Fixed Income Insight
January 15, 2004

McDonnell Investment Management Market Outlook for 2004

Economy and Interest Rates

The global economy generally managed to ride a fairly smooth course in 2003 despite the turbulence in Iraq and the lurking threats of terrorism. Looking ahead to 2004, business conditions and economic growth appear optimistic. We expect that the slow pace of job expansion will accelerate moderately during the year. We also expect a positive but more subdued stock market improvement compared to 2003. Bonds are more likely to be challenged this year in the face of economic growth and the potential for inflation. Bond rates, in our opinion, are modestly inclined to rise defensively to contain the risk of unbridled growth and inflation, even if the Fed is slow to raise the federal funds rate.

Continued spending by individuals on homes, cars and discretionary items along with the Bush tax cuts have contributed to keeping the American economy buzzing. While geo-political and terrorist risks remain a source of concern with the potential to break the momentum in the economy, American consumers have remained characteristically resilient, in the spirit of "life goes on" buoyancy.

During the third quarter of 2003, U.S. GDP growth took a major leap forward, setting the stage for expectations of sustained growth and decent earnings for U.S. companies and individuals. Monetary and fiscal policies are set in high gear with low borrowing rates, high federal spending and reduced taxes. Even after the threat of deflation waned, the Fed continued to hold rates at historical lows based on its concern about the "output gap," the weak recovery in job generation and persistently low inflation.

This year, most economists and market analysts are predicting higher interest rates in line with conventional expectations that growth increases inflation risk, along with increasing budget and trade deficits. In the December survey of economists by the *Wall Street Journal*, the average prediction for the 10-year Treasury called for a 50 basis point increase by the end of June and a nearly 100 basis point upward change by December 31. Only one economist expected interest rates to fall this year. In the last two years alone, the survey has called for considerably higher rates than what actually occurred. So far, in the early days of 2004, interest rates remain low, which is in line with the Fed's opinion that there is considerable slack in the job market making it unnecessary to raise rates.

Barring catastrophic surprises, current economic momentum along with fiscal and monetary policies make it hard to argue that the economy is likely to weaken over the next twelve months. Inflation is likely to move higher given expected 4-5% GDP growth as well as commodity prices and foreign currency trends. In addition, the White House is likely to do all that it can to help create jobs in this election year. At the same time, the Fed continues to justify a low federal funds rate based on slow job growth, strong productivity and restrained inflation, as well as the potential for sudden global disruptions.

Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

We worry that waiting too long to proactively blunt inflation, a sudden inflationary surge could occur in 2005 (or as late as 2006), with serious ramifications for leveraged industrial and individual borrowers. The monthly change in consumer credit, for example, has been exceeding the change in personal income for the past six years. The combined budget and trade deficits are projected to surpass $1.1 trillion in 2004, over 10% of GDP. That's why we believe that the market may impose its own restraints by pushing interest rates up on its own whenever economic news appears to be a little "too good." This may mean that bond prices and performance may have a challenging year. Recent economic indicators suggest gradual, but not necessarily steadily, rising interest rates.

By late in the second quarter of 2004, we expect the Fed to begin changing its cautionary tone related to the relative weakness of the economy. Improved corporate earnings and activity are likely to necessitate some additional hiring and increasing technology purchases, and capital investment should enhance job growth for select manufacturers as well as many service industries. In the interim, the stock market should hold its positive momentum while the bond market adjusts to higher rates, particularly in the short to intermediate (i.e. 2-year to 5-year) maturity range, producing some yield curve flattening. This view is especially vulnerable to event risk having to do with global politics and terrorism. To some extent these risks will keep bond prices within a range since bonds—especially Treasuries—are still the preferred defensive refuge in uncertain times.

A case could be made for interest rates to remain relatively low throughout the year. Growth is not out of control, nor is inflation. There is a historical basis for lower rates over long periods. A look back over time shows that the ten-year Treasury averaged less than 4% for the first seventy years of the 20th century. However, natural forces toward higher interest rates due to economic growth, high commodity prices, and budget and trade deficits suggest an upward correction in rates may be necessary to keep rates from soaring later, if not this year.

Bond Market Expectations

► Treasury and Agency Bonds

In 2003, the Lehman Long Term **Treasury Bond** Index produced a total return of 2.48% while the Lehman Intermediate Treasury Bond Index grew by 2.11% as yield levels rose slightly from the start of the year.

In 2004, we expect interest rates to climb gradually. Based on today's rates, if interest rates increase 50 basis points, the ten-year Treasury note would have a break-even total return.

Last year, **Mortgage-backed agency** bonds produced a slightly higher average return of 3.07% due to their high carry (i.e. yield) and higher rates in the second half of the year, which slowed prepayments. Odds favor a similar scenario for 2004.

► Corporate Bonds

Last year, **investment grade corporate bonds** outperformed Treasuries in both the intermediate and long term maturity ranges due to substantial quality spread tightening that occurred relative to "A" rated and "BBB" rated bonds. The Lehman Intermediate Corporate Index had a 12 month return of 7.47% return while the Lehman Long Corporate Index returned 10.81%.

In 2004, some spread tightening opportunity still remains in the BBB range. Overall, we expect average returns to range between break-even and 5% with lower credit rating bonds having the potential for better returns, assuming that interest rates rise by about 50 basis points.

►Municipal Bonds

In 2003, munis outperformed Treasuries with interest rates on longer term bonds falling despite rising Treasury yields and record municipal supply. The Lehman Municipal 10 Year Index produced a 5.7% total return. When adjusted for high tax bracket investors, investment grade returns were comparable to the corporate bond index but with less credit risk, since the municipal index is heavily comprised of AAA insured securities.

Next year, munis are likely to find it harder to diverge from Treasury bond trends if interest rates continue to rise since their relative attractiveness would diminish. However, municipal bonds could still outperform Treasuries in a rising interest rate market if their pace lags Treasuries. Overall, we anticipate that a 50 basis point increase on the 10 year municipal bond will produce about a break-even return.

Credit Issues

Credit quality differences narrowed last year between the various risk rating categories. The perceived recovery and improvement in the economy reduced the credit risk premium on all domestic fixed income securities. We expect a similar movement in 2004 as long as economic growth continues and no surprise credit crisis emerges.

Corporate Bonds – Time Again to Distinguish Credit Quality

In retrospect, 2003 generally saw corporate credit spreads tighten across the board, but especially among lower rated credits. Downgrades diminished as did global and domestic defaults. In the process, fundamental credit distinctions in the markets loosened with all boats taking the wind at their backs. We expect 2004 to be a year with fundamentals again taking precedence. Among the most positive corporate credit trends we saw in 2003 was the focus on de-leveraging and using free cash flow to pay down debt. While many lower rated companies still have work to do in order to relieve their debt burdens, we expect that free cash flow will increasingly be in competition with equity holders. Investment grade corporate bond credit strategies to enhance investment returns in 2004 include: utilizing the steep credit curve to take advantage of roll down especially at the BBB level, taking on structure risk (e.g. subordinated securities) and taking advantage of some remaining crossover opportunities in the “BB” and lower investment grades.

Despite tight spreads, a moderate overweight in corporates could hold up early in the Fed tightening cycle, partially thanks to an expected decline in corporate issuance. Some important risks for corporates remain. Many corporate borrowers remain heavily leveraged and vulnerable to a sudden rise in rates despite their debt reductions. Company stock and bond valuations appear high. Credit default swaps are becoming an increasingly important factor in the market because they have the potential to artificially influence intrinsic bond prices.

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Municipals – A Recovery in the Nick of Time
Credit spreads tightened for municipals like they did for corporates, but by smaller margins for most credits. California and Healthcare were notable exceptions to this tightening. Tobacco bonds improved as the risk of a draconian class action verdict eased. In contrast to corporates, municipal credit rating trends were more trying with diminishing revenues related to the national downturn having a delayed impact on credit quality. Consequently by dollar volume, downgrades exceeded upgrades by all three rating agencies for the first time in years. Many state governments led the list of troubled credits which recorded huge budget deficits leading to direct and related credit downgrades. Other sectors hurt most by the downgrade wave were special revenue (e.g. tobacco bonds) and healthcare.

While there were no notable municipal defaults in 2003, there were serious fiscal strains spilling over from states to local governments in various parts of the country from California to New York and in between, including Pittsburgh, PA., which was approved for state fiscal oversight. While hospitals produced decent financial results by and large, a fair number of individual downgrades resulted from cost pressures, bad debt expenses, Medicaid and competition. Airport traffic picked up from low levels hit after 9/11, but enplanement peaks were still off. Reserves built up prior to the decline in air activity helped the sector glide through the year but with vulnerability remaining among troubled carrier hubs like Pittsburgh and Denver.

Municipal Sectors
In 2004, we look for states to continue to recover, most local governments to continue facing pressure but with relief in sight from the expected improvement in the national economy. One notable exception is the state of California, which poses the greatest risk this year with its huge budget deficits still needing to be addressed. The difference between a "fiscally stressed" California and a "crisis" will soon be decided by the voters at a March referendum to approve a $15 billion deficit bond financing. Among other credit sectors, local G.O. education bonds could be facing more taxpayer resistance as aging baby boomers start losing some of their enthusiasm for supporting property tax levies. We expect continued stable results from public power, water/sewer and transportation credits. Hospitals should not do badly, but a sorting out process between winners and losers is nearing. The Medicare bill that passed in 2003 should provide a dose of support for healthcare providers. Airports could get dicey as airport gate contracts are renegotiated at hub airports.

With 49% of all municipal credits being insured last year, underlying credit quality issues assumed lesser status than they would otherwise. As long as the bond insurers maintain solid performance and low losses, the differential for buying weak underlying credit issues will likely be small. However, the risk of a bond insurer faltering justifies the long term case for paying attention to the primary credit associated with an insured bond issue. Uninsured credits, like many states, have the potential for some credit improvement this year and could be opportunities for high grade investors.

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Summary of What We Expect for 2004: Key Conditions Impacting the Economy

Positives:

- GDP growth of 4% to 5%
- Good corporate earnings
- Historically low inflation and Fed Funds rate through at least first half of year
- Fiscal stimulus in place (tax cut and federal deficit)
- Moderate to strong consumer spending
- Pick-up in technology spending and capital investment
- Cheap dollar helping some manufacturing exports
- Reductions in overcapacity for some industries
- Steady but not sharp increases in job expansion
- Lower marginal tax and dividend tax rates

Negatives:

- Increasing risk of inflation
- Rising commodity prices
- Rising cost of some foreign imports
- Trade deficit
- Budget deficit
- Geo-political and terrorism risks/costs
- Overcapacity in some industries may slow job growth
- Companies leveraged
- High consumer debt

Interest rates

- 50% chance of gradual increase in interest rates
- 30% chance of more than a 50 basis point increase in rates by year end
- 20% chance of no change or lower interest rates
- Yield curve likely to flatten

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