Fixed Income Insight
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Bonds Surpass Expectations During First Quarter Due to Subdued Jobs Picture – Patience is the Watchword

The bond market gained ground this quarter despite the fact that the overall economy continues to generate solid growth in the form of positive monthly economic reports and corporate profitability. After a relatively thin job growth report in February, the market began to reverse budding expectations that the Federal Reserve was moving closer to tightening monetary policy. The rather tame jobs picture has helped bonds to mainly go up in price, the opposite of what most economists and market experts expected to happen at the start of this year. While the Fed held fast to its 1% federal funds borrowing rate, Chairman Greenspan, in a January 28 release, backed away from statements made last year that interest rates would stay low for a "considerable period of time." Fine tuning his comments further at the March 16 FOMC meeting, the Fed reaffirmed the lowest funds rate in 46 years, and stated that it could be patient before having to tighten.

Continued low interest rates are a reflection of modest inflation reports and expectations. Most analysts are currently pegging inflation expectations to the level of new jobs. However, underneath the surface, current low interest rates are probably also tied to other factors, including foreign central bank purchases of U.S. Government bonds to manage their currency as well as an unquantifiable "flight to quality" factor related to the lurking shadow of terrorism. Escalating energy prices have been a highly visible exception to stable prices; however, they have thus far failed to draw most other prices upward.

In a recent report, the economic research firm of Bridgewater Associates, Inc. reasoned that two factors are most at work in holding down inflation. The first factor is a glut in global labor (i.e. China and India impact, especially given currency policies) and, second, productivity gains resulting from the huge investments in technology during the 1990's.

This is not your typical recovery.

Job growth or "the lack thereof" is a heated topic in the current Presidential election. The markets have joined this debate as to why jobs are not being generated at a faster clip. The question of whether jobs alone drive economic growth and subsequent inflation may be a bit oversimplified. Nevertheless, that is the focal point that this market has targeted to determine whether or not a tightening will be required. The current job growth picture does not replicate typical recoveries following a normal cyclical downturn. The large number of jobs created in the second half of the last decade to handle the explosive growth of technology pursuits were not all built on a permanent foundation of real growth. Take for instance the "paper tiger" companies related to the Internet, telecom, as well as the one-time crisis avoidance heroes that managed to protect us from Y2K, and one can see that a fair share of jobs were not sustainable. When stock market valuations on many of these companies eventually tumbled on these lucrative, short-lived business pursuits, many highly paid direct and peripheral jobs could no longer be justified.

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Most of the high flying jobs of the 90's technology boom were not likely to be recreated after the recession had run its course. However, the beneficial side effect of the boom is that technology advances of the last decade left behind more efficient infrastructures to enhance and extend productivity improvements, helping companies to do more with less. Nevertheless, the expectation of returning to the peak of prosperity after a structural dislocation is unrealistic. For similar reasons -- looking back 70-80 years -- the economy of the 1930's was slow to recover once the economy began to readjust to the technology advances of the assembly line, and the market unwound its own irrational exuberance of the 1920's.

Fiscal and monetary policy remain in high gear, setting the stage for higher rates later.

Still, economic growth and consumer confidence have mostly pointed upward. Accommodative monetary and fiscal policies are in place to stimulate the domestic economy and consumer spending. The question of whether there is a risk of overheating the economy, which would drive up inflation and then interest rates, remains an open question.

Assuming Chairman Greenspan's assessment that productivity gains have nearly run their course is correct, then more jobs are likely on the horizon to meet production targets. That would be a drag on earnings unless prices are raised. As long as the economy does not fall into a tailspin, we expect that the market and the Fed will begin to anticipate inflation and begin the process of tightening. Conventional wisdom suggests that if we continue to keep both pedals down on fiscal and monetary policy, particularly as productivity improvements are exhausted, we are likely to rekindle the inflation flame already being kept warm by today's high fuel costs. If this scenario plays out, we believe that interest rates are more than likely headed up, possibly before the end of this year, unless consumers "run out of gas" or a new "flight to quality" concern rears its head.

Distinguishing bond credit quality takes on heightened importance.

Corporate management's recent emphasis on improving the balance sheet, reducing leverage and maintaining earnings presents a better case for credit quality. However, quality spread tightening for corporate bonds was so strong last year that weaker companies probably got ahead of themselves in price appreciation relative to higher grade issues. Corporate spread tightening experienced in 2003 is not likely to be repeated. For corporates, most of the good news is already built into these levels. Sound fundamentals continue to underpin credit spreads as we move into the second quarter. Municipal bond investment grade quality spread opportunities are limited given the abundance of bond insurance. However, some uninsured bond issues have some room to tighten, such as in California and for non-governmental issues, such as hospitals. In general, municipal credit trends lag corporates because a substantial portion of their revenue structure (e.g. income, sales or property taxes) is either collected or distributed on a delayed basis from the time that it is earned.

Richard A. Ciccarone
Managing Director & Chief Research Officer,
McDonnell Investment Management, LLC

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