



Fixed Income Insight Third Quarter 2007

August 22, 2007

Review & Outlook of the 2007 Economy and Markets

→ *Market Setting*

- ❑ Substantially heightened market volatility has 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 to 2.5% this year.
- ❑ Unemployment is holding near a five year low. Sufficient job growth is likely to keep the jobless rate below 5% through year end.
- ❑ Concerns about high commodity prices, the slumping housing sector and the fallback in the 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 dipped in August related to overall market jitters.
- ❑ Stocks enjoyed a steep rise in the second quarter and early third quarter due in part to M&A activity and continued positive earnings; however, a reversal has been in play 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 may be spilling over to general economy.
- ❑ Corporate earnings expectations remain positive but at diminishing growth rates.
- ❑ Global liquidity has recently tightened significantly although economic growth still appear generally positive.
- ❑ Geopolitical tensions pose a backdrop risk for the market.

→ *Outlook For Interest Rates and the Markets*

- ❑ Fed appears likely to respond to broadening of the sub-prime contagion by lowering its borrowing rate.
- ❑ 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.

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

- ❑ We expect 10-year Treasury yields to close the third 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 headed significantly 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

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