

## **FIXED INCOME COMMENTARY LETTER SECOND QUARTER 2007**

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### **OVERVIEW**

The second quarter of 2007 was again volatile, due to the drop in U.S. treasury bond prices and the sharp increase in yields, ongoing concerns about the course of the U.S. economy, leveraged buy-out activities, and the continued negative impact of the declining housing market paired with the sub-prime loan situation. The U.S. economy showed strength, growing at a faster pace than predicted, supported by a consistent Fed, low unemployment, a continued rise in wages, and measured growth in consumer spending. The recent environment created a buyer's market and investors were able to invest in quality securities at a discount, extending yields. Bond investors should be optimistic but remain cautious in the near term.

### **U.S. ECONOMY**

The Federal Open Market Committee (FOMC) maintained its "no change" monetary policy, leaving its target for short-term interest rates steady at 5.25%. This may indicate that Fed chairman Bernanke is comfortable with the current course of the economy. The likelihood of a rate cut is close to zero. Yields on short-term U.S. Treasury securities with maturities of less than one year fell, while the yields on intermediate- and long-term bonds with maturities ranging from 1 to 30 years increased.

The final revised real GDP (the output of goods and services produced by labor and property located in the United States) increased at an annual rate of 0.7 percent in the first quarter of 2007. The first quarter's figures represented the slowest GDP growth in four years. In the fourth quarter of 2006, real GDP increased 2.5 percent. The Federal Reserve's outlook for the second quarter of 2007 is expected to be higher than the rates of the first quarter; estimates are around 3 percent. This increase is assumed to be of a temporary nature, since the push has mostly been driven by increased inventories and higher exports. GDP numbers for the remaining quarters in 2007 are expected to be below the Fed's comfort level of 3 percent.

The unemployment rate remained unchanged at 4.5 percent during the second quarter of 2007. Unemployment is expected to remain steady. An increasing unemployment rate may indicate that the economy could slip into a recession, forcing the Fed to lower interest rates. Nevertheless, current rates are a positive sign for the economy because as long as consumers are employed, they will spend. The consumer side of the ledger represents about 70% of GDP. Job and wage growth,

therefore, become crucial factors in extending the economy's momentum. Consumer spending increased by 3.8 percent during the first quarter, slightly down from the 4.5 percent increase in the last quarter of 2006. The decrease resulted from a combination of inflationary and housing market pressures. Exports continued to grow during the quarter, mostly due to the cheaper U.S. dollar.

## **HOUSING**

The housing market along with the sub-prime mortgage situation continues to put a drag on the economy as home prices were flat to down. Sales of existing homes declined further during the quarter, reaching the lowest point in four years. The supply of existing homes increased, while prices of existing homes fell for the 10<sup>th</sup> consecutive month. The negative trend for the overall housing market is expected to continue over the medium term as sub-prime delinquencies and foreclosures are increasing inventories and putting increased pressure on house prices throughout the country. The flat housing market may lower consumer spending, since spending in recent years was materially driven by home equity appreciation and borrowing. Federal regulators continue to push for noticeable oversight and tighter lending standards. Sub-prime mortgage delinquencies and default rates accelerated in the second quarter of 2007. Major news regarding sub-prime mortgages was the trouble of one of Bear Stearns hedge funds. Rating agencies Moody's, S&P, and Fitch are expected to lower their credit ratings for selected mortgage-backed securities and funds in the weeks and month ahead. Aside from these issues, borrowers are facing increasing mortgage rates, which may put another damper on the already depressed housing market since potential home buyers have to bring more money to the table.

## **BENCHMARKS**

The U.S. investment-grade fixed income market (Treasuries, bonds, and mortgage-backed securities) as measured by the Lehman Brothers Aggregate Bond Index lost some ground during the quarter, with a negative 0.52 percent return for the period. Its return was positive 0.98 percent for the first six months of this year. The index increased by 0.54 percent in April, lost 0.76 percent in May, and ended the quarter down another 0.30 percent in June.

The total return of the Lehman Brothers Intermediate Index (securities with intermediate maturities) rose by 0.48 percent in April, fell by 0.64 percent in May, and rose another 0.02 percent by the end of June, ending the second quarter with a total return of negative 0.35 percent. Its return was 1.44 percent year-to-date.

## **INTEREST RATES**

The Fed's current opinion is that inflation will be moderate over time and that the economy will likely expand at a moderate pace over the coming quarters, despite the

ongoing adjustments in the housing markets. Readings on core inflation have improved modestly in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. It also warns that “the high level of resource utilization has the potential to sustain those [inflation] pressures.” Some of the signs of accelerating economic growth can not be entirely disregarded.

The Federal Open Market Committee (FOMC) conceded a decidedly mixed economic picture in June, but continues to worry that inflation is the predominant threat. With the FOMC’s emphasis on inflation, it is more likely that any move in rates will not happen until the latter part of the year.

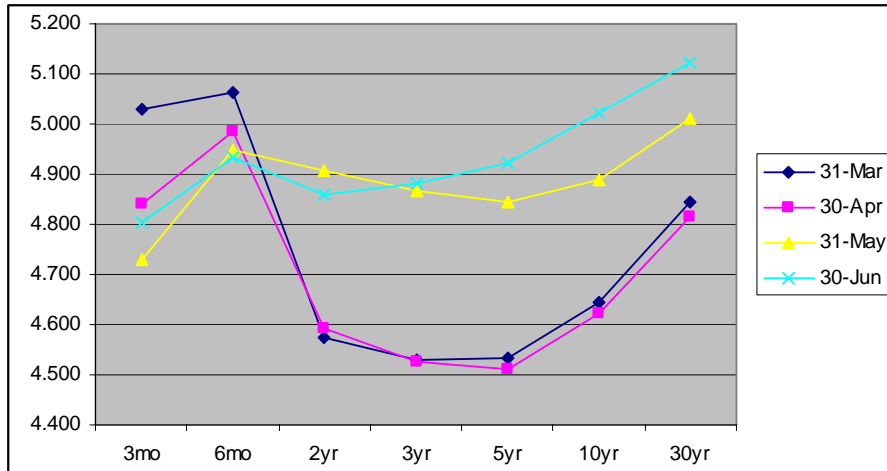
In addition, many investors are still looking for reassurance about the sub-prime mortgage situation. The question remains: Will the Fed acknowledge the gravity of the sub-prime problem for housing and mortgages, or will it continue its position that there is not enough to worry about? The Fed will do little to alleviate the problem by again stating: “The adjustment in the housing market is ongoing.”

As the following Treasury yield table shows, yields on short-term U.S. Treasury securities with maturities of less than one year fell, while the yields on intermediate- and long-term bonds with maturities ranging from 1 to 30 years increased across the board during the quarter.

	Change in Basis Points:				
	31-Mar	30-Apr	31-May	30-Jun	03/31/2007 to 6/30/2007
3mo	5.028	4.840	4.731	4.802	-22.6
6mo	5.063	4.987	4.947	4.935	-12.8
2yr	4.574	4.591	4.908	4.858	28.4
3yr	4.531	4.525	4.867	4.882	35.1
5yr	4.532	4.511	4.846	4.921	38.9
10yr	4.644	4.622	4.888	5.024	38.0
30yr	4.843	4.813	5.010	5.124	28.1

Source: Bloomberg





Source: Bloomberg

For the first time in over one year the yield curve is positively sloped. What does this mean and why is it significant? The U.S. Treasury yield curve plots the effective interest rate for short- and long-term bonds with increasing times to maturity. A positively sloped yield curve, which is the norm, indicates that investors receive more in yield, or interest payments relative to price, for bonds with longer maturity periods than for bonds that mature sooner. This is typical because it compensates investors more for the risk of investing in longer-term securities. As recently as early May of this year, the yield curve was inverted so that shorter-term, for example three-month, Treasury bills yielded more than longer-term, such as the five-year notes. The yield of the 10-year U.S. Treasury note, which is commonly used as benchmark for mortgage interest rates and other key lending rates, increased from 4.644% on March 31 to 5.30% on June 12, before falling slightly to 5.024% on June 30, increasing by 38 basis points over the quarter. The yields on two, five, and thirty-year Treasury notes increased by 28, 39, and 28 basis points, respectively, over the same period.

The value of a corporate bond also incorporates a credit spread, which is the additional yield that it provides relative to a Treasury security with similar maturity. Credit spreads have also been widening as fixed-income investors are beginning to demand additional compensation (in the form of yield) for assuming the risk that the issuer of a corporate bond will default on its obligation. As credit spreads widen, the values of corporate bonds drop, hurting the returns of funds that are overweight in corporate obligations relative to fixed-income benchmarks.

The yield spreads between corporate bonds and Treasuries of comparable maturity held firm during the quarter. On average, investment-grade debt commanded 83 basis points (or 0.83 percent) more than Treasuries. Below-investment-grade issues

yielded approximately 250 basis points (or 2.5 percent) more on average, down from a 275-point spread in the previous quarter.

The 12-month trailing default rate on corporate bonds was unchanged at 1.4 percent in June, again at a 10-year low.

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## **SECTOR UPDATES**

Investment-grade corporate bond prices decreased in value as we saw a large sell-off during the second quarter of 2007. Selling was triggered in part by continued concerns about sub-prime mortgages. Since the economy shows signs of strength, along with healthy fundamentals, strong corporate earnings, and ample liquidity in the secondary market, investment-grade bonds should recover in the intermediate term. However, market quality concerns could cause spreads to continue to widen in the short-term, especially for lower grade credits.

The municipal bond market has been under a bit of pressure as a result of the declining offering levels in recent months. Nevertheless, municipal bond rates continue to track treasury rates and yield increased during the last quarter. We expect a flattening of the curve in the month ahead as the bond markets consolidate.

ICM's clients' assets are invested in quality, investment-grade corporate bonds within many different sectors. This diversification spreads any adverse effects among sectors thereby reducing the overall risk within client portfolios.

## **LOOKING AHEAD**

The problem with the sub-prime market and its impact on the U.S. economy is expected to continue, and is likely to cause the FOMC to place greater importance on the language for the August and September meetings. The Treasury and municipal yield curves are likely to flatten slightly throughout the remainder of the year after the large sell-off during the past quarter. We believe our position at the belly of the curve will be the best place to benefit from a rise in these curves.

Sufficient diversification has been 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. One approach is to swap existing shorter maturities for longer ones. By buying longer maturities at a discount, we can achieve a significant yield increase.



We maintain our disciplined approach of investing appropriately for each client. We will invest funds when we find compelling value candidates that fit strategically in individual portfolios.

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