ENDURING HEADWINDS

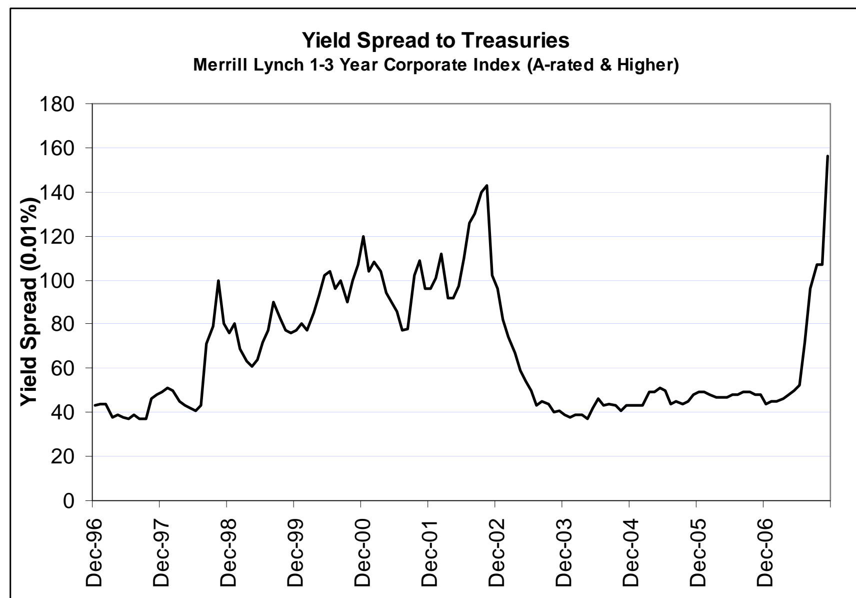
Five Themes for Our 2008 Investment Outlook

EXECUTIVE SUMMARY:

Our five core themes for the risk-averse, short-duration, and buy-and-hold corporate cash investor are:

1. Economy and Interest Rates: Looming Recession Risk and Lower Rates
2. Corporate Credit: Battered and Cheapened, but Not Down and Out
3. Market Technical Factors: A Wary Market Short on Liquidity
4. Asset-backed Securities (ABS): Show Me the Collateral
5. Return Expectations: A Steady Hand Wins the Game

As we read our tea leaves for 2008, a note of caution for the reader is in order as both the market and the economy are in a precarious situation fighting the housing and credit double corrections.



Source: Merrill Lynch Global Index System (www.mlx.ml.com)

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What a difference a year makes! A year ago, we titled the article of our 2007 outlook "*Mostly Smooth Sailing with Occasional Choppy Water.*". However, what we experienced was more like a tsunami. As the subprime credit crisis played out longer and harder than most expectations, many corporate treasury investors were especially impacted. This is because many of the bruised asset types including money market funds, asset-backed commercial paper and auction rate securities were investments of choice in some cash portfolios.

Last year we properly forecasted the general direction of market developments but underestimated the great reversals of market liquidity and investor euphoria. While conservative investors were rewarded with respectable returns, they did not do so without some anxiety and restlessness. As we try our tea leaves again for 2008, a note of caution for the reader is in order as both the market and the economy are in a precarious situation fighting the housing and credit markets double corrections.

As with all of our publications, we are mindful of the relevancy of market outlooks for the risk-averse, short-duration, and buy-and-hold corporate cash investor. Here are our five core themes for the New Year.

1. Economy and Interest Rates: Looming Recession Risk and Lower Rates

The subprime crisis and an ensuing liquidity crunch forced the Federal Reserve's hand in lowering the benchmark federal-funds rate by a full percentage point to 4.25%. The Fed did so without taking its eye off the inflation ball. We thought the GDP would be below the economy's long-run potential, at just under 2% annualized. It turns out that the U.S. will have grown at a respectable pace of 2.5% (assuming 1% for the fourth-quarter). Even as the housing and credit markets sank deeper, the third and fourth quarters posted strong growth rates of 3.8% and 4.9%, respectively.

Looking out to 2008, we see the risk of recession creeping up to a statistical coin-toss of 50/50. Higher costs of doing businesses, tighter bank credit and fatigued consumer spending may make it difficult for the economy to avoid losing steam, even with stimulating Fed policies. Until and unless excess housing units are absorbed and national home prices stop falling, which may not come until early 2009, the consumer-

dominated U.S. economy may continue to have trouble finding a firm footing.

As a result, we expect the Federal Reserve to continue lowering interest rates in 2008. This means we are likely to see short-term yields decline from current levels. On the other hand, the "fool in the shower" concern, an analogy of one who turns the hot water all the way up to warm a cold shower, could rekindle inflationary worries that may cause a quick snapback in rates once the economy stabilizes itself and inflation fears return.

2. Corporate Credit: Battered and Cheapened, but Not Down and Out

We stepped into 2007 knowing that the waters could be choppy. Thankfully, our concerns of higher corporate debt levels through buyouts and share repurchases did not materialize as funds dried up quickly after the subprime credit issue took center stage. Instead, 2007 will be remembered as the year the "structured credit" bubble burst and discussions of risk management returned to boardroom agendas. In focus were a number of structured products, or repackage bonds, with questionable asset collateral and complicated risk mitigation techniques that failed real life tests.

We think that concerns with financial credits and a slower economy will continue to weigh on bond investor sentiment in 2008. Several large financial issuers are in a capital replenishing mode to make up for subprime-related write-downs. Issues in consumer credit, commercial real estate and leveraged loan areas may result in higher credit losses. However, well-diversified commercial and investment banks should continue to benefit from liquidity and capital relief from monetary and fiscal authorities. While specialty lenders and those sensitive to capital markets may see tougher times ahead, many of the well-run regional banks could perform better with their quintessential "safe-haven" status.

In addition, the non-financial sector is still in a decent shape. Profit growth in the U.S. non-financial sector is likely to slow down, but cash reserves are ample, debt coverage ratios are firm and borrowing rates are still relatively low. Aggressive share repurchases, a major concern for bond investors, should subside more in 2008. Credit-worthy firms can still issue debt at very low levels despite higher spread relative to Treasury bonds.

In summary, we think softer credit fundamentals are fully reflected in corporate spreads. With wide yield spreads and low event risks, 2008 can be a great year for corporate spread performance relative to Treasury securities if the subprime spill-over is limited. In fact, investment-grade corporate bond yields are now cheaper than the post-Enron era[1].

3. Market Technical Factors: A Wary Market Short on Liquidity
After years of insatiable demand for yield by investors and the torrent of new issues, the supply-and-demand dynamics now show the signs of mean reversion with dried-up liquidity and cautious investors. Now, the question is – when will liquidity return?

Recently, we've seen corporations seize opportunities to raise debt whenever the market stabilizes. We think this trend will continue. Short-term market uncertainty may cause issuers to issue less commercial paper and more term debt to lock-up funding. More short-term issuance may be a good sign of issuers feeling less uneasy about the liquidity crunch. On the demand side we expect investors to remain in higher-quality names and not chase after tarnished names. Commercial paper issuances, in particular asset-backed commercial paper, may continue to dwindle, more as the result of issuers' retreat than from diminished demand.

A key challenge for 2008 is that there will be more bonds maturing in this year than in 2007 or 2006[2], suggesting greater funding needs. In a market still fumbling for stabilization, how investors absorb the new debt will likely follow the fundamental credit stories. No doubt that the Fed will come to the aid by luring liquidity back into the market, but its effectiveness remains to be seen. As the market stabilizes itself, the return of foreign investors to US bonds may reinforce the positive momentum later in the year.

In short, once the credit market finds a way to break out of its current liquidity grip, we could see a dramatic turnaround for much improved market conditions.

4. Asset-backed Securities (ABS): Show Me the Collateral
Last year, the asset-backed sector held up well despite some asset quality weaknesses. High credit ratings, attractive yields spreads and the absence of corporate event risk made these securities attractive for cash portfolios. This still remains true, but the broader ABS sector received the "guilty by

association" verdict due to losses in subprime ABS and CDOs (collateralized debt obligations) backed by subprime mortgage loans.

What began as an isolated risk of faltering sub-prime ABS/CDOs in early 2007 re-emerged in late summer as a broad-based re-pricing of asset-backed credit risk. We think the spread widening in asset-backed commercial paper (ABCP) and term ABS backed by prime credit card and auto asset collateral was unjustified. We do not believe those securities share the drawbacks of limited collateral disclosure and thinly traded volumes that are trademarks of subprime ABS/CDOs.

We believe the marginal credit quality deterioration in the non-mortgage ABS market will be gradual and manageable. We think this mispricing presents good buying opportunities in certain asset-backed names. As the risk pendulum swung to the other side causing investors to question all things asset-backed, we view notes backed by prime credit card and auto collateral as core holdings in cash portfolios.

5. Return Expectations: A Steady Hand Wins the Game

The past year may be remembered as the year of the great risk "resets". Esoteric investment vehicles including extendible ABCP, auction rate securities (ARS), structured investment vehicles (SIVs) and yield plus funds sank the returns of many aggressive investors. Meanwhile, performance of the more traditional government and corporate portfolios was quite respectable. For the first 11 months of the year, index total returns were 7.1% for Treasuries, 6.3% for agencies and 6.0% for corporate bonds rated A and higher, all maturing between one and three years. These returns compare to 5.2% for the three month T-bill[3]. As a consequence, we've seen more cash investors return to the humble enclaves of Treasury, agency, bank and corporate instruments.

Our 2008 return outlook is surprisingly similar to our call from last year. Near-term market uncertainty and the inverted shape of the yield curve may benefit investments in the shorter end of the maturities with higher yield potential. Although the Fed may not be done with its easing policy, we are hesitant in moving up the yield curve for much lower yield levels. We think a Fed-engineered economic revival may mean that inflation concerns return to the center stage late in the year. The short portfolio maturity bias in an inverted yield curve environment could mean a good chance of keeping principal investments safer, a point not lost in an uncertain market environment.

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[1] The Merrill Lynch 1 to 3 Year Corporate Index yield spread to Treasury on 11/30/07 was 156 and 143 on 10/31/07, according to Merrill Lynch Global Index system www.mlx.ml.com.

[2] Investment-grade corporate bond maturities were $603.4 billion in 2008, $483.0 billion in 2007 and $459.7 billion in 2006 according JPMorgan 2008 Credit Outlook, Table 9, December 14, 2007.

[3] Merrill Lynch Global Index System year-to-date returns through November 30, 2007 were Treasuries (G1O2) 7.06%, Agencies (G1P0) 6.31%, Corporate A-rated and higher (C110) 5.95%, and 3-month Treasury bills (G0O1) 6.63% (www.mlx.ml.com).