FIXED INCOME STRATEGY HIGHLIGHTS …. MAY, 2008

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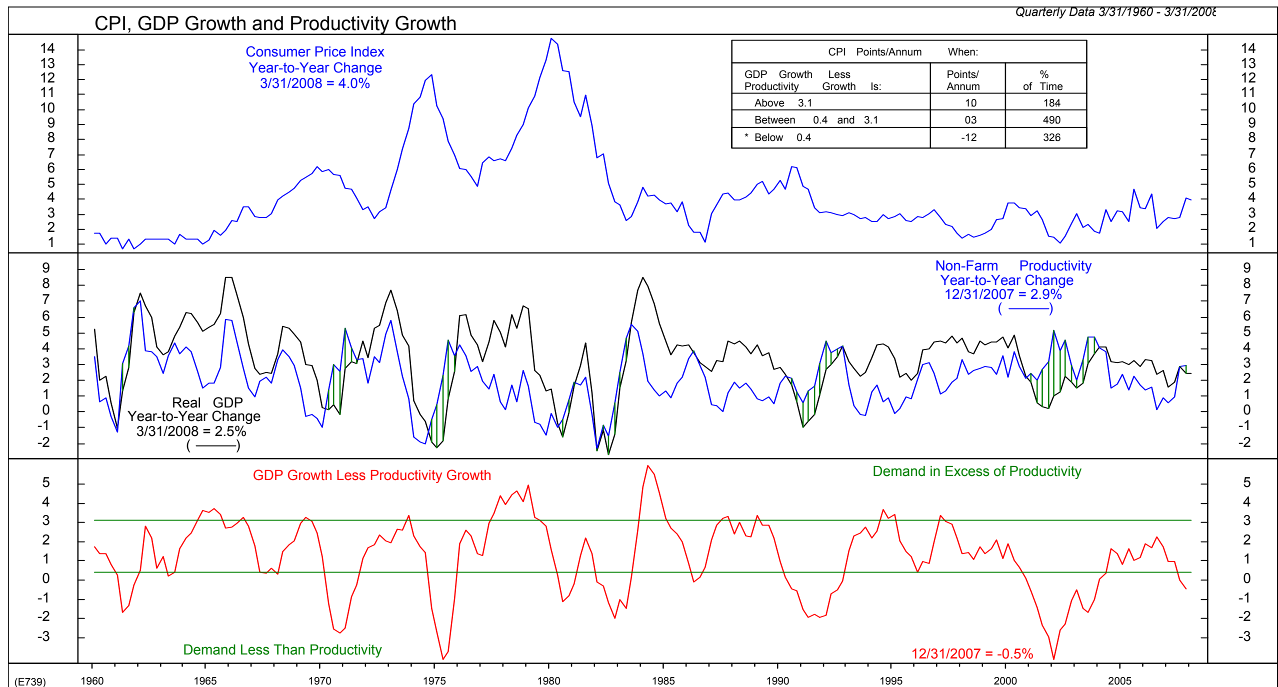
GENERAL MARKET OBSERVATIONS

- **We expect interest rates in the U.S. to stabilize at current levels, recognizing that global rates in the developed countries (including the U.S.) are still quite low and should support a healthy yield curve.** This backdrop continues to be particularly favorable for industrials and cyclicals in the U.S. and should generate higher share prices in these sectors as 2008 progresses. We continue to emphasize that in aggregate economic evidence still supports a continuation of U.S. economic expansion albeit at a slower pace. As we approach the summer months, we expect to see a reversal in the U.S. slow down with the real gross domestic product (GDP), averaging about 1.5% in the first half of 2008, to a level closer to the 3.0% for the second half. Although we have trimmed our earlier forecast of 3.5% level for real GDP growth in 2008, we remain optimistic that the U.S. economy remains on firm footing. If slowing aggregate demand and potentially muted wage pressure don't alleviate near term inflationary pressure (see Figure I), we would expect the Fed to go to the sidelines at the next FOMC meeting.

Figure I



Source: Ned Davis Research

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.

THE U.S. ECONOMY

- **During the first quarter the housing implosion spread throughout the investment markets and precipitated extreme volatility and a flight to quality in the bond market.** Existing home sales fell 1% to 4.89 million in April, following a 1.8% decline in March. The market consensus was expecting a slightly bigger decline. Sales of condos and co-ops fell 5.2%, reversing part of the surprising increase in March and February. Single-family home sales fell by a more modest 0.5%. While sales declined, inventories of homes for sale jumped 10.5% to 4.55 million. However, since the data is not seasonally adjusted, it could be biased higher as inventory typically increases for the spring selling season. This pushed the supply of homes on the market at the current sales pace to a new cyclical high of 11.2 months. The rise in inventories is quite disturbing. As long as inventories are high, there will be downward pressure on construction and prices. The housing weakness is far from over.

- **Initial jobless claims fell 9,000 to 365,000 in recent weeks and below market expectations.** The four-week moving average inched higher to 372,250 The number of people continuing to receive unemployment benefits held steady at 3.1 million and signaled difficult labor market conditions. The level of claims is consistent with a weakening, but not collapsing, labor market. We continue to look for non-farm payrolls to decline 50,000 in May and the unemployment rate to increase to 5.5%.

- **The Consumer Confidence Index fell 5.6 points in May to 57.2, its lowest reading since October 1992, and the fifth straight monthly decline.** This pessimistic assessment was related to business conditions with expectations near their lowest levels in some 28 years and corresponds to a -1.7% GDP year over year comparison. These weakened signals against inflationary expectations must be very discouraging to the Fed. Supporting this deterioration in confidence was bolstered by the continuing drop in home prices falling some 14% in the first quarter compared to a year ago, according to the Case-Shiller report. However, there was some positive news on housing in April showing new homes sales rose some 3.3% and the first recorded increase in six months.

- **University of Michigan consumer sentiment was essentially unchanged at 59.8 in May**. The preliminary survey is now at the lowest level since the 1980 recession. The deterioration in confidence has been spurred by falling home prices, rising unemployment, and record high energy prices. The collapse in confidence points to downside risk to consumption, as there is a currently a huge gap between confidence and spending. Consumers are also growing increasingly concerned about higher prices. Consumers expect an inflation rate of 5.2% over the next 12 months, likely reflecting the recent surge in energy prices. However, long-run inflation expectations also increased. The expected rate of inflation over the next five years rose to 3.4% from 3.2% in April, signaling concerns about price stability according to Michelle Meyer, chief economist at Lehman Brothers.

- **We expect that the persistent housing slowdown coupled with sub-prime mortgage defaults will continue to put pressure on the economy for several months to come**. In addition recent rising gasoline prices in the summer months could restrict families' disposable income and negatively affect consumer psychology. Another added concern is that corporations have yet to ramp up capital spending as would have been expected at this juncture in the economic cycle. To a greater extent stronger profits and very positive cash flows have been hoarded by corporate treasuries for the purpose of stock buy backs or acquisition at current equity price levels rather than enhanced capital spending on plant and equipment or system upgrades. These factors coupled with depressed consumer sentiment and rising inflation expectations put the Fed in a difficult position. We expect Fed officials to continue to talk tough on inflation, citing rising inflation expectations despite the fact that U.S. economic growth expectations having diminished. However we support the Fed's position that the weakened economy should drive inflation lower by year end and allow the Fed to more room to use a proactive monetary response.

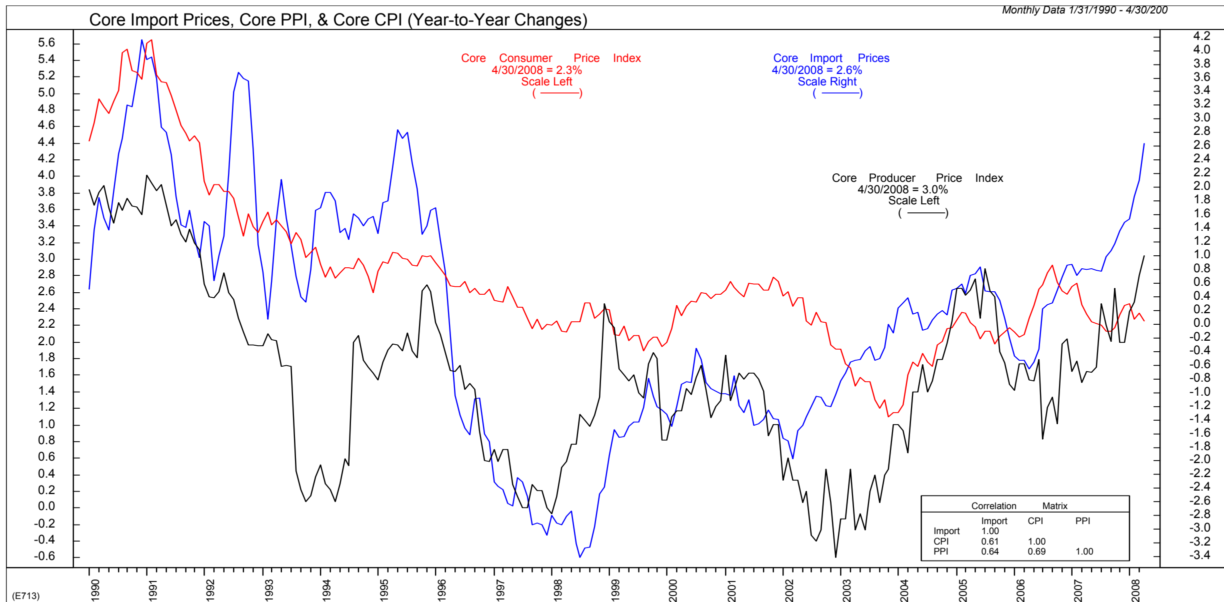
- **The Fed maintained a supportive stance emphasizing the credit turmoil as the paramount issue.** Minutes of the April 29-30, 2008, FOMC meeting were released along with an update to the Committee's economic projections through 2010. The minutes revealed some interesting insight into the decision to cut the Federal funds rate by 25 basis points at the April meeting, but the discussion on the outlook has since been superseded by more pessimistic Fed speakers concerning the U.S. economic outlook.

- **Most surprising was the admission by most members of the Fed that "the decision to reduce interest rates at this meeting was a close call."** This implies that the FOMC was close to a pause even in April. Significantly, much of the concern about severe disruptions to financial markets, which had motivated the aggressive policy actions at the beginning of the year, appears to have abated in the minds of most members by the end of April. On the other hand, the minutes note that "economic activity had not deteriorated significantly" since the March meeting, but that "the risks to economic growth were still skewed to the downside" — an assessment that was removed from the April directive. The Committee foresaw the weakest activity over the next few months, with a recovery in the second half of the year and into 2009.

- **On the inflation outlook, FOMC members cited "concern about upside risks", noting elevated commodity prices and some indications of rising inflation expectations.** They also indicated that uncertainty about the inflation outlook had increased, but that "a modest easing" would "balance better the risks" to achieving the Fed's dual mandate. On the policy front, the Committee stated that even if the economy was "contracting slightly in the near term," it would not warrant additional easing and that any shift in policy would be determined by a change in outlook.

- **Chairman Bernanke is still clearly concerned with inflation.** Although inflation is still expected to moderate over the next several quarters, confirmed by recent Core Consumer Prices, Fed participants are still concerned that recent Core Producer and Import Prices may be lead indicators of a deteriorating CPI. See Figure II. The Federal Reserve remains concerned with the rise in global interest rates, the high level of resource utilization, high energy and commodity prices, the decline of the dollar and slower productivity.

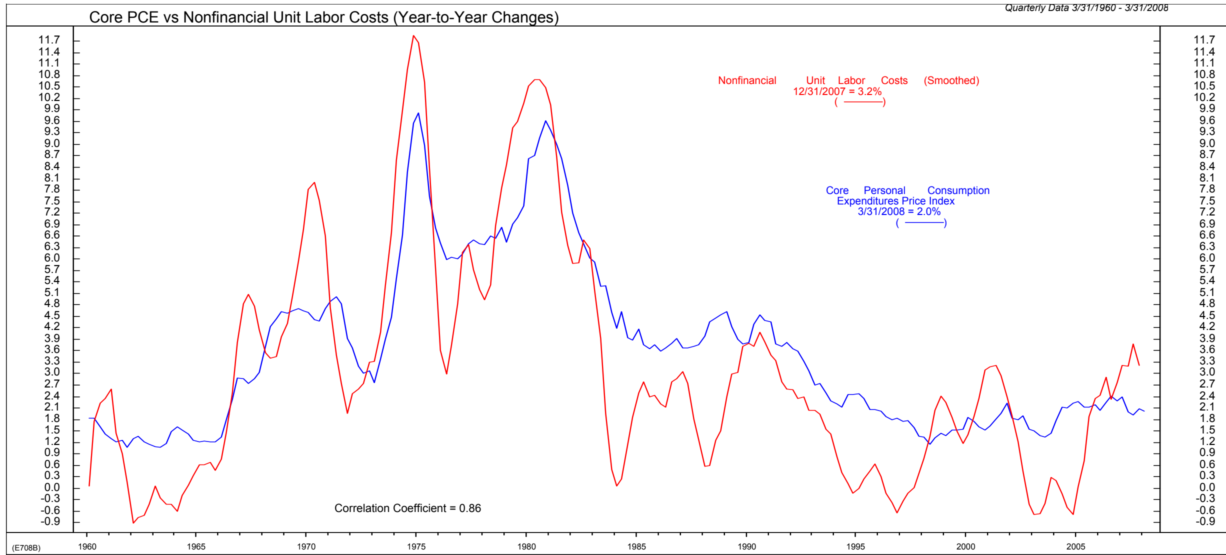
Figure II



Source: Ned Davis Research

- **Changes in the GDP forecast were consistent with an adverse supply shock since the January projections.** GDP growth forecasts were revised down sharply for the past several months, while inflation forecasts were revised up, with PCE inflation bumped up a full percentage point for 2008 (Figure II). The central tendency on both inflation measures were revised upward slightly for 2009, but remain within the Fed's "comfort zone" for 2010. The 2009 and 2010 growth outlooks were mostly unchanged, but the central tendency for the unemployment rate increased over all three years, implying a persistent upward revision to the perceived weakness in the labor market going forward. Despite Unit Labor Costs running at 3.2% year over year, the personal consumption expenditures are still running at a comfortable 2.1% year over year.

Figure III



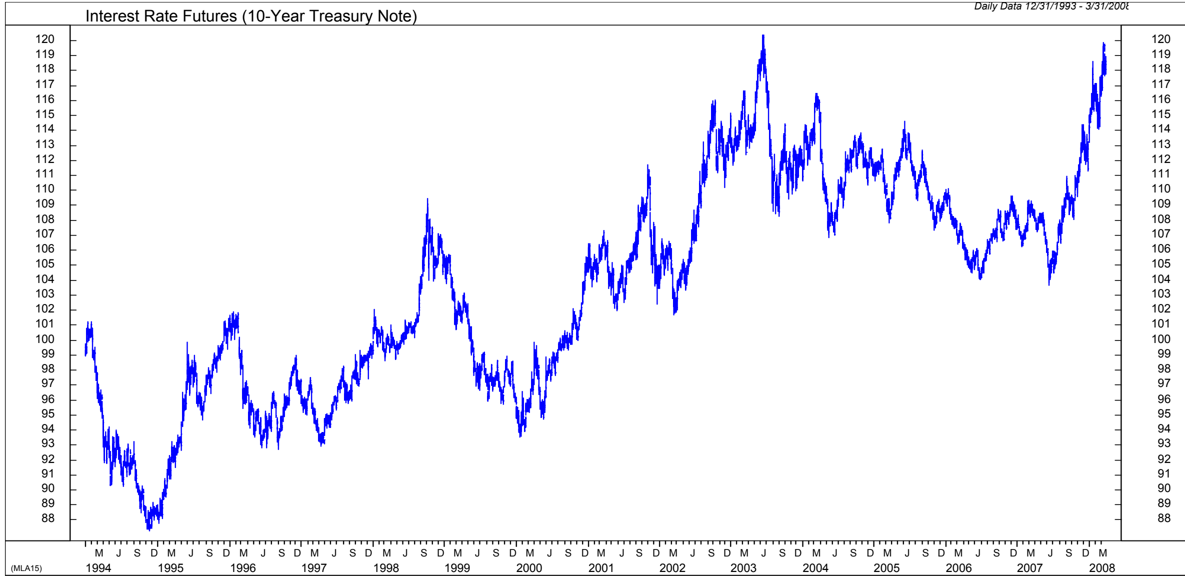
Source: Ned Davis Research

- **The first quarter GDP was revised up by 0.3% to 0.9%**, the main source of the strong growth came from a downward revision in imports, slightly weaker exports and slightly lower inventories. These results showed that U.S. final sales were expanding rather than a previously reported contraction. This recent data suggests that our 1.5% GDP forecast in the first half of the year is attainable with a stronger 2nd half at the 3.0% level still possible. The improvement in the near term outlook improves the likelihood that we will avoid the official label "recession".

THE U.S. FIXED INCOME MARKET

- **United States Treasury bonds have outperformed all other U.S. fixed income sectors over the past 12 months, gaining 12.2% on a total return basis.** Investor preference for safety of the government market caused rates in this sector to plummet further during the quarter. The 3.41% level recorded at the end of March was as much as 180 points lower than rates last June. See Figure IV 2007-2008. The outperformance in Treasuries, however, is unlikely to continue in our view especially as risk aversion recedes and the Fed concludes its easing cycle. Given already entrenched safe haven sentiment and only modest upside governments, global sovereign debt does not provide investors with much value at this time. That said, for diversified portfolios anchored with government securities, we favor short-duration positions relative to longer maturities. Reference Figure V's near term inflection point reach in March 2008

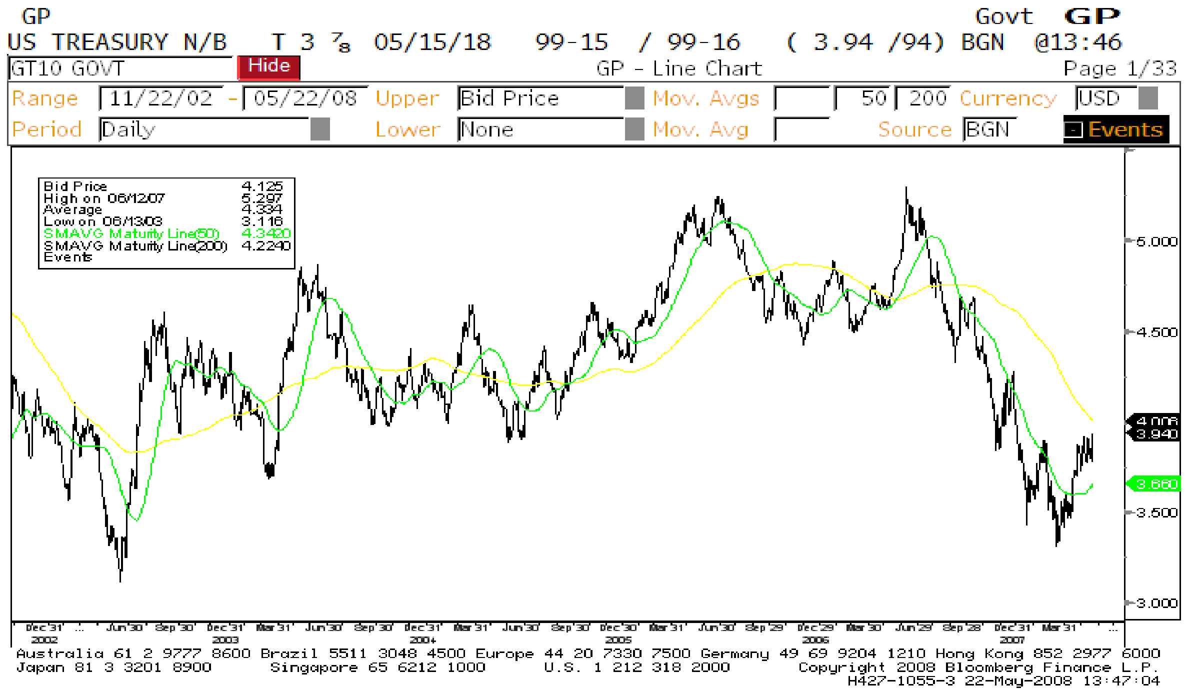
Figure IV



Source: Ned Davis Research

➢ **The Federal Reserve has utilized a variety of traditional and nontraditional mechanisms to restore market liquidity and stabilize the U.S. economy.** Some progress has been made, but we believe that further easing is needed to improve liquidity and reduce risk aversion. The extended period of financial restraint, emanating from ongoing problems in the housing and mortgage markets, will continue to constrain the economy throughout 2008, in our view. The U.S. slow down is likely to be moderate, with growth staying below trend until early 2009.

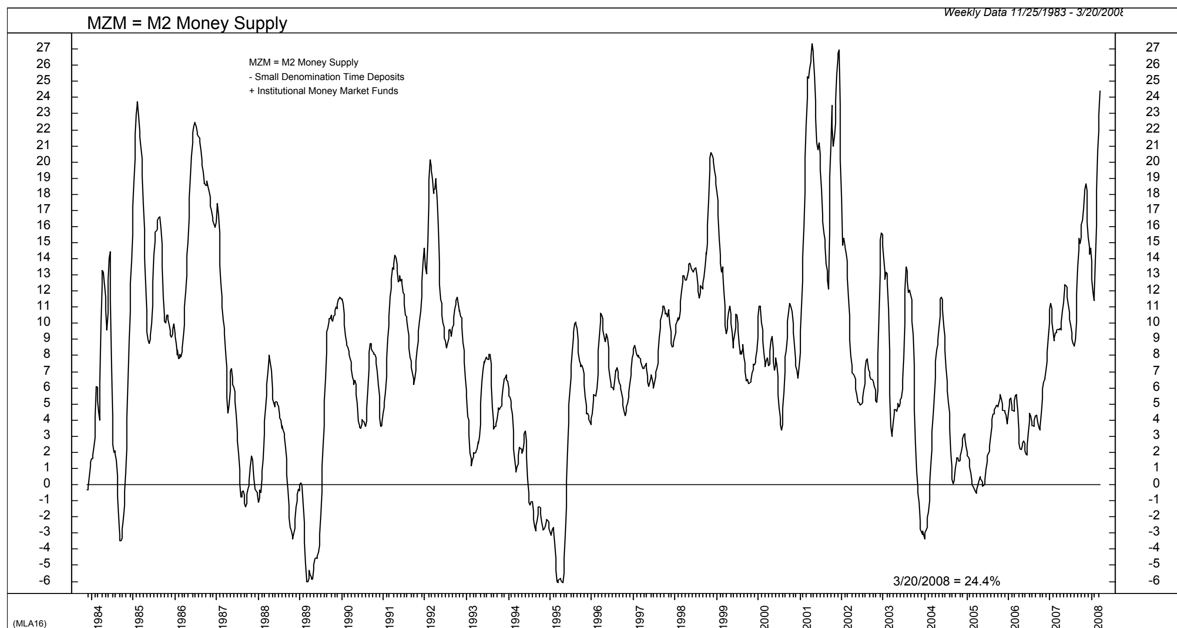
Figure V



- **Municipal rates moved in the opposite direction.** Turmoil among bond insurers unnerved many investors who had viewed the insurers' AAA ratings as essentially sacrosanct and many of these buyers have moved to the sidelines. It is noteworthy to mention that the liquidity and credit issues at many investment banks caused these institutions to limit market commitments. At the same time, failed auction rate programs and hedge funds unwinding arbitrage trades have added huge supply to the market. Prime municipal yields, while down from a late February peak are higher than Treasury rates throughout the yield curve, an unprecedented situation as the "normal" 80-85% ratio has been turned upside down.

- **The Federal Reserve initiation of a number of new programs to enhance liquidity among primary broker-dealers, and the expansion of accepted collateral for direct borrowings, have helped to restore some confidence in the credit markets since mid-March.** The Fed has addressed the credit disruptions by injecting massive liquidity into the system. See Figure VI showing money supply targets (M2 Money Supply). The federal funds rate has been lowered 300 basis points to the 2.25% level since September and the discount rate has been reduced from 6.25% to 2.50%. In addition the Federal Reserve expanded their support directly to the Wall Street firms to relieve the threat of spreading delinquencies resulting from the Bear Stearns debacle. The Fed-backed sale of Bear Stearns to J.P.Morgan was supported by an unprecedented $29 billion government back loan keeping the capital markets solvent. As the GDP growth dropped to a paltry 0.6% rate recorded in the fourth quarter, most pundits have concluded that the U.S. has entered a long protracted recession. The Fed's monetary response appears to have placed a declining dollar and rising inflation of lesser importance at this juncture.

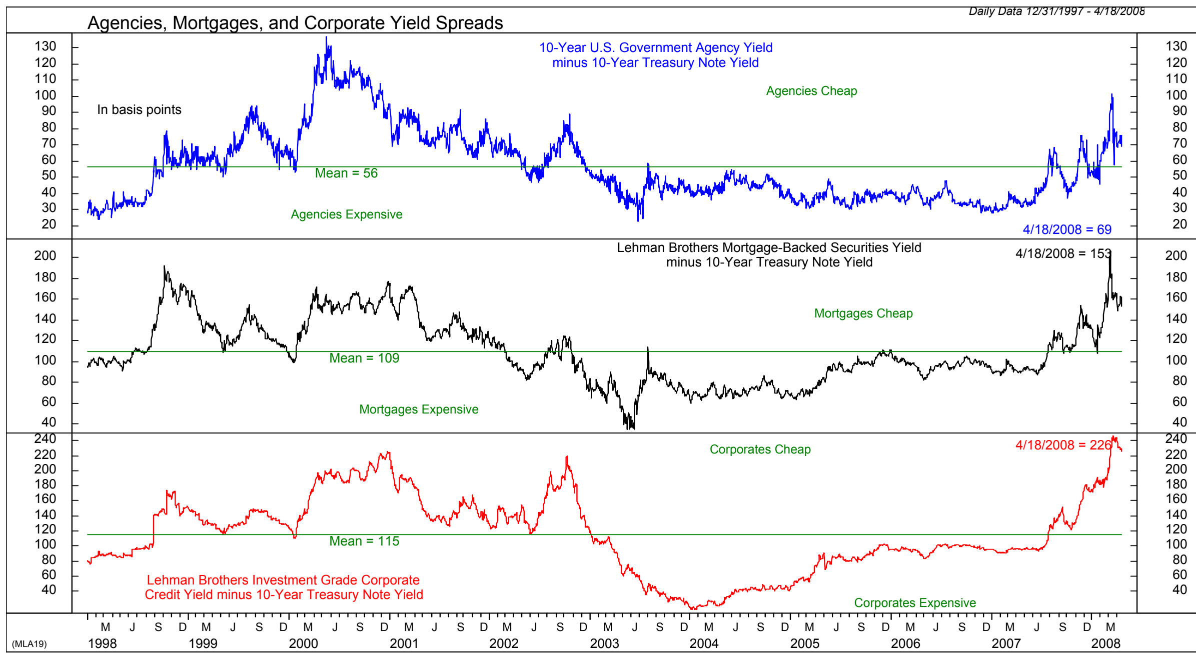
Figure VI



Source: Ned Davis Research

- **Bond spreads have significantly narrowed in both high- and low-quality sectors, propelled by improved sentiment in the financial sector.** This has narrowed levels substantially in default swaps indices, a key indicator that risk among these institutions is perceived to have declined. Mortgage bonds also continue to trade better, fueled by interest in high-quality agency-backed issuers. Investor interest is being supported by recently lowered regulatory constraints on Freddie Mac, Fannie Mae and Federal Home Loan, and confidence triggered by the backstop provided by the Federal Reserve to Bear Stearns.

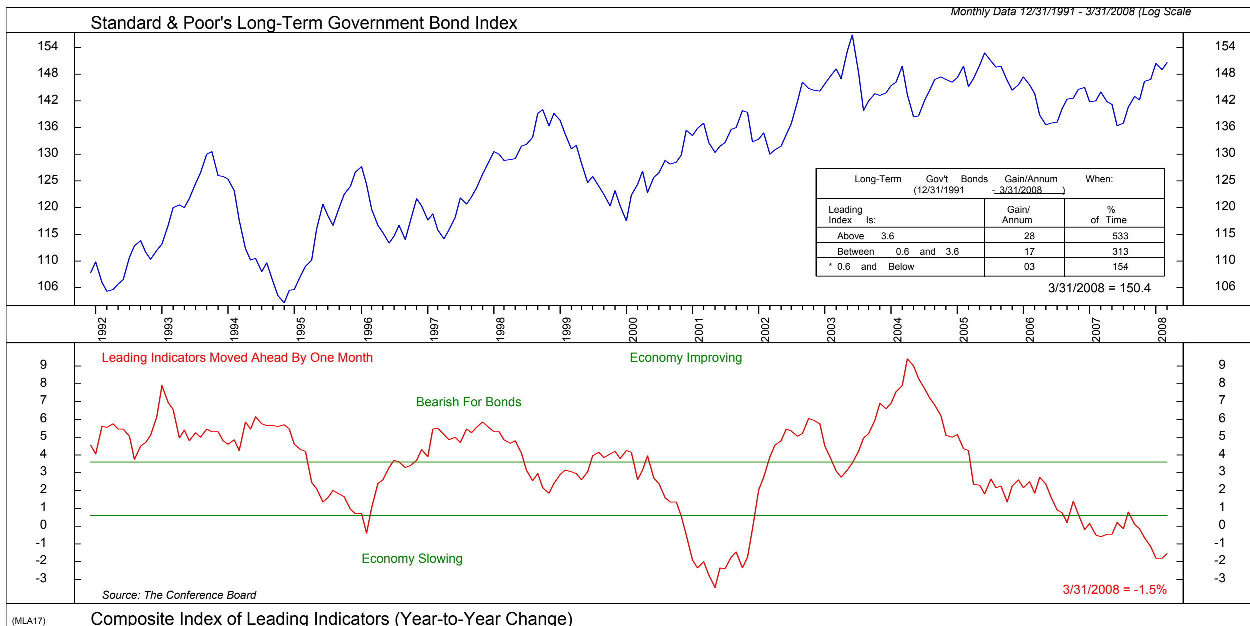
Figure VII



Source: Ned Davis Research

➢ **The municipal bond spreads have widened against Treasury issues as a function of investors requiring less risk. Ten-year spreads between Treasuries and insured munis have narrowed to 50 basis points or 89% of the yield curve.** Also, the slope of the municipal curve has become steeper in anticipation of future interest rate cuts. The pick-up in yield between 2 year and 10 year securities has increased to over 50 basis points. We recommend premium coupons and in the 5-12 maturity range to provide higher cash flow during this period of a slightly higher rate environment.

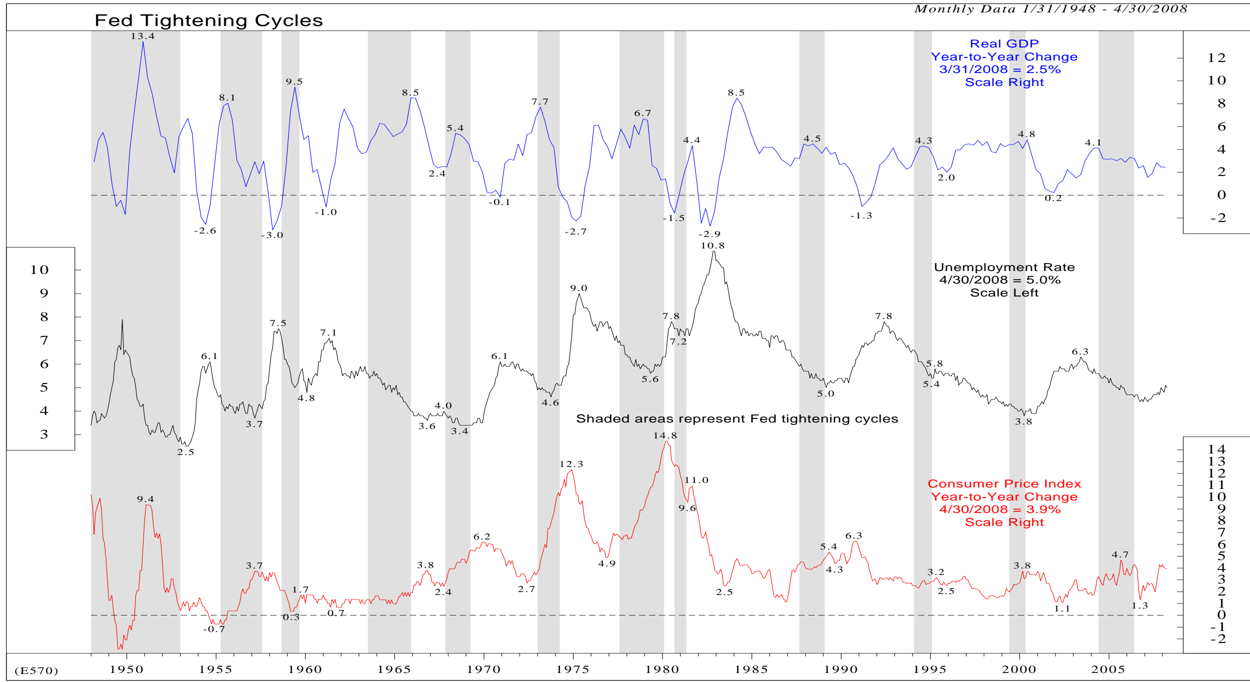
Figure VIII



Long-Term Gov't Bonds Gain/Annum When: (12/31/1991 - 3/31/2008)		
Leading Index Is:	Gain/ Annum	% of Time
Above 3.6	28	533
Between 0.6 and 3.6	17	313
* 0.6 and Below	03	154

Source: Ned Davis Research

Figure IX



Source: Ned Davis Research

FIRM UPDATE

ALTMAN INVESTMENT MANAGEMENT, LLC is celebrating its seventh year managing investments for our valued clients, dedicated to servicing our investment partners in good and more difficult times, by achieving both consistent and superior investment performance relative to our benchmarks across both equity and fixed income classes. Our singular focus on investment performance and exceptional client service, with seasoned investment professionals, continues to solidify our long-term partnerships. To further accommodate our growing client needs we recently opened another office in downtown Princeton on Chambers Street and introduced several new products and professionals dedicated to continuing our tradition of achieving the superior results that our clients should expect and deserve. We recognize that over the past year it has not been particularly easy to stay the investment course, especially during volatile periods in the markets. During periods of uncertainty, we especially appreciate our clients, business partners and friends for their continued confidence in our process and expertise. We look forward to celebrating our ten year anniversary with the same degree of energy and passion as on the first day of incorporation.

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