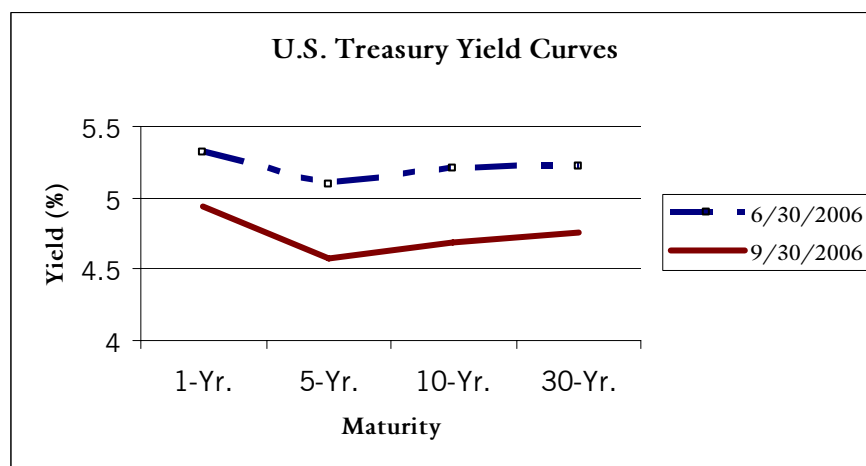


FIXED INCOME COMMENTARY LETTER THIRD QUARTER 2006

Overview

- Bond investors rejoiced the conclusion of rate hikes by the Federal Open Market Committee (FOMC) at their August meeting. The Fed's pause at a 5.25 percent federal funds rate, coupled with signs of softness in the housing market and slower economic growth projections, rallied bond prices across all maturities. The Lehman Aggregate Bond Index, a broad measure of the U.S. investment grade bond market, rose sharply, offsetting earlier year-to-date declines in the index. The 3.81 percent total return for the third quarter pulled the index to a 3.06 percent total return year-to-date. The Lehman Intermediate Government/Credit Bond Index, restrained somewhat by its lack of exposure to long maturity securities, returned 3.20 percent during the quarter.
 - Favorable bond market performance was not isolated to the U.S., although the U.S. Aggregate was the top performer for the quarter. The Global Aggregate Index returned 3.43 percent, resulting in a year-to-date return of 2.69 percent. While some pundits of non-U.S. bond investing may be mildly disappointed, there were bright spots beyond our borders. The Asian-Pacific Aggregate leads, year-to-date, with a dollar hedged return of 3.75 percent.
 - The bond market generally rewarded properly diversified risk takers during the quarter, as reflected by the 6.36 percent return for emerging markets, and a 4.07 percent return for the U.S. high yield sector. The narrower yield spreads over investment grade debt that accompany such strong performance may diminish the relative advantage for risky investments in the near future. Even risk-averse investors, especially those desiring a hedge against inflation, participated in the market rebound, with the U.S. TIPS sector returning 3.56 percent for the quarter.
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Source: Bloomberg

Interest Rates

- The U.S. Treasury yield curve moved in a similar pattern as in the second quarter, but reversed direction, with yields falling for all maturities. This *parallel* shift reflected declines of about one half percent for two, five, 10, and 30-year maturity Treasury securities. The curve also remains *inverted* with short rates higher than long maturity rates. Middle maturities, often referred to as the *belly of the curve*, now reflect lower yields than short and long maturities, making the parallel characterization less precise.
- The widespread decline in interest rates reflected expectations for slower economic growth in the U.S., a growing global surplus of excess savings, and weakness in commodity prices that should presage lower inflation expectations. Flagging inflation appeared in the second quarter's Core Personal Consumption Expenditures (PCE) report of 2.7 percent. (The prior report was 2.8 percent.) This decline in inflation is consistent with Fed Chairman Bernanke's position that inflation typically peaks with a six-month lag after economic growth peaks. The recent growth peak in the first quarter of 2006 seems consistent with a prediction of further slowing in inflation through year end.
- The outlook for U.S. interest rates remains positive, even with the sharp declines of the quarter. While few expect a repeat performance next quarter, the positive inflation landscape and solid global demand, including demand from non-traditional investors such as hedge funds, should support current prices in anticipation of an eventual shift in Fed policy to easing with rate cuts.

Sector Updates

- All sectors of the U.S. Lehman Aggregate Index participated in the rally, with the Credit (or corporate) sector finishing at the top with a return of 4.51 percent for the quarter. As interest rate declines impact prices most for longer maturities, those sectors with the longest duration (maturity) were most rewarding. As noted, the top-performing Credit sector reflects duration of 5.91. The Treasury sector, with a duration of 5.04, returned 3.68 percent; the Mortgage-Backed Security (MBS) sector, with a duration of 3.81, returned 3.63 percent, and the Agency sector, with the shortest duration of 3.58, also finished last, with a return of 3.22 percent.

Lehman 3Q06 Sector Returns (%)	
U.S. Treasury	3.68%
U.S. Agency	3.22%
U.S. Credit	4.51%
MBS Fixed Rate	3.63%
5-Yr. Municipals	2.58%

Source: Lehman Bros.

- As mentioned in the Overview, risk was generally rewarded during the quarter. As measured by corporate credit quality, returns accurately reflected this bias. The AAA-rated sub-sector returned 3.70 percent, the AA-rated sub-sector returned 4.19 percent, the A-rated sub-sector returned 4.67 percent, and the BAA-rated sub-sector returned 4.80 percent. However, it is noteworthy that the incremental return for moving into the lowest investment grade category, BAA, was modest, compared to other down-in-credit-quality strategy decisions. Investors have apparently decided that any forthcoming softness in the economy should not lead to material deterioration in corporate America's credit conditions.
- Fixed-rate mortgage-backed securities, while not having the highest sector returns for the quarter, has been the top performing sector on a year-to-date basis. The bond market rally also heightened the risk of mortgage prepayment to investors, although that level of risk is subdued in comparison to recent years.
- Municipal bonds, likewise, rewarded investors with generous returns, especially on an after-tax basis. Issuance of general obligation bonds has been the lightest since 1999, when compared to total new issuance, due to increased tax receipts at state and local government levels. This appears to be another indication of the broad strength of the domestic economy.

Looking Ahead

- The third quarter bond market rally ended abruptly on October 6th, when revised payroll figures from the U.S. Department of Labor added 810,000 jobs created to the employment statistics. Hawkish remarks by Fed members have also tempered investors' bullish inclinations, which led to profit taking and a slight backup in interest rates. The direction of the next Fed monetary policy action will be data dependent and possibly extended further into the future. Geopolitical risks continue to cast their shadow on the markets.
- The minutes of the September FOMC meeting indicated that persistence of inflationary risk concerned the members of the Committee. Numerous recent statements by members have reiterated that stance. This has caused the anticipated Fed ease in monetary policy, as predicted by the futures market, to be extended further into 2007.
- The domestic economic outlook is shadowed by weakness in the housing and automobile markets. Credit quality should be a major concern to investors as a weakening economy and tight credit spreads over Treasuries increase the risk on investments. Uncertainty can lead to risk aversion, which favors U.S. Treasuries and AAA-rated agency and corporate obligations for upgrading portfolios.

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