

FIXED INCOME COMMENTARY LETTER FOURTH QUARTER 2006

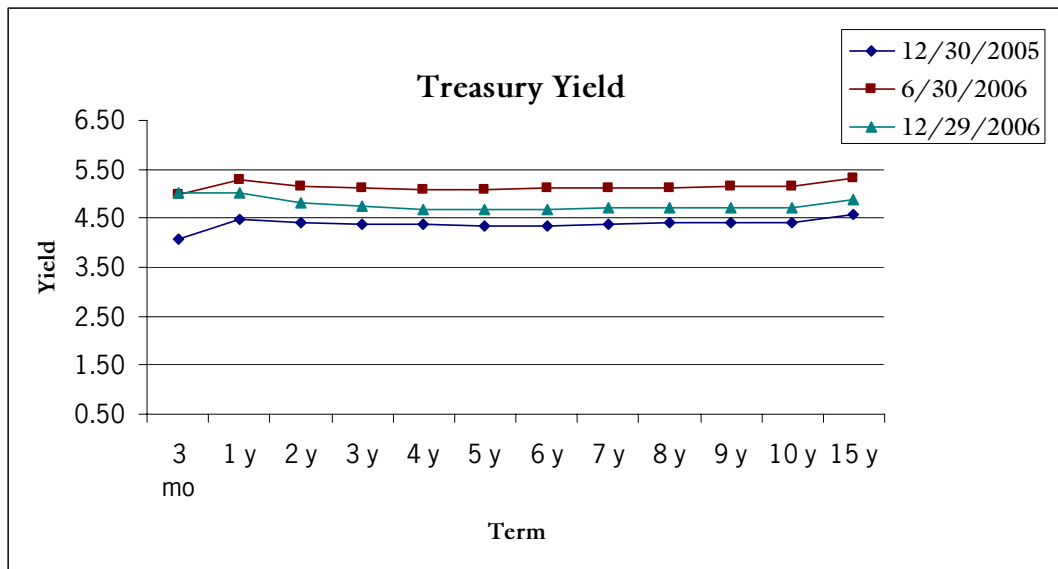
Overview

- The Lehman Aggregate Bond Index rose by 1.24 percent during the quarter, and the Lehman Aggregate Index gained back the value lost during the first two quarters, ending 2006 up 4.33 percent.
- Housing investment, consumption, and inventory growth continued the downward trend in the fourth quarter, although the economy regained some strength in December. Globalization, new technologies, and market reforms continue to keep a lid on inflation. A containment of inflation expectations implies that there is little pressure for central banks to tighten policy. The December Federal Open Market Committee (FOMC) minutes addressed the concern with inflation versus anticipated uneven growth, and characterized housing's slowdown as "substantial." This language was less hawkish than prior sentiment, which is a small step towards easing policy.
- Total production growth in October and November was revised down. The total finished goods Producer Price Index (PPI) rose slightly in December, although the November total and core Consumer Price Index (CPI) were suggestive of receding inflationary pressure. Mild temperatures held down utility production in December, while the December Payroll report indicated increasing wage pressure and a diminishing slack in the labor force. For the fourth quarter as a whole, output declined at a 1.3 percent annualized rate after rising at a 4.3 percent pace in the third quarter. The Institute for Supply Management (ISM) Manufacturing Index also showed a similar pattern.
- The political shift of control, as result of the mid-term elections, will have an important impact on the capital markets. The Democrats are assuming power at this point in time, just when the returns to capital are at historical highs and the rewards to labor are coming in at more than 40-year lows¹. The bond market could benefit in the long term with the expectation that a divided government will help control spending; however, the bond market could also be hurt by perceived risks to inflation.
- Milder than normal winter weather lowered crude oil, energy, and oil-based product prices. Gold prices were also pressured by weaker oil prices. Macro-economic concerns, especially over fears of an economic slowdown in the U.S., dampened sentiment towards the base metals complex including copper, aluminum, and lead.

¹ Source: Morgan Stanley

Interest Rates

- The Treasury yield curve remained in slightly inverted territory during the fourth quarter. The slope of the curve has historically correlated with the business cycle. Recent deceleration of retail sales would support a steeper curve should it persist; however, the shape of the curve is unlikely to change until we reach the end of the current business cycle. Until the Fed begins rate cuts, it is possible that the 2007 curve could stay at or near its current slope level.



Source: Bloomberg

- Municipal market new issue volume was high in the final two months of the year, largely due to record low yields for longer-term loans, thin-credit spreads, and increases in housing bond financing.
- On a global basis, Euro-area GDP growth turned out to be strong and the United Kingdom's economy lead to a sizable fiscal tightening. The Bank of England continued rate hikes in the second half of the year while the Fed has paused since June.

Sector Updates

The rally in corporate bonds continues to be driven by healthy corporate sector performance and strong technical bids for credit. As a result, spreads plunged to

exceptionally tight levels over the past year. High-yield spreads appear to be overvalued and due for a setback as the economy cools and profit growth decelerates. But overall, the credit market has good technical momentum behind it and these fundamentals are expected to continue in 2007.

The municipal curve continued to flatten. The two-year to 30-year spread continued to narrow in 2006, and achieved 46 basis points (historically the flattest at least over the last 10 years) at the end of November 2006. If yields and credit spreads remain largely contained, the ability of the tax-exempt asset class to outperform will depend on the relative shape of the curve. A steeper curve will drive capital into municipal cash while a flatter curve will have the opposite effect.

The Mortgage Backed Securities (MBS) Index finished the year with 122 basis points in excess of returns. Rebounding from a disappointing 2005, mortgages saw stronger demand throughout the year. On the supply front, issuance has also been strong. In fact, net issuance has stayed above \$20 billion per month for most of the year.

Looking Ahead

There are many potential market outcomes for the coming year and each involves a different ending point for the yield curve. Among the many possible outcomes, we consider the following three scenarios as the most significant possibilities:

- The economy continues to weaken and the Fed begins to cut rates in the first quarter;
- 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.

We believe that the belly of the Treasury curve will be the best place to benefit from a steepening of the yield curve. Various bond instruments can be employed to enhance portfolio returns if the Fed is intent on holding for an extended period of time.

As always, sufficient diversification is our risk management principal, and we attempt to position our clients' portfolios strategically in order to handle a dynamic interest rate 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.