MOSTLY SMOOTH SAILING WITH OCCASIONAL CHOPPY WATERS

Five Trends to Watch in 2007

EXECUTIVE SUMMARY:

As 2006 drew to a close, corporate cash investors found themselves in a surprisingly benign market. Despite the 100 basis-point increase in the Fed funds rate, major short-duration bond indices brought in positive returns almost universally.

As managers of corporate cash investments, we picked five trends that reflect what we feel may have the greatest impact on high-grade, short-duration, and buy-and-hold traditional corporate cash investment accounts.

The five trends to watch are:

1. Economy and Interest Rates: Respectable with Range Bound Rates
2. Corporate Credit: Fundamentally Healthy but Bondholders Beware
3. Technical Factors: Positive with Plenty of Support
4. Asset-backed Credit: Weakening but Still a Safe Haven
5. Return Expectations: Decent but Less Satiable

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As 2006 drew to a close, corporate cash investors found themselves in a surprisingly benign market. Despite the 100 basis-point increase in the Fed funds rate, major short-duration bond indices brought in positive returns almost universally. The strong Treasury yield curve rally after the Fed went on hold in June and the tightening of corporate yield spreads to Treasury securities were two of the main drivers behind a successful year for cash investors.

In our observation of the outlooks for 2007, market strategists seem to have a difficult time agreeing with each other. Is the economy slipping into recession or picking up the pace? Will inflation or disinflation confront the Fed going into the new year? Is the 10-year Treasury note yield going to 6% or 4% or even lower? Will corporate America continue its double-digit earnings growth? Is private equity friend or foe of bond investors?

As managers of cash investments, we find that many of the debates are of little relevance to our core constituents. We chose to pick the five trends that represent our understanding of what may exert the greatest impact on the mostly high-grade, short-duration, and buy-and-hold traditional corporate cash investment accounts.

Economy and Interest Rates: Respectable with Range Bound Rates

Looking back at the trajectory of real GDP growth for the past three quarters, it is safe to assume that the economy is losing some momentum. On the other hand, the substantial cooling of the housing market does not appear to spill over to other sectors. As a result, we think growth will likely remain at a pace to be somewhat below the economy's long-run potential, averaging just below 2% annualized between the fourth quarter of 2006 and the second quarter of 2007. The risk of recession is not zero, but the possibility is remote. Recent inflation statistics seem to suggest that core inflation will likely fall within or slightly above the perceived Fed comfort zone of a 1-2% annualized rate over the same period.

Given our below-trend GDP growth expectation and our sanguine inflation outlook, we see short-term rates holding steady though at least the first half of 2007. The 3-month Treasury bill rate may remain in a tight range of 4.8%-5%, while long rates may drift upwards toward a range of 4.8%-4.9%.

The baseline assumption for our rate outlook is that the housing market will have a soft landing. We expect the next move, if any, in the Fed funds rate to be an ease in the second half of the year, should the weakness in the housing market push the unemployment rate higher. Given our sub-par growth outlook for the economy, we do not see a Fed tightening in the cards for 2007.

Corporate Credit: Fundamentally Healthy but Bondholders Beware

The Federal Reserve's most recent US Flow of Funds report reveals that the US non-financial corporate sector continues to post very strong profit growth. The First Call analysts' estimates are looking for solid, albeit decelerating, earnings growth over the next several quarters. Despite slight decreases in cash flow and cash to debt ratios, the ratio of debt to total market value in the Flow of Funds report actually declined to an 11-year low of 41.3% in Q306. A return to a positive financing gap, defined as capital spending less profits, dividends and inventory adjustments, suggests that corporations are investing heavily in capital expenditures to sustain their recent earnings growth. Similarly, financial firms saw profitability at record levels and asset quality statistics at historically low levels despite an inverted yield curve and weaker consumer asset quality statistics.

However, the credit voyage is not without choppy waters. For concerned bondholders, the accelerated path by corporate America to go private means the near certainty of higher debt burdens and lower credit ratings. There is no evidence that the recent craze will subside in 2007. Some market strategists argue that even with the latest run-up of equity prices US corporate assets remain undervalued. Ironically, the building of strong corporate balance sheets in the last several years to record levels of liquidity and cash flow strength only makes many companies prime targets for leveraged-buyout (LBOs) operatives. Additionally, LBO firms found themselves accumulating large sums of funds with relative ease from institutions and wealthy individuals who seek greater investment returns in a higher risk-tolerance environment.

The list of potential LBO candidates has grown from traditionally smaller, below-investment grade names to much larger, highly rated industry titans. In a sense, no firm is immune from the shopping spree. Recent rumored interests in Anheuser-Busch and the Home Depot are just two such examples. Both names suffer subsequent credit ratings downgrades, even though no buyout deals came to fruition. In fact, high-grade bonds may be more susceptible to an LBO, as they lack bond covenant protections typically found in high yield securities.

In summary, corporate fundamentals in 2007 may not be as robust as in 2006, but should stay healthy by historical measures. However, event risk related to LBOs is the largest threat to bond performance.

Market Technical Factors: Positive with Plenty of Support

We view the technical supply-and-demand factors in 2007 to be quite positive in a soft landing scenario.

Wall Street firms are predicting $900 billion in new issuances for investment grade corporate bonds in the new year-about the same level as in 2006. LBO firms are increasingly tapping a different and much larger leveraged loan market for financing needs, making supply overhang in the corporate bond market less onerous. Assuming the existing shape of the yield curve holds in 2007, issuance in short maturities will likely continue to be scarce, except for floating rate note (FRN) issuance. Incidentally, 2007 will also be a record year for FRN redemptions, canceling out the bulk of the increases. Therefore, aggregate outstanding short corporate paper should not increase meaningfully enough to impact spreads.

On the demand side, 2006 marked the third year that foreign investors owned the largest percentage of US dollar-denominated corporate bonds, with more than 29% of the total market. The rapidly growing presence of foreign investors demonstrates the ongoing global demand for corporate bonds and may partly help explain the resilience of credit spreads and low bond market volatility. This trend persisted despite the recent dollar slide against other major currencies, the automotive sector's credit problems, and the LBO financing wave. We think non-Japan Asia and oil-producing countries will continue to be the sources of demand growth in 2007. This macro trend is not likely to turn on a dime, even in a harder-than-soft landing scenario.

Additionally, the recent boom for credit derivatives, or insurance protection against bond defaults, has reduced risk premium, making credit spreads tighter across the credit sectors. This secular trend, benefiting from recent regulatory and accounting changes, may continue into the future and make credit spreads well supported.

Finally, the almost universal cautious stance by bond portfolio managers towards tight credit spreads and the buying-on-dips mentality are providing a reality check and relative value discernment that should help insulate credit spreads from large moves in either direction.

So the abundant liquidity that fueled the surge in mergers and acquisitions may continue well into 2007, but we expect strong technical backing in the bond market to help investors shoulder any potential whiplash should the credit environment turn for the worse.

Asset-backed Credit: Weakening but Still a Safe Haven

We have long argued the merits of including asset-backed securities (ABS) in cash portfolios because of their high credit ratings, comparable yield spreads to corporate securities, and more importantly, the absence of shareholder-driven corporate event risk. In 2007, we expect this sector to hold up well despite rich valuations and some asset quality weakness.

Much of the sector's weakness comes from two related sectors: sub-prime home equity loans (HEL) asset-backed securities (ABS) and collateralized debt obligations (CDOs), the areas of the ABS market we avoid as corporate cash managers. The significant weakening in the housing market has started to negatively impact HEL and other residential mortgage-related collateral performance, and there is potential for widening in these ABS spreads. CDOs may feel the negative impact as well, as they have been aggressive buyers of sub-prime and option ARM mortgages in the last several years.

The non-mortgage ABS market may experience steady deterioration in fundamentals, reflecting rising delinquencies and charge-offs due to the absence of cash-out home equity refinance activities. Nonetheless, we view this sector as a safe haven from corporate event risk. The moderately higher credit card charge-offs should not be problematic due to more stringent bankruptcy laws, the strength of the major credit card operators, and the substantial cushion in extra yield spreads over credit costs. Cash-strapped borrowers may decide to delay new car purchases, affecting prepayment behavior, but the credit quality of prime auto ABS should be similar to credit card transactions. Finally in the student loan sector, rising costs of education should energize growth in securitization volume. Private credit loan securitization, in addition to guaranteed loans, should expand further.

Return Expectations: Decent but Less Satiable

The intertwined themes from the macroeconomic, credit, structured, and market factors point to respectable, but not robust return prospects for corporate cash investors. By this assessment, we mean that short-duration securities should offer comparable returns to other fixed income asset classes with less interest rate and credit risk in 2007. On the flip side, the likelihood of returns above 4.50% to 5.00%, as indicated by the prevailing market yields of most short-term indices, seems low.

For investors of money market funds and other cash instruments, the inverted shape of the yield curve and the trajectory of short-term interest rates will likely keep average maturities relatively short for most of the year to capture the higher yield in the front end of the curve. For investors with a slightly longer time horizon, the large negative yield gap between the overnight rate and the 2-year note yield, currently at 48 basis points, constitutes a disincentive to extend in maturities unless a Fed easing move becomes imminent. This short bias by many active cash managers will likely keep principal investments safe, but also limit the return potential.

Many market participants expect the Federal Reserve to start lowering the Fed funds rate in the second or third quarter of 2007. While such events will certainly provide a boost for total bond return, cash investors may not be better off due to lower reinvestment rates. Given our optimistic view of the technical factors supportive of credit spreads, we think credit is still a better bet than interest rates in 2007.