nigeria), steady demand and mother nature's flurry of hurricanes, prices hit an all time record high of \$50 per barrel just as the quarter ended. For the third quarter, the combination of Fed tightening and higher oil prices caused intermediate- and long-term bonds to perform relatively well with positive returns. The flattening yield curve indicated that the bond market was hardly worried about inflation and that the Fed may be ahead of the market cycle. According to Lehman Brothers Indexes, long Treasuries had quarterly total returns of 6.36%. Intermediate Treasuries showed a positive performance of 2.2%, which fell short of investment grade intermediate corporates at 3.49% and ten-year municipal bonds at 4.14%. These relatively solid third quarter returns brought bonds back into the plus column for the year to date.

#### *More rate hikes on the way?*

Mr. Greenspan and the Federal Reserve stuck to their pronouncement of measured rate hikes. They held fast despite generally languishing economic conditions throughout the summer. Believing that a defensive Fed stance was necessary to maintain a balanced economy of moderate growth, the Federal Reserve justified its position to act in order to preempt budding inflation in light of the lowest Federal Reserve rates in over 40 years.

We anticipate that the Fed will continue to raise rates in at least one of its two remaining meetings this year. With Federal Reserve borrowing rates still below 2%, further incremental rate hikes are intended only to moderate growth, not to draw it to a sudden halt. The key issue is whether the economy will generate sufficient profitability and job growth to maintain consumer spending and capital investment. A big part of that question depends on whether fuel costs are lowered before heating costs are added to the equation. Initially, rising oil prices tend to have a dampening effect on the economy causing bond prices to go up and stocks to languish, much like the impact of higher taxes. If the perception changes that the problem won't be short-lived, then the chance for a period of higher interest rates due to inflationary pressures—coupled with a slow economy—increases.

#### *Oil at center stage - no pain, no gain.*

The prospects for oil prices could well be the key to the economy and to the bond market in the fourth quarter and beyond. There is some comfort in recognizing that the circumstances creating the recent surge in prices may be due to some temporary influences. Hurricanes impacted drilling facilities and refineries in the Gulf of Mexico, while a political crisis in Nigeria threatened to disrupt deliveries from there. Nevertheless, larger issues remain that raise our long term awareness of the vulnerability of global sources, particularly those from the Middle East. Under current and foreseeable circumstances, it is not unrealistic to be prepared for more volatility and higher oil and heating prices.



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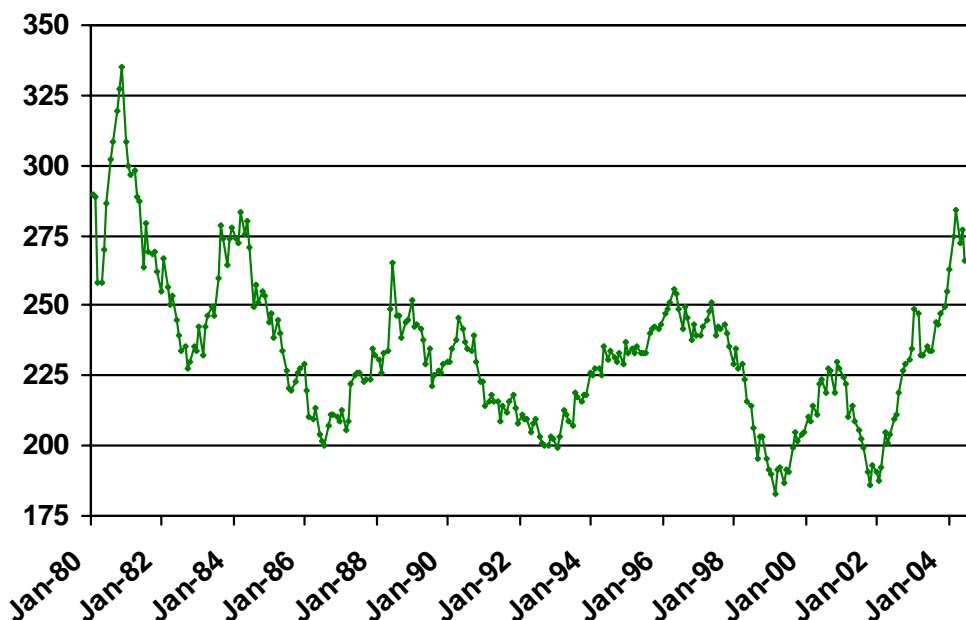
Oil prices are still nowhere near the negative growth burden that they were in the 1970s when they reached an inflation-adjusted equivalent of \$80 per barrel; however, they could spell at least near term growth problems for the U.S. and global economy if they are sustained. One notable difference that might cushion the impact of oil on the economy is that oil consumption may not have as much an influence on the overall U.S. economy as it did 25 years ago. Bridgewater Associates, Inc., an independent economic research company, reasons that “while oil consumption has been rising, it has been a falling percentage of total output. Oil consumption now constitutes about 3% of GDP, well below the 11% it reached in 1980. Oil at \$50 matters, but the impact is still not large enough to substantially affect the overall economy.”

In a worst case scenario, sustained high oil prices could lead to a stalling of the global economy. Moreover, the situation could lead to higher prices on a host of other goods and services if a confluence of supply and demand circumstances keep other commodity prices high. Such a combination, if it occurs and persists, could threaten us with a 70's style stagflation.

**Commodity Price Index at 23 year high.**

While inflation, as measured by the Consumer Price Index (CPI), still remains relatively low (annualized CPI at 2.7%), the Commodity Research Bureau/Reuters Futures Price Index (CRB) closed near 285 on September 30, the highest level since 1981. The CRB/Reuters index is intended to be an early warning for potential inflation since it includes an equal-weighted average of commodity price levels, including basic product sources such as food, metals and fuel. Although the CRB has not been shown to have a high correlation with the CPI, it raises the suggestion of cost push inflation when its trend is longer lasting. When you look at the lofty level of the current CRB index (see chart below), the current US CPI number is remarkable by its contrast. The relatively manageable CPI has been made possible in large part by the beneficial global impact of productivity improvements as well as lower prices on goods imported from low cost countries. In the latter case, how long can the benefits from imports be maintained if we cannot balance them with the appropriate level of exports? Our current account deficit remains on a steadily wrong course, presenting a long-term concern.

**Commodity Research Bureau Index  
January 1980 – October 2004**



Source: Bloomberg

## *A silver lining?*

There may be some good news in all of this. The silver lining of higher oil prices lies in the potential it presents for an entrepreneurial economy facing the reality of a world too dependent on oil to fuel its economy. Facing this issue sooner rather than later is probably in our best interest. Higher oil prices are raising economic feasibility prospects for increased oil exploration, alternate fuels and better conservation. Drilling rig exploration is up again, the hybrid car Prius has a long waiting list for orders, alternate fuel power generation ideas are coming off the dusty shelf and the new Boeing Dreamliner plane, whose chief advantage is fuel efficiency, looks like it will become more of a reality than a dream. Perhaps the era of the low mileage sports utility vehicle may be nearly over. Although persistent high oil prices in the foreseeable future would likely keep the economy in a slower motion than we have been accustomed to in recent years, the opportunity that is presented might be one that it is better to take advantage of now rather than later. The old adage “no pain, no gain” may be appropriate here to better maintain global economic balance for future generations.

## *Expectations.*

Without reaching for worst case scenarios, we expect that the economy will likely finish the year with a growth rate close to 4%. Corporate earnings should be fairly good—but not great—due to satisfactory sales, fairly lean operations, low debt costs, and no big upturn in the jobless rate; but there also should be lower margins in many industries because of higher commodity prices. Current and projected trends suggest a somewhat more positive market for equities in the fourth quarter, but the stock market could get derailed if the upward trend in oil prices is not offset with good news on other fronts. We don't expect the fourth quarter to continue the recent steady gains in the bond market.

Inflation risk may be increasing and should be watched for sudden market obsession with the rising CRB index. It doesn't appear that the market at large is paying much attention to the CRB so far because it believes that commodity increases in general have been created by short term influences. Looking at the steady rise in the CRB since 2001 suggests otherwise. The trade and budget deficits are not helpful to long-term bond rates either. Geo-political and terrorism risks lurk to make markets nervous and more volatile and may temper any rate rise. In our view, these are times when a balanced, diversified portfolio structure is warranted.

## *Key rates on 10/1/04:*

	<u>Treasury</u>	<u>Corporate (AA) Industrials</u>	<u>Municipal AAA Uninsured</u>
<b>2-year</b>	2.62%	2.95%	1.89%
<b>5-year</b>	3.37%	3.84%	2.55%
<b>10-year</b>	4.13%	4.72%	3.47%
<b>30-year</b>	4.89%	5.51%	4.58%

Sources: Thomson Financial Markets, Lehman

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