Fixed Income Insight
August 6, 2003

A Shaken Bond Market Looks for Interest Rate Stability

After hitting their lowest yield levels in 45 years, bonds began an abrupt bounce back upward after June 13 and continued the upward ascent through the end of July. Yields on the 10-year Treasury stood at 4.47% on July 31, 2003, nearly 40 basis points higher than at the start of the year and 140 basis points higher than the low point in mid-June. Interest rates on corporates and municipals have also moved higher, in sympathy with treasuries and agencies. Investors' sentiments are that the economy and corporate earnings appear to be optimistically positioned for better days ahead. Reinforcing the point, the Beige Book report issued on July 30 revealed that growth was positive in most Federal Reserve Districts. In addition, the ballooning federal deficit supports the probability that a new burst of treasuries may flood the bond market driving yields up.

As interest rates moved up, the yield curve steepened even further. Historically, such a positively shaped curve suggests that higher rates are probably on the horizon. The swiftness that interest rates moved up since June leaves open the possibility that the market is ready for a pause to test whether recent economic optimism can be sustained. Investors still stinging from fresh memories of the booming stock market of the late 1990s that burst suddenly into a prolonged slump are likely to be wary of any market that appears to go too far, too fast.

While corporate margins showed improvement in the second quarter, most gains were due to cutbacks and efficiencies rather than revenue growth. While GDP growth is expected to be positive, expectations as to the degree are relatively guarded. Moving interest rates up too rapidly could throw a wrench in the recovery, necessitating continued Fed support for low or lower rates later this year. Deflation is still a watchword at the Fed.

The decline in Treasury bond prices dragged down agencies, corporates and municipals in July. All bond categories across the yield curve are registering higher yields than at the start of the year. Credit quality hasn't been as much of an issue as it was last year in the corporate market. Quality spreads have narrowed as a result of improved credit prospects. For municipals and agencies, credit issues have played a somewhat larger role. A fiscal crisis in California and a downgrade by S&P on its bonds to BBB became a major issue for the market and widened spreads on uninsured paper. In the Agency arena, Freddie Mac paper languished as European investors sold the securities after revelations of accounting issues within the federally chartered companies.

Corporate Bonds

Corporate investment grade bond issuance has been running at one of the highest volume levels in the past decade. The 2003 credit environment appears relatively calm compared to the previous two years when many credits fell into speculative rating categories and, for some, default. It would appear that the trough of the credit cycle is behind us. According to S&P statistics, prior to the current deceleration in the pace of "fallen angels," the number of downgrades to speculative status rose every year since 1996. Overall, the ratio of downgrades to upgrades by all three major rating agencies is showing some improvement. This year could well have the best rating change ratio in at least five years if current credit and economic conditions continue on course.

Guiding Portfolio Strategies

MCDONNELL INVESTMENT MANAGEMENT, LLC

Fixed Income Commentary and Strategy
August 6, 2003

Corporate bond issuers generally have focused on improving their balance sheets by foregoing capital expenditures in favor of improving free cash flow. As a rule, companies are attempting to deleverage from generally very high debt ratios. Weak global conditions have hurt companies that depend heavily on overseas activities. For other companies, the weaker dollar has improved prospects for competing against imports in this country. As mentioned earlier, recent earnings reports are largely improved but heavily associated with margin improvement related to cutbacks, not revenue growth. Economic strengthening is evident but it is not sufficiently developed to avoid vulnerability. Pension underfunding on defined benefit plans related to older, larger industrial companies also remains a concern for future earnings. Although higher interest rates and improved equity values will help, many of these programs have been hurt and could require larger contribution requirements.

Favored Credit Sectors:
Our research maintains a preference for the following sectors:

- ► Financial services companies, especially banks and brokerages, due to low interest rates, satisfactory net interest margins, satisfactory loss rates, adequate provisioning, sound capital ratios and decent liquidity levels;
- ► Selected telecom and cable companies, excluding the weaker players in the category;
- ► Energy companies, bolstered by strong oil and gas commodity prices.

In addition, we have selective interest in media, consumer products, capital goods, aerospace/defense and non-merchant utilities. Nevertheless, our bottom-up approach to security selection recognizes that in every favored category there may be weak situations to be avoided. For example, companies in the financial sector that are too heavily exposed to mortgages and/or derivatives could be negatively impacted by higher interest rates.

Municipal Bonds
Municipals are also poised to set a new volume record primarily due to the heavy refundings that occurred in the first half of the year. A slowdown in refinancings is likely to dampen volume if interest rates remain at higher current levels.

On the credit side, municipal bonds typically lag corporates during credit cycles. While state credits are adversely affected by a recession almost immediately, many other municipal sectors have built-in cushions to the early stages of a downturn. These issuers receive revenues from property taxes or essential purpose services such as utilities, transportation, health care or education. Moreover, conservative governmental bodies often maintain prudent reserves in the case of downturns. That is why the impact of the recent economic downturn has had a delayed impact on most municipal sectors.

Fixed Income Commentary and Strategy
August 6, 2003

The erosion in tax and fee revenues is just starting to show up in a negative downgrade trend affecting municipal issues. In the first half of 2003, the combined total of the three major rating agencies showed, for the first time in a number of years, downgrades outpacing upgrades (473 to 369). The dollar volume of downgrades also exceeded upgrades by a 4.8:1 ratio as indicated by Smith's Research & Ratings. Those municipal sectors seeing the most downgrades were special revenue bonds (tobacco, project finance), health care bonds and leases. The best sectors for upgrades were related to utilities (water, sewer, electric) and housing bonds.

Municipals are also more sensitive to regional economic conditions than corporates because they depend on local employment, income growth and business conditions. This year, the Pacific coast states have the most stressed economies and job bases. Pockets of weakness can also be found in New England, and the eastern North Central states. No region is clearly dominant on the positive growth side; however, the Plains states appear to be leading in job growth, followed by pockets of strength in Florida, Nevada, New Mexico, Hawaii, Vermont and Virginia.

The California fiscal crisis casts a pall on municipal credit quality. With a reported $38 billion deficit, a stalemated budget session and the political uncertainty related to the potential recall of the Governor, the largest state in the Union challenges the notion that equates state government general obligation credits with risk free investments. As a result of the downgrade to BBB status by S&P, yields on the state's paper widened by historical standards. While the state officially approved a budget during the first days of August, the compromise involved one-time revenue infusions and deficit borrowing that defers the crisis into the future. Despite realistic concerns about the budget, its approval averted a potential credit crisis which would have precluded the ability to borrow to cover a cash gap, reminiscent of past G.O. bond financial debacles like New York City and Cleveland. While the overall default rate of municipals has remained low during the recent downturn, individual problems could emerge with project and revenue bonds. Tobacco bond issues have not fared well as litigation portends judgments against the tobacco firms. In addition, a downturn in cigarette sales related to major tobacco settlement companies has reduced coverage levels.

Favored Credit Sectors:

Our research maintains a preference for the following sectors:

- Water and sewer bonds due to their essential purpose character and relatively low rates for city and large district entities;
- Electric revenue bonds due to their essential purpose and relative insulation from deregulation as compared to the investor-owned utilities;
- Ground transportation and toll revenue bonds, excluding start-up tollways, due to less cyclically sensitive traffic flows and sufficient coverage from specific fuel and/or sales taxes;
- Local general obligation bonds that are not heavily reliant on state shared revenues or states with high unemployment.

Fixed Income Commentary and Strategy
August 6, 2003

During the remainder of 2003, we look for the fixed income market to be more impacted by interest rate movements than by credit situations. Historically, a rise in credit defaults often follows the trough of a recession. Therefore, we are wary of highly leveraged outliers in the corporate arena that are inadequately protected to weather a slow recovery. On the municipal side, we continue our vigilance for credits that are unusually debt laden and positioned in weak regions or operating environments. We are also guarded in the event that interest rates do not level off, as we currently expect, thereby exposing credits or investment programs with high reliance on rates to vulnerability.

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