

# FIXED INCOME COMMENTARY LETTER FIRST QUARTER 2007

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## Overview

For the first quarter of 2007, the markets experienced volatility, primarily stemming from concerns over a U.S. economic slowdown, a declining housing market paired with the sub-prime loan situation, concerns of tightening by Chinese authorities, and continued tensions in the Middle East. In the last three quarters of 2006, the U.S. economy grew at only about a 2.25% to 2.50% real rate, slightly below what is considered its long-run potential. The Federal Reserve's outlook for 2007 is likely even somewhat lower than those rates. Regardless, the U.S. economy has remained resilient due to low unemployment, a continued rise in wages, and measured growth in consumer spending. This variety of factors should lead investors to be cautious, but reasonably upbeat about the near future.

The housing market continues to be a headwind for the economy as home prices are expected to trend flat to down over the medium term. A key question to keep in mind is how steep will the slope of price declines be? No matter how steep, it constitutes a reduction of the housing benefit to consumer spending since spending in recent years was materially driven by home equity appreciation and borrowing. In addition, federal regulators are beginning to demand tighter lending standards, which could be a drag on the residential real estate market. Already this quarter, sub-prime mortgage default rates accelerated and unfortunate stories about lax lending practices became regular news. Sub-prime mortgages were a material portion of the total new mortgages issued during the last few years. Note that only a minority of all these mortgages will default, but it appears the entire category is being painted with the same broad brush, which potentially will result in a contraction of mortgage credit and thus housing demand. If the "marginal demand" of sub-prime borrowers is removed from the market, a major crimp will be put in housing's demand side. Forced selling by some of those buyers could also temporarily increase the supply overhang.

Offsetting this scenario, we continued to experience historically low unemployment rates. As long as consumers have jobs, we are confident they will spend (and spend and spend). The consumer side of the ledger represents about 70% of GDP. Job and wage growth then become crucial factors in maintaining the economy's momentum. How much push we'll get from both of these factors is a big unknown. On the other hand, exports have been growing at a fast rate in recent months, no doubt partly due to the cheaper U.S. dollar.

The Federal Open Market Committee (FOMC) maintained its hands-off monetary policy, leaving its target for short-term interest rates steady at 5.25%, but dropping its bias to tighten, which few investors expected. Yields on short-term U.S. Treasury securities fell (so bond prices rose), while the yields on intermediate and long-term bonds changed little over the quarter. Throughout the period, numerous economic reports presented conflicting views of inflationary pressures. For example, housing and manufacturing activity looked weak, yet the labor market proved to be strong. Debt has become very cheap, especially

for the corporate version of sub-prime homeowners, namely high-yield or “junk” bonds. The extra interest rate these borrowers must pay, above what the government pays, is called the spread. Note that history reveals credit spreads are cyclical.

As for benchmarks, the U.S. investment-grade fixed income market (Treasuries, bonds, and mortgage-backed securities) posted a healthy 1.5% quarterly return, as measured by the Lehman Brothers Aggregate Bond Index. The index declined by 0.04% in January, recovered by 1.54% in February, and ended the quarter unchanged in March. The total return of the Lehman Brothers Intermediate Government/Credit Index rose by 0.04% in January, continued upwards by 1.38% in February, and increased at the end of March by 0.17%, ending the first quarter with a total return of 1.59%.

We remain in the camp of believers that the economy won't slip into a recession and that a big, bad, bear market isn't lurking just around the corner. After all, monetary policy is not (yet) restrictive.

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## Fixed Income Markets

The Fed's current opinion is inflation will be moderate over time, though it warns that “the high level of resource utilization has the potential to sustain those [inflation] pressures.” In addition, the signs of resurgent economic growth, as noted in the FOMC January statement, subsided somewhat towards the end of the quarter, yet those indicators are now all but gone. The Fed is again using its measured language that also described the soft economy in the third quarter of last year: “Recent indicators have been mixed.”

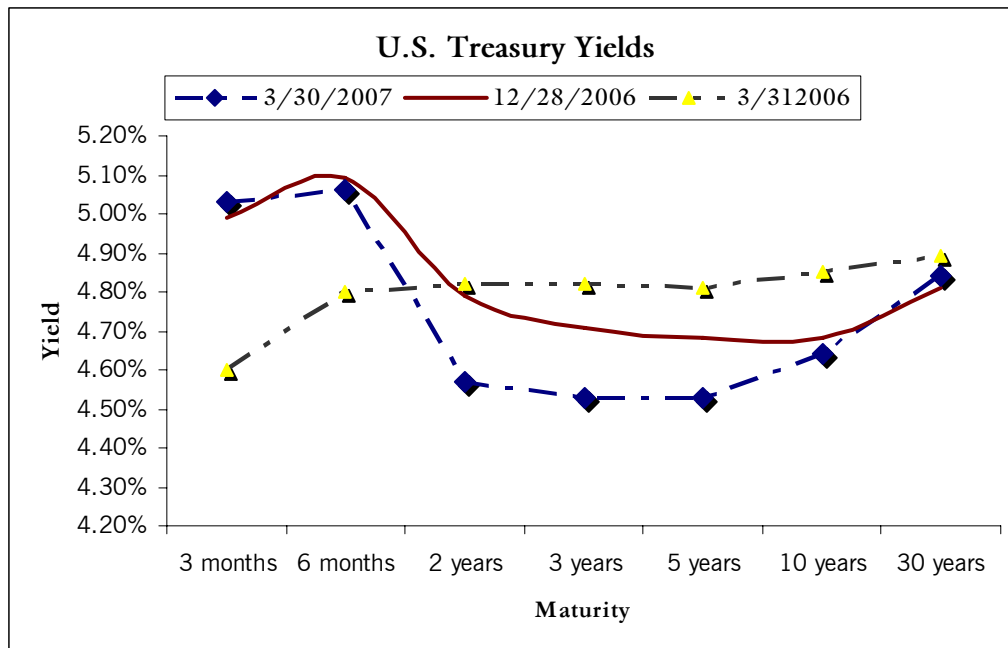
Most institutional fixed income managers seem to expect the Fed to ease interest rates sometime this year, based on an expectation that the primary risk to the economy is a stall. However, the most recently released minutes of the FOMC show they were concerned the odds had increased for inflation failing to moderate as expected, and that inflation risks remained the Committee's predominant concern. We believe the risk is that the Fed may overshoot the target on inflation protection, and in turn, choke the economy into a recession with a tight money policy. Normally, a weakening economy reduces the need to raise interest rates, assuming an increase in inflation does not coincide with slowing GDP (what was termed “stagflation” in the 1970's). Front and center is the overriding question of just how much the economy will slow. Is it poised to be bad enough to engender a recession and a full blown bear market? If so, could it be avoided, and will the Federal Reserve be the market's savior (by easing interest rates) or nemesis (by raising them still higher)?

The bottom line is the Fed conceded a decidedly gloomier economic picture in March than in January, although it does not appear the Committee is prepared to consider easing just yet; rather, they are ruling out tightening. The markets are right to put higher wagers on an ease than before. Still, with the FOMC's emphasis on inflation, it is more likely that the first rate cut will not happen until the later part of the year.

Another reason interest rates may stay elevated is because our federal debt is dependent on demand from foreign countries to buy our bonds. This could force the U.S. to

maintain higher Treasury rates in order to entice foreigners to continue supporting our deficit spending—this issue is worsened by a weak U.S. dollar. In fact, the dollar has been trending down in value versus foreign currencies since its last peak in late 2005. The exchange value of the dollar versus the euro is particularly noteworthy with the dollar close to an all time low when compared to that currency. There has also been talk out of Europe about the possibility of further rate increases in Europe’s key bank rate before year end, further complicating the prospects for lower U.S. rates.

As the following Treasury yield graph shows, the quarter produced little change in yields on bonds with maturities of 10 years or longer. Investor demand drove down the yield on short-term notes, further steepening the curve from its previously flat shape. After being inverted for nearly 10 months, the yield curve has regained some positive slope from the two to 10-year maturities. The yields on two and five-year Treasury notes fell 22 and 18 basis points, respectively, as the market started to price in a higher probability that the Fed would soon reduce its interest rate target.



Source: Bloomberg

The yield spreads between corporate bonds and Treasuries of comparable maturity remained at historically low levels. In this environment, one of our current strategies is to take advantage of the changing spreads and swap out existing shorter maturities with longer ones at discounted rates where we can add additional yield.

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## Sector Updates

Investment-grade corporate bond prices gained some ground in early March after a late-February sell-off, but the recovery was short lived. Another round of selling was

triggered by continuing concerns about sub-prime mortgages. Healthy fundamentals, strong corporate earnings, and ample liquidity in the secondary market should help investment-grade bonds recover. However, market jitters could cause spreads to widen in the short-term.

ICM's clients' portfolios are invested in quality investment-grade corporate bonds within a multitude of sectors, which provides diversification (spreading potentially adverse effects among sectors and therefore reducing overall risk). From a sector perspective we currently like the defensive nature of the consumer non-cyclicals and are avoiding areas in the technology space such as telecom. We also continue to monitor the media and entertainment area.

The municipal bond market is under pressure as the steady offering levels have begun to weaken and the steepening of the municipal curve has begun to increase speculation that the flattening cycle may cease. (i) Municipal bond rates also continue to track Treasury rates.

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## Looking Ahead

In our last commentary we introduced three scenarios regarding how the economy could affect interest rates. We stand by the latter two scenarios currently, but much will depend on what will happen at the next FOMC meeting on May 9<sup>th</sup>. Here are the three possible economic circumstances we discussed last quarter:

- The economy continues to weaken and the Fed begins to cut rates in the first quarter (this obviously did not occur);
- The economy continues to weaken, but the Fed waits until late 2007 to cut rates; or
- The economy rebounds slightly and the Fed holds rates steady.

The extent of the problems within the sub-prime market and its impact on the U.S. economy is expected to continue, and is likely to place greater importance on the FOMC's return to its measured language, and we will continue to monitor the portfolios in light of the Fed's decision. (ii)

We would expect the Treasury and municipal yield curves to steepen gradually throughout the remainder of the year (iii) and believe the belly of the curve will be the best place to benefit from a rise in these curves. We will employ various bond instruments to enhance portfolio returns, especially if the Fed is intent on holding for an extended period of time.

Sufficient diversification has and continues to be one of our risk management principals, and ICM's fixed income investment strategies are specifically designed to handle a dynamic interest rate environment. Going forward, we maintain our disciplined approach of investing appropriately when we find compelling bonds appropriate for your portfolio. We appreciate the opportunity to continue managing your assets and are always available to discuss your portfolio.

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<sup>i</sup> Municipal Market Advisors Tuesday, March 27

<sup>ii</sup> Municipal Market Advisors, Friday March 16, 2007

<sup>iii</sup> Morgan Keegan Fixed Income Research March 26, 2007

