FIXED INCOME STRATEGY HIGHLIGHTS

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GENERAL MARKET OBSERVATIONS

- **Initially it appeared that Fed monetary policy had an easier time stimulating a weak economy several years ago than it has today, slowing down a strong economy without causing exogenous shocks.** However today we are faced with the inverse situation we had several years ago when the average company balance sheet was stretched and the consumer financial situation was in better shape. This time, corporations are flush with cash and it appears that the consumer wealth binge may be drawing to a close. Stephen Roach, Morgan Stanley's chief economist, has written about this phenomenon in numerous pieces, and describes the post bubble U.S. economy and the onset of global rebalancing. (1)

- **As interest rates in the U.S. stabilize at current levels, global rates in the developed countries (including the U.S.) are still very low and supporting 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 2007 progresses. We continue to emphasize that in aggregate economic evidence still supports a continuation of expansion, albeit at a slower pace. As we begin the third quarter, we expect to see further evidence of a material slow down in the gross domestic product (GDP), from about 4.0% in the second half of 2006, to an annual rate closer to 2.5% for the balance of the year. Although we have trimmed our earlier forecast of 3.0% for real GDP growth in 2007, we remain optimistic that the U.S. economy remains on firm footing. We expect that slowing aggregate demand and potentially muted wage pressure should alleviate any near term inflationary fears at the next FOMC meeting in September.

- **Despite mortgage lending practices and the enormous appetite of hedge funds and private equity firms taking on excessive risk over the last several years, we believe the U.S. economy remains resilient.** Therefore we expect a measured response by the Federal Reserve in the weeks and months ahead.

THE U.S. ECONOMY

- **Quarterly earnings continued to advance better than expected in the second quarter across most economic sectors of the broad market.** After weathering the storm of multiple compressions against a backdrop of heightened geopolitical tensions, elevated oil prices, and rising interest rates, we are strategically positioned to benefit by rising equity valuations in the second half of 2007 as the Federal Reserve develops a more accommodative policy. After advancing 9.4% in 2005, and exceeding 10% in 2006, we expect last year's trend in double digit earnings growth will likely give way to more normal trend-like growth. This should curtail investors' concerns of an economy that's overheating as the rest of the year unfolds.

- **Chairman Bernanke still highlighted that inflation is a key concern.** Although inflation is still expected to edge lower over the next two years, participants in the June FOMC meeting were concerned and concluded that the recent improvement in the CPI could be due to "transitory influences and unsustainable". The Federal Reserve has focused on the rise of global interest rates, the high level of resource utilization, high energy and commodity prices, the decline of the dollar and slower productivity. The Fed did note however that the slowdown in productivity may be smaller than what economists currently estimate. According to Joseph Kalish a senior strategist at Ned Davis Research, Inc. several Fed governors emphasized the importance of keeping inflation expectations at or below current levels, if core inflation is to moderate as expected. The consensus view is for subdued consumer spending in reaction to the housing slump, where sales of existing homes have slowed and housing starts are falling. Homeowners continue to see sales of their homes declining, and the cost of home equity financing significantly higher than previously expected. Added to this headwind are persistently high energy costs putting continued pressure on the consumer's ability to spend.

(1) Stephen S. Roach, Chief Economist, Morgan Stanley & Co, Inc. "*Global Economic Commentary*" October 2006.

- **The revised market view is supported by the recent Federal Open Market Committee's (FOMC) decision to leave the target Fed Funds rate unchanged at 5.25% since the June meeting**. While the core inflation rate is trending at a higher rate than the Chairman's stated between 1.0-2.0% tolerance levels, he has indicated that inflation will moderate in the coming months as economic activity slows. A "substantial" cooling of the housing market, as well as his observation that recent economic indicators are now "mixed", departed from the previous comments and has set the stage for a more accommodative Federal policy in the next several quarters.

- **Since recent sub prime lending practices could curtail normal market liquidity, we are expecting the Federal Reserve to remain on the sidelines, avoiding the possibility of the U.S. economy dipping into a recession by increasing interest rates.** The U.S. economic growth has slowed since the first quarter of 2006 when real growth was as high as 5.5%. Taking into account all the revisions, the U.S. economy grew at an annual rate of 3.4% in the second quarter after adjustments for inflation. At present we believe that the first half of 2007 real GDP grew at a rate of between 2.0-2.5% but still on solid footing versus the first quarter growth rate of a revised .06% rate. For the twelve months ending June, real GDP advanced 1.8%.

- **We are anticipating material deceleration in economic growth, which would further alleviate wage concerns.** The average real gross domestic product (GDP) was revised downward by 0.3% for the three year period from 2004-2006 or from 3.5% to 3.2%. This lower activity caused a downward adjustment in corporate profit growth by a full percentage point against a revised disposable income figure over the past three years of close to $180 billion. This upward revision put the savings rate into positive territory. It now appears that as the deceleration has begun in 2007 our cautious stance on the willingness and the ability of consumers to refinance their housing wealth has gained some credibility. Weakened spending patterns finally materialized, against an already attenuated savings rate environment. In lieu of the recent up tick in refinancing activity, impending stress to the financial system appears to be gathering steam. This further confirms that we should continue to spend our research efforts on the defensive consumer staple companies in the market place. We are focusing on businesses that are proactively implementing strategies that could develop into secular growth paths and could depart from their more recent poor operating histories. Further discussion on portfolio construction can be found in the *Portfolio Strategy and Sector Allocation* section of this commentary.

- **The trade deficit widened on higher oil prices to $60 billion in May, narrowing on a twelve month basis to $763 billion, compared with $717 billion in 2005.** Exports are expected to be higher by some 11.0% ($.45+ trillion) with imports still on a solid growth path advancing some 10-11.0% to $2.5 trillion. More importantly we are closely monitoring the U.S. trade deficit with China which we anticipate will grow to $246 billion and accounting for a record 30.7% of the U.S. total goods deficit. We estimate the import component as high as $290 billion of the total. The size of this number is not as relevant from a political risk perspective; because as much as a third of this deficit is the result of U.S. companies investing abroad in order to export back to the United States. It is important to note that a large part of the financial surpluses from foreign trade are invested back into the United States. During 2006 net capital inflows into the United States were $895 billion compared to $839 billion in 2005. In terms of the flow of funds, the improvement in the federal deficit suggests less government borrowing. The Federal deficit for the first eight months of the year ending September was $152 billion or about 1.0% of GDP and is expected to be $205 billion according to the Bush administration. This compares to $248 billion in fiscal 2006. Tax receipts are growing at an 11.8% rate and outlays are increasing at a rate of 5.7% due to strong corporate profit performance and capital gains. If this trend continues, the Federal budget could be balanced by the spring of 2008.

- **The ISM Semiannual Economic Forecast indicates both the manufacturing and non-manufacturing sectors rose 1.0 point to 56.0 in June and above expectations for the third consecutive month.** Most of the improvement came from a 4.6 gain in production which equates to a 4.4% annual rate of growth in this cycle. As new orders slowed and backlogs contracted for several months, economists have concluded that a slow down in the pace of business growth is now imminent. This points to a real GDP growth of closer to a 3.1% rate, down from the 3.5% rate reported earlier. Price pressures eased slightly with the index falling 3.0 points to 68.0 with the number of commodities up in price falling to l0, the fewest since mid 2003.

- **Residential Sales and Construction continues under pressure.** Pending home sales fell again in May by 3.5% resuming the downward trend with new home sales off 15.8% from a year ago. This now indicates a gradual moderation in the rate of decline. According to S&P/Case-Shiller, home prices recorded their biggest drop in over 15 years in April. Prices have fallen in each of the four months this year. Housing prices still remain under pressure

across most regional markets, with the median home falling 0.7% over the past year. However, home prices appear to have stabilized around 4.0% above their year ago levels according to Ned Davis Research and forming a bottom, as of the end of June according to many economists.

- **The Consumer Confidence Index fell 6.9 points to 105.0 in August, its lowest reading in a year. The turbulence in the credit markets has not yet made its way to a reduction in interest rates expectations.** The weakness in the jobs measures suggests upward pressure on the unemployment rate, which would allow the Federal Reserve to ease the funds rate. Economists expected this index to fall as slower U.S. economic growth unfolds. We expect this trend to continue as the shake-out of the sub-prime mortgage market and higher energy prices should contribute to further deterioration in the current readings. Durable goods orders continued to confirm that the economy is indeed slowing. Orders remained under pressure declining 2.8% in May, as civilian aircraft orders dipped 23%. The fear is that the forecast of mid single digit growth in real capital expenditure may be subjected to more serious downward revisions. Despite this negative news, wages have been trending higher, as evidenced by recent employment cost index results of 3.3% and a better than expected unemployment number at 4.5%.

- **The implicit price deflator, a measure of inflation in the GDP report was 2.7% versus 4.2% in the first quarter.** In June, however, the consumer price index (CPI) advanced by 0.2% and the producer price index (PPI) fell by 0.2%, with year over year gains of 2.7% and 3.3% respectively. We expect the core rate to remain at 2.2% as slower production growth has been disinflationary. In the past the Federal Reserve has expressed some concern over rising inflation against new lows in the U.S. dollar against many currencies. This recent slowing pattern in headline inflation should alleviate some of the pressure on Federal Reserve policy, and allow the FOMC to remove its tightening bias in the next meeting.(2)

- **Our view is that the U.S. economy will continue to slow down in the coming months, with real GDP growth forecasted at an annual rate of 2.5% in 2007, against a backdrop of 2.5% CPI inflation and a gain in corporate profits of 5.0- 6.0%.** GDP grew at a .7% annual rate in the first quarter against a 2.2% annual rate in the fourth quarter and below expectations of 3.5%. This annual rate was less than half of the first quarter rate of 5.6% in 2006. These profits reflect the national income accounts after adjusting for capital consumption allowances and inventories. This forecast compares to a real GDP of 3.3%, a CPI of 3.2%, and corporate profits of 9.4% in 2005.

THE U.S. FIXED INCOME MARKET

- **Tighter financial conditions are likely to accelerate the Fed's timetable for easing policy. We would expect rate cuts to commence in the fall.** While sharp erosion in the credit-sensitive sectors has occurred, bond markets are not poised for a sustained meltdown under current conditions. The sub- prime lending market dislocation is being driven by liquidity, not credit quality. Market volatility has not run its course, as credit organizations search for liquidity to satisfy both sides of their markets.

- **The persistent housing slowdown coupled with sub-prime mortgage defaults could continue to put pressure on the economy for several months to come.** In addition recent rising gasoline prices 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 strong profit and very positive cash flow are being hoarded by corporate treasuries for the purpose of stock buy backs or acquisition rather than plant and equipment or system upgrades.

- **On a positive note we have experienced continued strength in the non-farm employment,** and the low unemployment rate should help bolster consumer confidence and provide enough discretionary income to sustain a reasonable level of economic momentum. However, we are still mindful that we could be in a period of sub par business activity that lasts several quarters. Comments by the former Fed Chairman Greenspan that the possibility of a recession in the near term is imminent are still circumspect. However we do concur that growth below the trend line rate remains the most likely scenario.

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(2) *Economic Insights: Inflation,* published by Altman Investment Management, LLC, August 2007

- **Another concern expressed by the Fed, aside from the CPI level rising above their stated comfort level, is that hourly wages have been rising at a 4+% annual rate**. Core inflation is running at about 2.2% with the Fed Funds currently at 5.25% and the real rate of 3.1%. The real rate is still far below the average rate of 4.0% that is consistent with this later stage of the business cycle. Moderating productivity gains as compared to year ago levels is complicating the Fed's task of curtailing headwind inflationary tendencies of an over stimulated economy. Therefore, we have concluded that as long as the economic growth is positive and appears sustainable; our forecast is for the monetary authorities to remain on hold as they continue to monitor the current conditions. The legislative gridlock in Washington curtailing excessive spending behavior for the next two years and increased tax collections by the Treasury should have the effect of reducing the Federal deficit as the economy continues to grow.

- **Although we appear to be at the end of an impressive tightening in the interest cycle, financial conditions do not reflect restrictions in market liquidity.** Real (adjusted for inflation) Fed Fund rates are relatively low. The possibility of slower economic growth has prompted predictions that the Federal Reserve will ease in the coming months. In recent weeks economic growth indicators have continued to fall off dramatically. This coupled with continuing credit market pressures confirm our underlining assumption that the Fed is likely to cut interest rates at the next FOMC meeting reversing their earlier neutral stance.

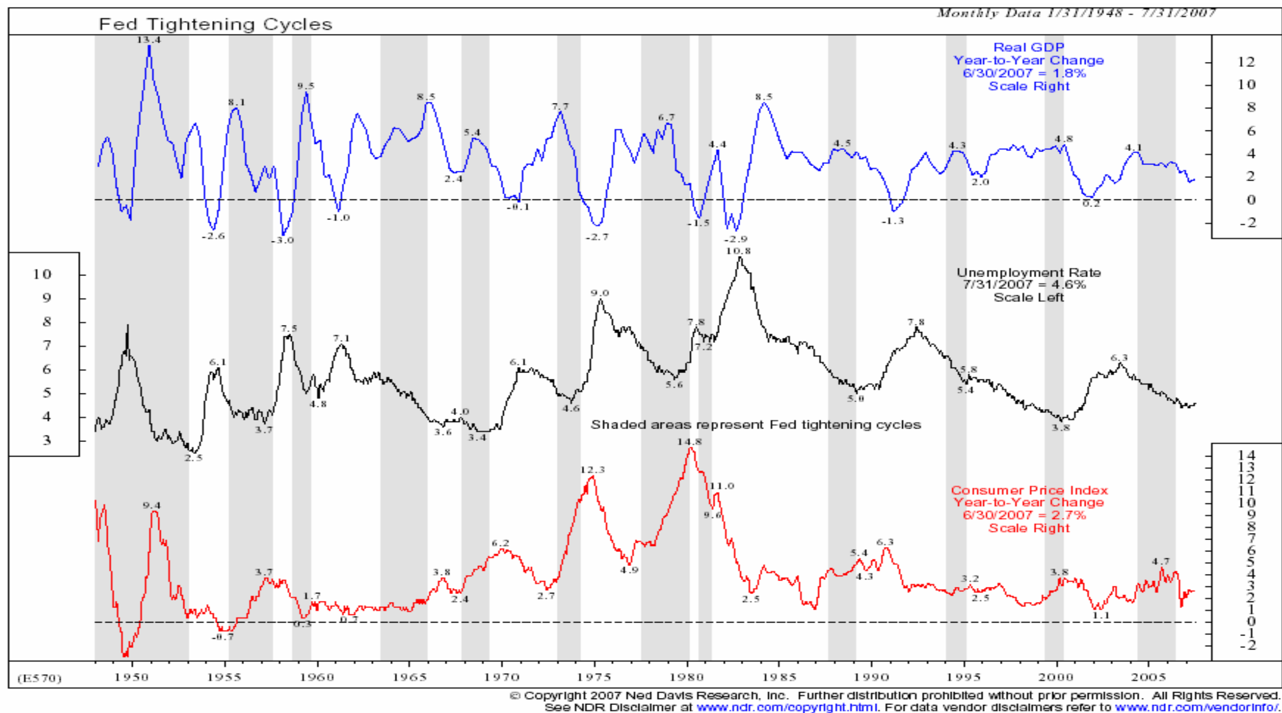

Figure I

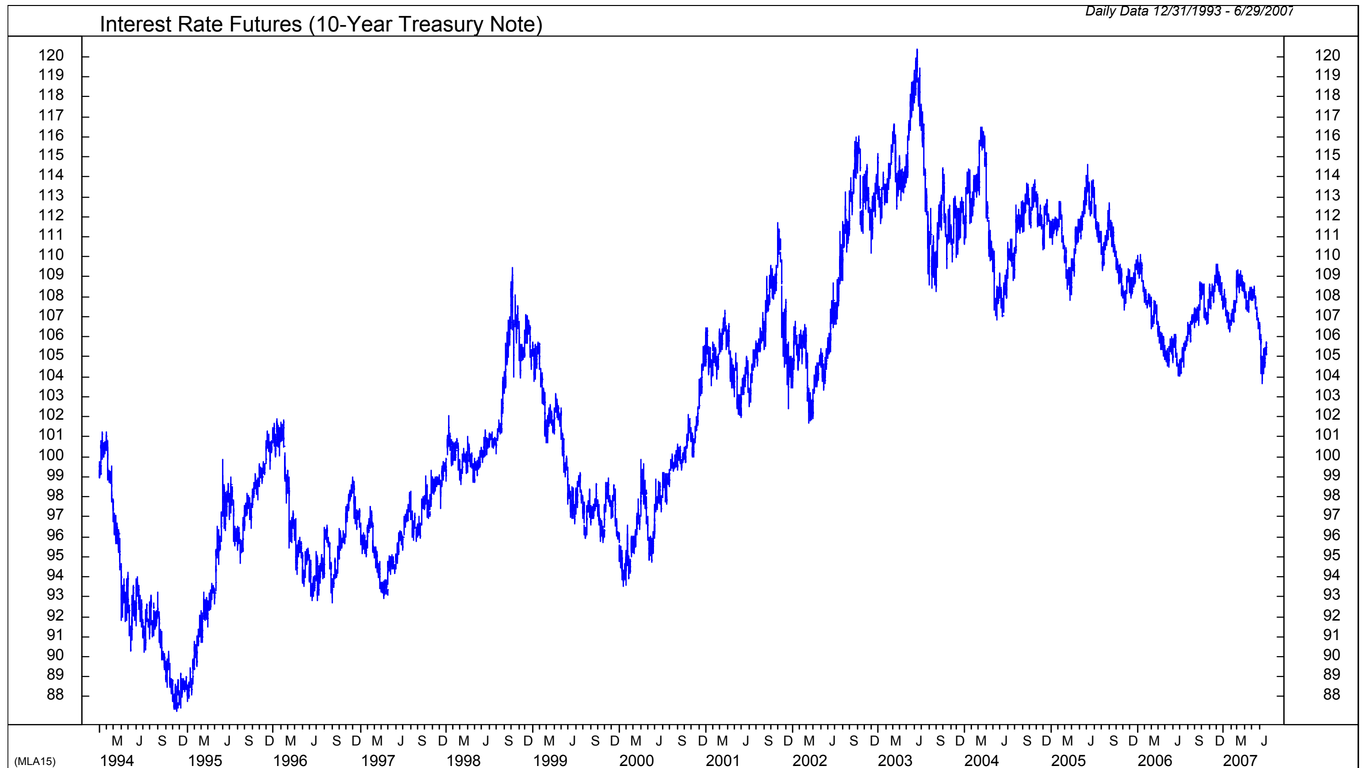

Figure II

➢ **A sharp rise in risk, in the context of softer economic fundamentals and substantially tighter financial conditions, should shift the Fed's timetable in lowering over-night rates sooner than later.** We would expect the Fed to ease rates at least 75 basis points by year-end. This would allow the yield to steepen more positively, thereby providing better "carry" for the banking institutions. Investors in high quality, U.S. agency backed mortgage product should feel comfortable in maintaining their positions over the long-term, because the credit quality has not deteriorated.

Figure III

- **The municipal bond spreads have widened against Treasury issues as a function of investors requiring less risk. Ten-year spreads between Treasuries and insured municipals 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.

- **The municipal bond market has continued to perform well against longer-term taxable issues, with yields as a percentage of taxable yields, maintaining relatively stable spreads throughout the period**. The one to thirty year spread in the prime municipal yields was 120 basis points at the end of 2005, but dropped to 98 points at mid year and closed the year at a modest 59 basis points. The Treasury curve remains slightly inverted as it has all year. Municipal investors should avail themselves of appropriate taxable securities, which have attractive after-tax yields. This is especially true in the shorter maturities where the taxable yield curve is inverted, while the 'muni' curve is positively sloping. We continue to recommend premium coupons in the 5-12 maturity range to provide higher cash flow during this period of flat to a slightly higher rate environment.

FIRM UPDATE

Altman Investment Management, LLC completed another successful quarter with a strong showing in new business prospects and superior investment performance relative to our benchmarks across both equity and fixed income classes. Our singular focus on exceptional client services, with seasoned investment professionals, continues to solidify our long-term partnerships. To further accommodate our growing client needs, we have opened a new office in downtown Princeton on Chambers Street in the first quarter and introduced an international component to our product line. The close of this year's June quarter marks the completion of our sixth year managing money for our clients under the Altman Investment Management banner. While achieving these superior results that our investment clients should expect and deserve, we are compelled to also point out that it's not always easy to stay the investment course especially during volatile markets. During these periods of greater uncertainty, we again appreciate our clients, associates and friends for their continued confidence and support in our program and look forward to celebrating our ten year anniversary with the same degree of enthusiasm and passion as on the first day of incorporation.

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.