

FIXED INCOME COMMENTARY LETTER THIRD QUARTER 2007

OVERVIEW

The third quarter of 2007 experienced a rally in the bond market and corresponding decrease in yields. Investors and traders alike anticipated that the Federal Open Market Committee (FOMC) would lower interest rates, which happened in September. This expectation led to a demand for debt, pushing prices up and yields down. Continued widespread concerns about the course of the U.S. economy and the continued negative impacts of the declining housing market paired with the sub-prime loan situation plague the capital markets. The U.S. economy experienced growth and was supported by low unemployment and continued measured rise in wages and measured growth in consumer spending. The current environment in the U.S. bond market continues to demonstrate excess demand, providing for little liquidity and forcing bonds to sell closer to a premium while lowering yield.

U.S. ECONOMY

The FOMC deviated from its “no change” monetary policy by lowering the target for short-term interest rates from 5.25% to 4.75% on September 18. These moves indicated that Fed chairman Bernanke is no longer comfortable with the current course of the economy, acknowledging the adverse effects of the sub-prime loan crisis and its impact on the housing market. The market is indicating a 50/50 chance for another rate cut in October. Yields of U.S. Treasury securities of all maturities fell through most of the quarter, bottoming and slightly recovering towards the end of September.

The final revised GDP (the output of goods and services produced by labor and property located in the United States) showed that the economy expanded at the fastest pace in more than a year in the second quarter, rising 3.8% from April through June. This expansion was mainly propelled by a surge in exports, indicated by data from Commerce Department reports. The weak dollar helps to sell U.S. goods cheaper in foreign countries. GDP numbers for the second half of 2007 are expected to be below the Fed’s comfort level of 3%, partially due to the big sell-off in credit markets in the third quarter that threatens to hobble growth. Analysts are calling for a number around 2%. More recent reports showed that residential construction slumped to a 12-year low in August and manufacturing cooled as well.

The unemployment rate increased to 4.7% during the third quarter of 2007. Unemployment is expected to remain relatively steady for the rest of the year, though an increase to 4.8% is possible. A larger than expected increase in unemployment may indicate that the economy could slip into a recession, forcing the Fed to lower interest rates further. The consumer side of the ledger represents more than two thirds of GDP. Job and wage growth, therefore, are crucial factors in extending the economy’s momentum. Consumer spending increased during July and August, 0.4% and 0.6% respectively. Current rates are a positive sign for the economy because as long as consumers are employed, they will spend.

HOUSING

The housing market along with the sub-prime mortgage situation continues to put a drag on the economy as home prices were down again. Sales of existing homes continued to decline for the sixth straight month, reaching the lowest level in five years. On the other hand, the supply of existing homes increased, while prices of existing homes continued to fall. 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 and in parts of the rest of the world. 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 better oversight and tighter lending standards. Sub-prime mortgage delinquencies and default rates accelerated during the third quarter of 2007. New housing starts and building permits decreased as well.

BENCHMARKS

The U.S. investment-grade fixed income market (treasuries, bonds, and mortgage-backed securities) as measured by the Lehman Brothers Aggregate Bond Index gained 2.84% during the quarter. The index increased by 0.84% in July, gained 1.23% in August, and ended the quarter up another 0.76% in September.

The total return of the Lehman Brothers Intermediate Index (securities with intermediate maturities) rose by 0.95% in July, 1.21% in August, and another 0.69% by the end of September, ending the second quarter with a total return of 2.87% for the period. Its return was 4.35% year-to-date.

INTEREST RATES

The Fed's current opinion is that readings on core inflation have improved modestly, but some inflation risk remains. The economy will likely see slower pace over the coming quarters due to the ongoing adjustments in the housing markets.

The FOMC agreed on an uncertain economic picture in August. Inflation was no longer the predominant threat, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth generally.

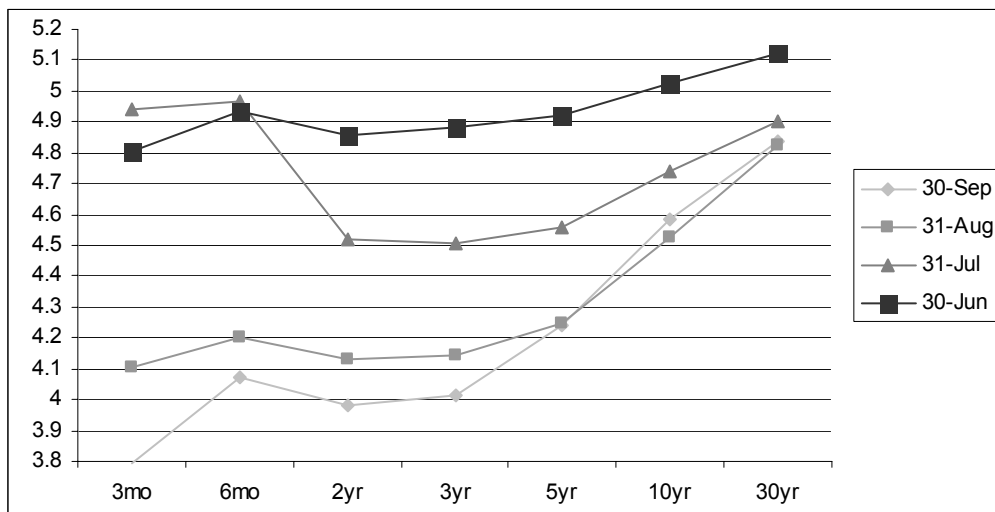
The latest move by the Fed indicated that it is now actively trying to reassure markets and investors alike about the sub-prime mortgage situation. The Fed somewhat acknowledged the gravity of the sub-prime problem for housing and mortgages in its most recent comments.

As the following Treasury yield table shows, yields of all maturities fell throughout the quarter.

Change in Basis Points:

| | 30-Sept | 31-Aug | 31-July | 30-Jun | 6/30/2007 to 9/30/2007 |
|------|---------|--------|---------|--------|---------------------------|
| 3mo | 3.899 | 4.106 | 4.941 | 4.802 | -90.33 |
| 6mo | 4.138 | 4.201 | 4.969 | 4.935 | -79.70 |
| 2yr | 4.000 | 4.132 | 4.517 | 4.858 | -85.83 |
| 3yr | 4.016 | 4.145 | 4.504 | 4.882 | -86.54 |
| 5yr | 4.229 | 4.244 | 4.561 | 4.921 | -69.24 |
| 10yr | 4.545 | 4.529 | 4.739 | 5.024 | -47.92 |
| 30yr | 4.786 | 4.822 | 4.902 | 5.124 | -33.76 |

Source: Bloomberg



Source: Bloomberg

The yield curve is positively sloped, which is typical because it compensates investors more for the risk of investing in longer-term securities. The yield of the 10-year U.S. Treasury note, which is commonly used as the benchmark for mortgage interest rates and other key lending rates, decreased from 5.024% on June 30 to 4.545% on September 30, decreasing by 48 basis points over the quarter. The yields on two, five, and thirty-year Treasury notes decreased by 86, 69, and 34 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. The yield spreads between corporate bonds and Treasuries of comparable maturity widened during the quarter.

The 12-month trailing default rate on corporate bonds was slightly down at 1.27% in June, again at a 10-year low.

SECTOR UPDATES

Investment-grade corporate bond prices increased in value as we saw a large rally during the third quarter of 2007. Buying was triggered by a credit crisis, interest rate cut expectations, a “flight to quality”, and continued concerns about sub-prime and housing. With the economy prospectively slowing, along with mixed fundamentals, and fading liquidity in the secondary market, investment-grade will likely continue to rally. Credit spreads may start to tighten as we start to see some reconciliation of the sub-prime effects. Spreads may widen for distressed and lower grade credits.

The municipal bond market will see increasing supply in the weeks and months ahead. Therefore, municipal bond rates no longer track treasury rates. Yield will be determined by demand and supply. We expect a steepening of the curve in the month ahead as the bond markets offerings increase.

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 show its “dire” face in the weeks and months ahead, and is likely to cause the FOMC to place greater importance on the language for this year’s remaining meetings. The Treasury and municipal yield curves are likely to steepen slightly throughout the remainder of the year after the big rally during the past quarter. We believe our position at the belly of the curve will be the best place to benefit from a steepening 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.

We maintain our disciplined approach of investing appropriately for each client. Each portfolio is assessed to ensure the fundamentals match the current market environment.

We request that clients advise ICM in the event that there are any changes in their investment objectives, financial situation, or whether they wish to impose or modify restrictions on the management of their account. Please call ICM at 800.488.4075 or visit our Web site, www.icmasset.com, if you have any questions or need additional information.

