

2ND QUARTER 2007

Have you ever eaten so much that you feel like you'll burst? Uncomfortable? Your stomach won't stretch another millimeter? That same gluttony and its aftermath are appearing in the high yield bond and bank loan markets. This is a consequence of the volumes of private equity deals whose risks and financing costs have pension and hedge fund portfolios belching from indigestion.

Couple the onslaught of buyout deals with a frenetic Treasury market and it would be safe to say that volatility got kicked up a notch during the second quarter.

If that wasn't enough U.S. pension funds, insurance companies and management firms who hold \$6 trillion of mortgage backed securities have been anguishing over the effects of billions of dollars of subprime loans gone bad.

All this consternation coinciding with a global increase in interest rates made for a lack-luster quarter.

The Federal Reserve board is concerned about inflation—the arch enemy of fixed income. Right now the inflation rate is in the upper end of their comfort zone. I too worry about inflation and interest rates but, I still believe the next move by the Federal Reserve will be to lower rates. Why?

Drive around middle class suburbia. You'll see tons of FOR SALE signs. Foreclosures are plentiful and consumer spending (which represents two-thirds of the economy) is deteriorating.

It's hard to be bullish on the economy when I'm not bullish on the consumer. A decline in retail and home improvement sales tells you just how confident consumers feel. Auto and clothing sales are down too. So are

sales of home furnishings. All reflect consumer discomfort. The slump in home prices has hurt; there's no more equity in those home equity lines to tap and spend.

Certainly the job market is robust, corporate capital spending is good, the stock market wealth effect is strong. But this economic cycle has passed the mature stage; it's over extended.

The slow motion economic train wreck I discussed last quarter is picking up momentum. Itemize some of the areas the experts say are contained but aren't: slumping home values, retail sales, widening bond spreads, subprime havoc, dicier private equity deals. Therefore, I can't imagine the Federal Reserve increasing interest rates with all these troubled moving parts.

I have confidence the Federal Reserve keeps watch on each afflicted area of the economy. Even though projecting the direction of interest rates is like trying to catch fog with your fingers, I don't believe the Fed has any choice but to stand pat or lower rates by year end.

We are presently in the upper end of the Treasury bond trading range. Not fun, but not a killer either. The market will be just fine.

So...watch as I do what the Fed does (or doesn't do), not what it says..

Stay cool this summer and enjoy yourself,

With warmest regards,

Marilyn