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U.S. BOND STRATEGY

May 26, 2006

Investment strategy and recommendations for the U.S. fixed income market

Special Report

U.S. CONSUMER SLOWDOWN: IS IT FINALLY HERE?

CHART 6
The Stimulus From Home Equity Extraction Is Over

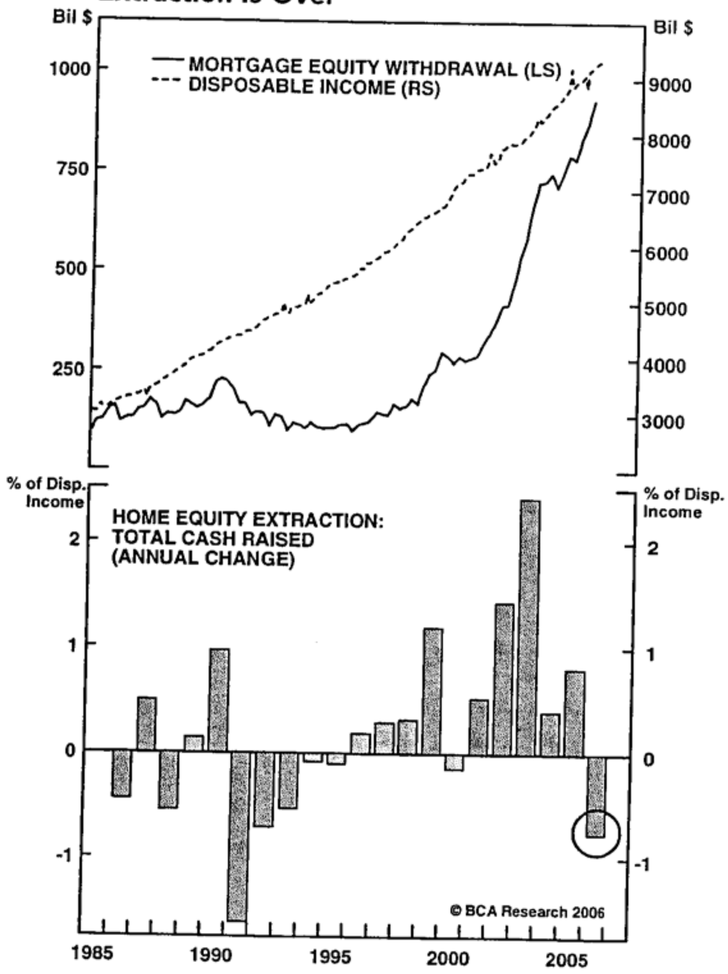
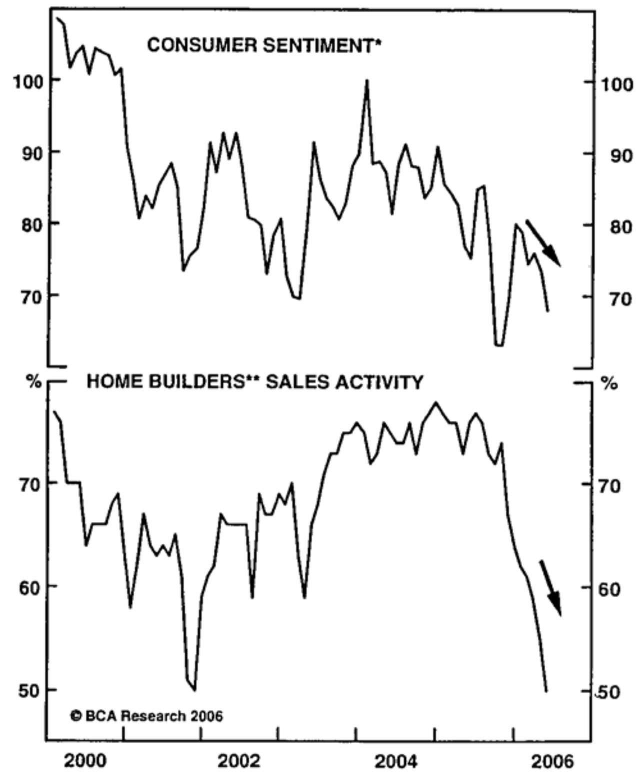


CHART 1
Housing And Consumer Confidence: Look Out Below



*SOURCE: UNIVERSITY OF MICHIGAN
**SOURCE: NATIONAL ASSOCIATION OF HOME BUILDERS

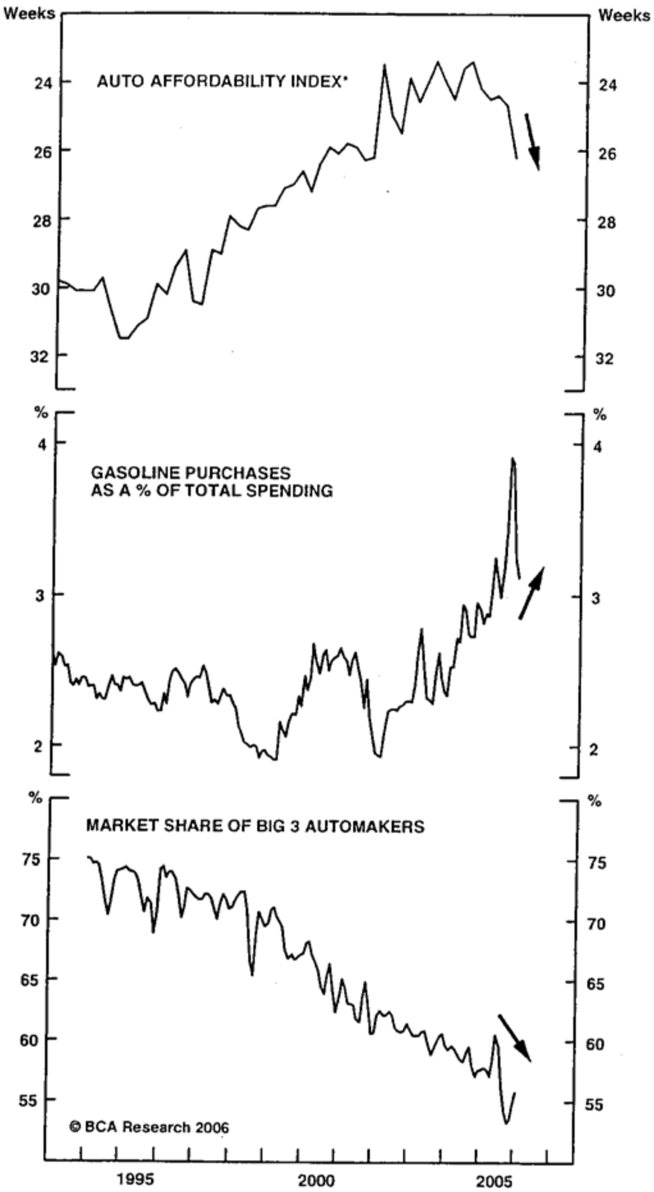
withdrawal hit all-time highs which, in turn, further fueled the consumption binge and contributed to a rundown in savings from income. However, the landscape has changed considerably in the past 6 to 12 months.

Interest rates have now risen significantly across the yield curve, energy prices are near record levels and the stimulus from housing is fading fast. The consumer sector's resilience in the past year in the face of these headwinds was, in large part, due to unusually low bond yields that helped sustain the housing bubble. Consumers felt extremely confident as wealth gains accumulated,

E10

AUTOS VERY WEAK

CHART 5
Auto Sector Outlook Is Bleak



*NUMBER OF WEEKS OF MEDIAN FAMILY INCOME IT WOULD TAKE TO BUY AN AVERAGE-PRICED CAR; SOURCE: COMERICA

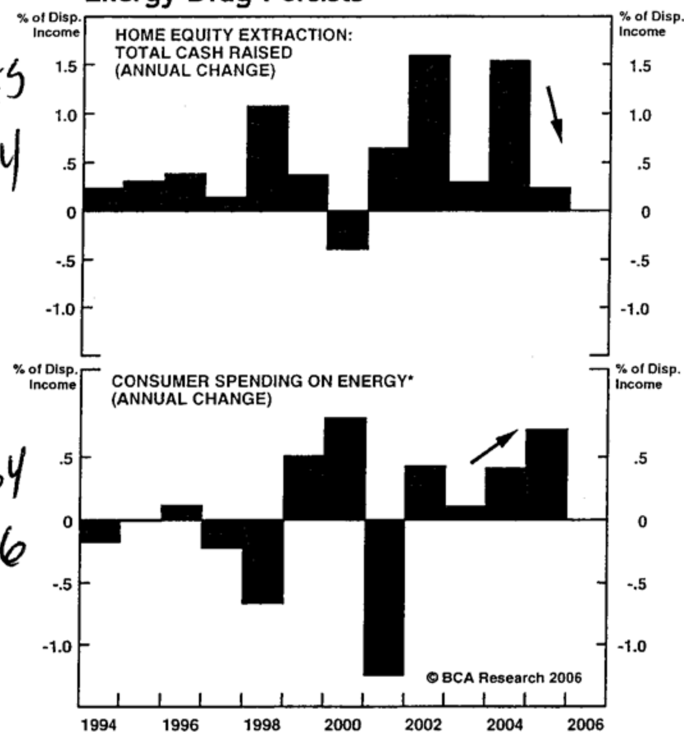
the time the Fed goes on hold. Auto affordability plunged in the third quarter and a further deterioration in Q4 seems likely (**Chart 5**). The high cost of gasoline also threatens to dampen auto sales. Spending on motor fuel as a percentage of total consumer expenditures is up sharply from its average in the early part of the decade (**Chart 5**).

CONVENTIONAL ECON. DRIVERS WEAKENING.

CHART 2
Stimulus From Housing Is Fading, Energy Drag Persists

HOMES TOPPY

ENERGY DRAG



*INCLUDES GASOLINE, FUEL OIL, NATURAL GAS, AND ELECTRICITY
NOTE: 2005 IS A BCA ESTIMATE FOR BOTH SERIES

power in recent years. **Chart 2** shows that growth in mortgage equity withdrawal (MEW) fell sharply last year, while the energy burden on consumers' pocketbooks has escalated.

MEW will not be a large contributor to consumer spending this year, and it may turn into an outright drag. The Australian and U.K. experiences offer important lessons for the U.S. In both cases, a deceleration in real estate inflation was quickly followed by a drop in MEW, which sparked a substantial moderation in retail sales growth. This occurred even though their respective central banks achieved a soft landing in the overheated housing sectors. The U.S. is likely headed down the same path, which means that investors should stay overweight bonds.

1

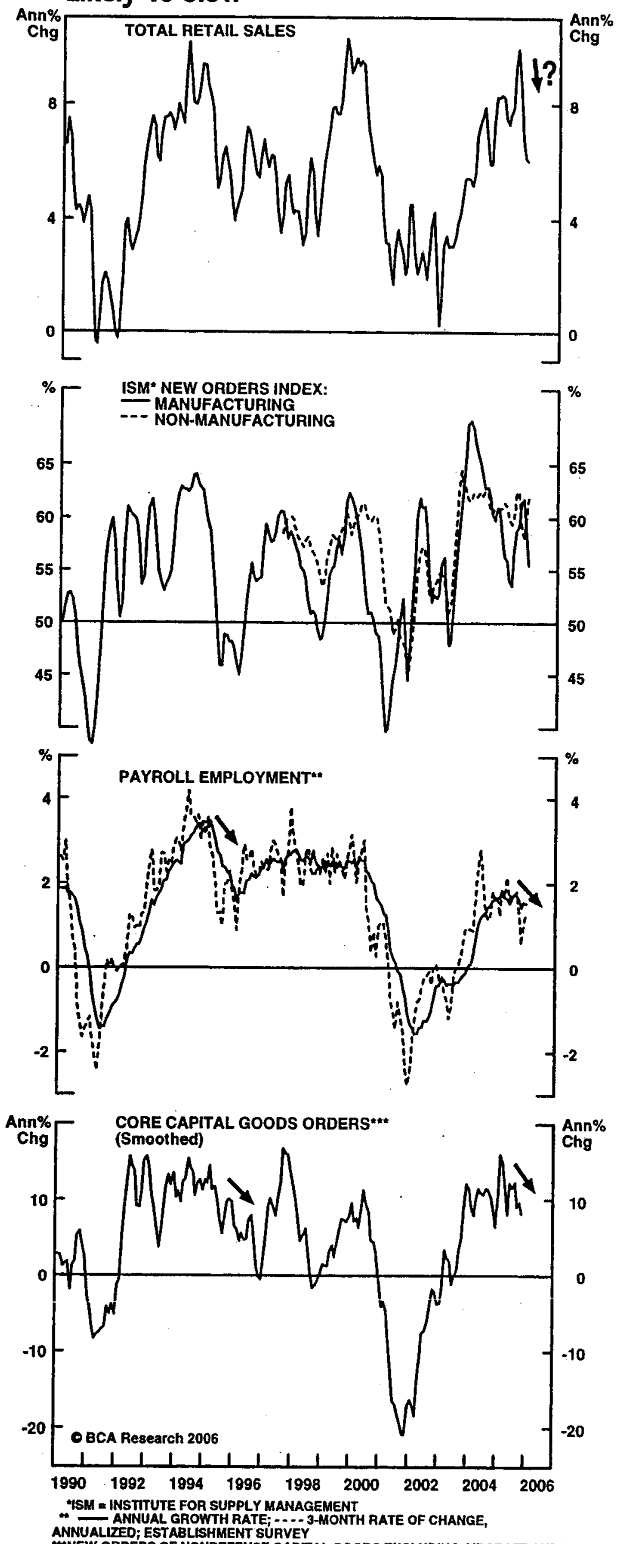
Table 1 and **Chart 3** present U.S. Treasury bond returns relative to cash around the time of the last three peaks in the fed funds rate. Typically, market

Positive: slowing economy cools inflation worries

2006:

CHART 10 SLOWER GROWTH

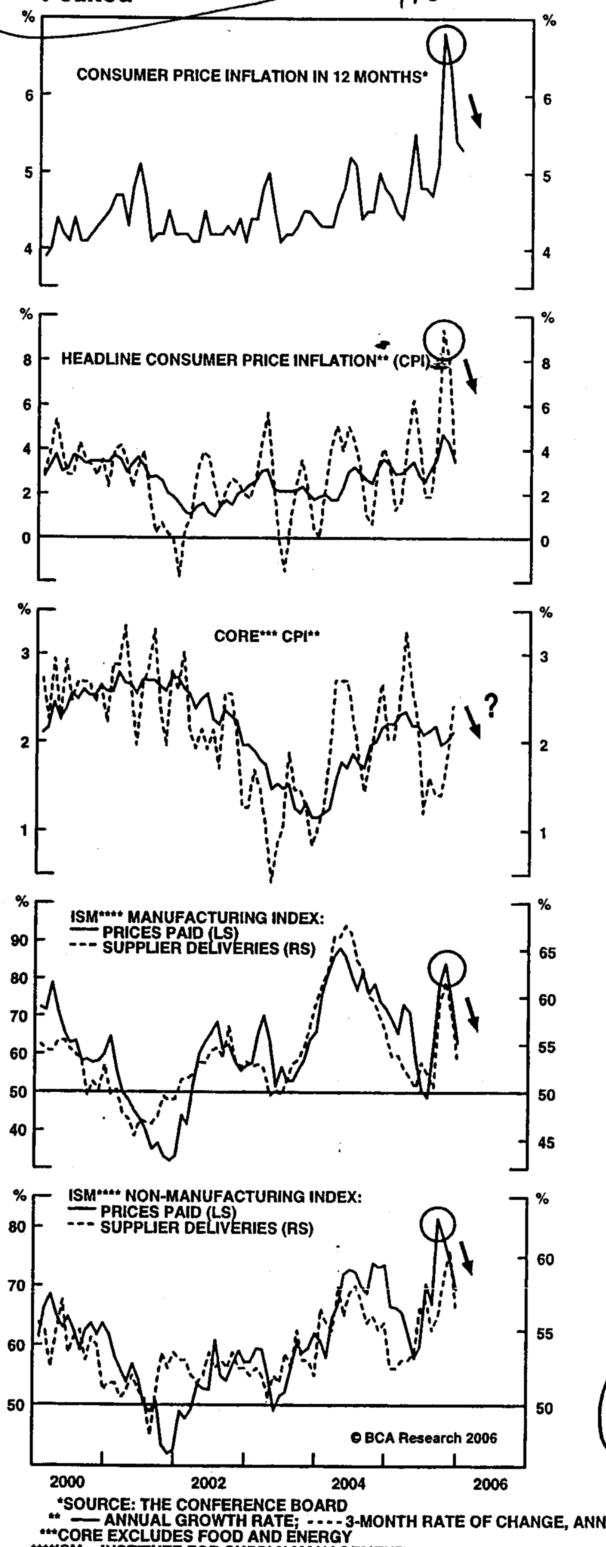
Payrolls And Investment Growth Likely To Slow



*ISM = INSTITUTE FOR SUPPLY MANAGEMENT
** —— ANNUAL GROWTH RATE; ---- 3-MONTH RATE OF CHANGE, ANNUALIZED; ESTABLISHMENT SURVEY
***NEW ORDERS OF NONDEFENSE CAPITAL GOODS EXCLUDING AIRCRAFT AND PARTS

CHART 11 TAMER INFLATION

Inflation Pressures Have Peaked



*SOURCE: THE CONFERENCE BOARD
** —— ANNUAL GROWTH RATE; ---- 3-MONTH RATE OF CHANGE, ANNI
***CORE EXCLUDES FOOD AND ENERGY
****ISM = INSTITUTE FOR SUPPLY MANAGEMENT

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ABOUT ECRI

In the Press

Despite layoffs/oil prices 2005 OK

12/29/2005

NEW YORK, Dec 29 (Channel NewsAsia) - 2005 proved to be a good year for the US economy.

Despite headlines of mass redundancies at companies like General Motors, high oil prices and continued fears over US pensions, the economy grew at a faster than expected pace with strong job growth.

2006 is set to be a year where all eyes will be on the US Federal Reserve which is set to stop raising interest rates.

In 2005, the economic headlines were dominated by the price of oil, which was expected to hit the economy and the consumer hard.

And after Hurricane Katrina, economists braced themselves for a downturn.

But the US economy held firm.

Brian Fabbri, Chief Economist, BNP Paribas, said, "We are sort of playing second fiddle to economy that has just done absolutely exceptionally this year in spite of a lot of pitfalls like energy costs, like consumer confidence declines, like the whole question of how the administration is handling everything and anything - all of these things are matters of concern; however people are wealthier."

So after an icy start, the US economy really picked up steam in late 2005.

At the beginning of 2005, many economist thought the US economy was skating on thin ice, but New york has recovered well from the shocks of the 2001 and so has the US economy generally with GDP growing above trend at 4 percent and 5 percent.

Part of the reason the American consumer has continued to spend is the continued boom in housing in 2005

Laksman Achuthan, Economic Cycle Research Institute, said, "If you've been a home owner, you've had some distraction in a positive way. Basically if you have been lucky enough to own a home during much of this while, you've seen a lot of negative headlines, and while you've seen things like energy or food prices spike up, you've also seen the value of your home spike up, and this wealth effect - even if you don't touch the money - you feel like it is savings in the bank account...(it) has an impact on you that allows you to still live the life you were living the year before."

High oil prices have meant record breaking profits for the oil companies too.

But it is not just the oil sector - banks, retailers technology sectors all posted strong profits in 2005, all boosted by strong productivity, a weak dollar and growing demand from Europe and Japan.

But there was a sense of nervousness; mass layoffs (and) pension plans have clouded an otherwise impressive economic performance.

So with so much end-of-year cheer for 2005, surely 2006 will be a bumper year too.

However, while many economists think 2006 looks strong, some economic data has started to shift.

Mr. Achuthan said, "Now when we look at the drivers of the economy, housing inventories, jobs and profits, we are starting to see them turn down and they are weakening. They are not recessionary, we are not forecasting a recession, but we do see softer or slower growth in the overall economy going forward."

!! 2005 was a very good year, while 2006 is seen by many economists as a transition year.

2007 for many looks much more scary, with growing debt problems and the looming retirement costs of the baby boomer generation.

more ECRI press quotes

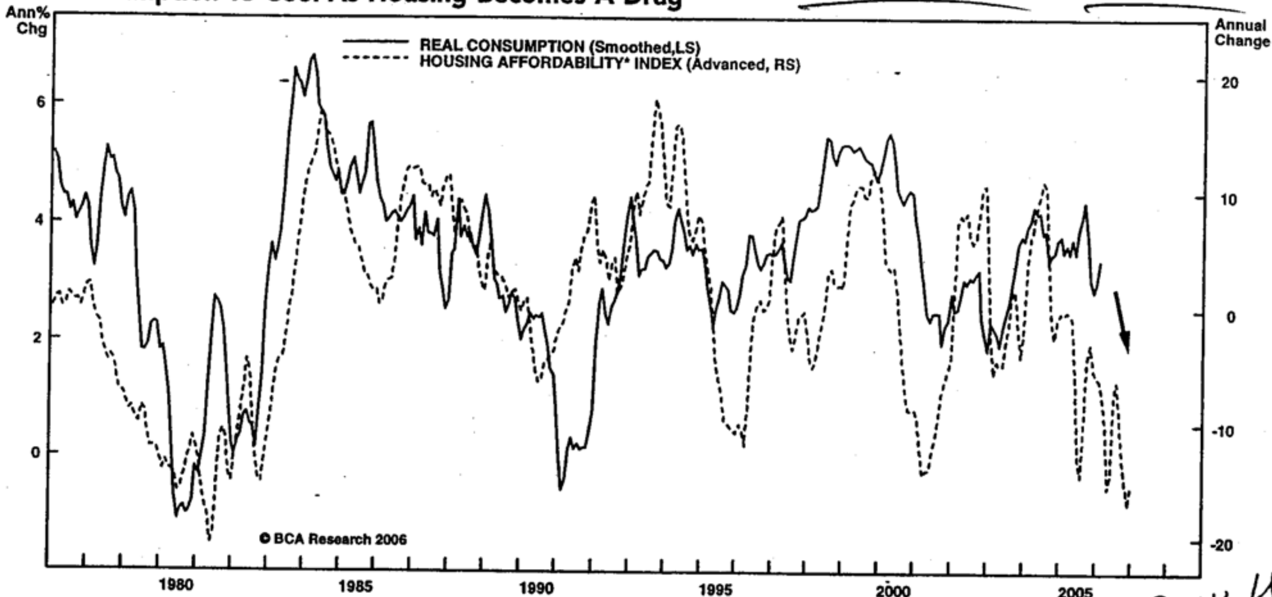
2005: "…a very good year…"
2006: "…a 'transition' year…"
2007: "…more scary, growing debt problems…looming retirement costs of the baby boomer generation…"

(4)

Housing slowdown = consumer slowdown…
The $64 Question: Will corporate spending fill the gap?

CHART 1
Consumption To Cool As Housing Becomes A Drag

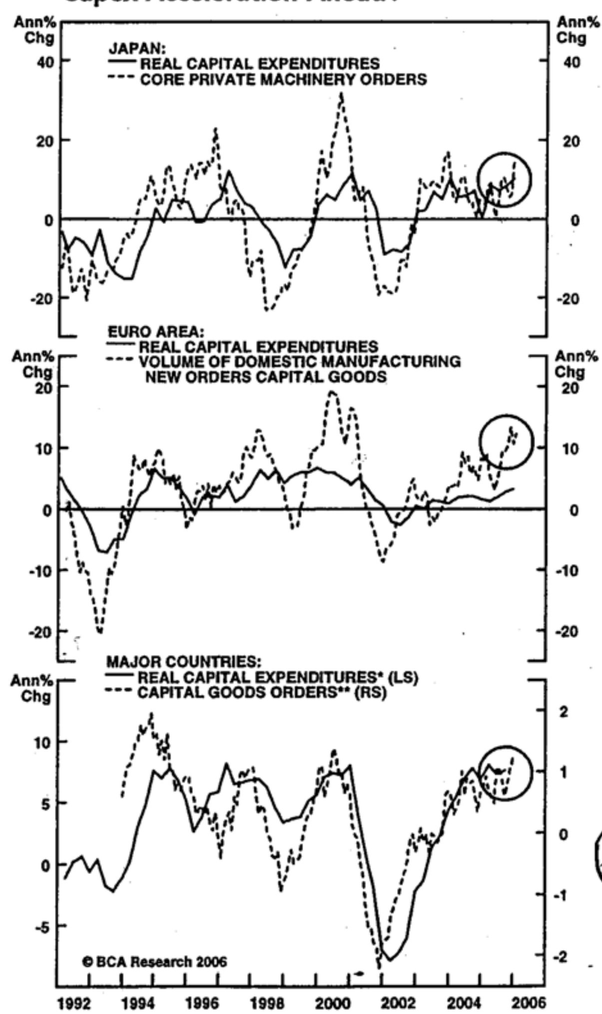
CONSUMER COOLS



*SOURCE: NATIONAL ASSOCIATION OF REALTORS

DOES BUSINESS PICK UP??

CHART 7
Capex Acceleration Ahead?



*GDP WEIGHTED AVERAGE OF U.S., U.K., JAPAN, CANADA & EURO AREA
**GDP WEIGHTED AVERAGE OF U.S., JAPAN, CANADA & EURO AREA

E7

shift to restrictive policy settings looms, and worries about higher inflation and interest rates will melt once investors realize that the key global growth dynamo is slowing.

In the near run, most equity markets, particularly the hot emerging bourses, as well as energy and base/precious metals are vulnerable if investors panic. The fear of massive leveraged trades unwinding rapidly as Japan moves towards lifting rates later this year seems overblown, given that rates will, at worst, creep up towards 50 or 100 basis points in a year's time, i.e. money will still be very cheap.

The bond market is also at short-term risk, but the cracks in the hot economic-sensitive markets in the past week or so indicate that much higher bond yields would prove self-limiting, i.e. would undermine economic growth prospects. In the U.S., the housing market is already under mounting strains, with prices flat over the past six months and activity drying up. Even higher mortgage rates would expedite the downturn and threaten an already mildly vulnerable consumer

Will businesses start spending their cash stockpiles? Evidence of corporate spending as companies plan large capital investments.

Companies Across U.S. Plan to Put Cash to Work, Giving Possible Boost to Economy

New York

A FEW YEARS AGO, one could hardly have found a candidate less likely to lead a new wave of corporate investment than glassmaker **Corning** Inc. Smarting from a multibillion-dollar optical-fiber bet gone wrong, the company had become a model of thrift, accumulating cash and paying down debt.

Now, though, Corning is getting back into the global investment game. This year, the company will spend as much as $1.5 billion as it expands a giant liquid-crystal-display plant in Taichung, Taiwan, and a clean-diesel-products plant in Erwin, New York. In 2003, the company's capital spending amounted to $366 million.

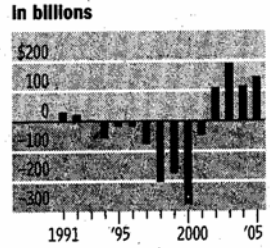
The impetus for the spending rebound: more confidence in the business environment. "We started to see new opportunities," says James Flaws, Corning's chief financial officer.

Across the U.S., companies are starting to put their money to work again, or at least are planning to do so. They have enjoyed strong growth and record profits in the past few years, but as they close in on the limits of their capacity, they face a choice: Stop growing, or start spending on people, plants and equipment.

Time to Spend?

In recent years, companies have been scrupulous savers, accumulating cash and investing relatively little. If they loosen up, that could boost the economy.

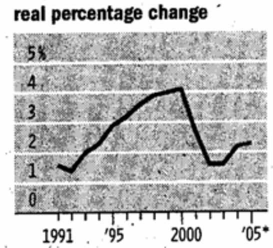
Corporate saving in the U.S.[1], in billions



[1]Undistributed profits plus depreciation minus gross investment

Sources: Commerce Department; Federal Reserve

Corporate capital stock, real percentage change



*WSJ estimate

RECENT DATA suggest they are choosing the latter. They added 2.1 million jobs in the year ended February, and in a recent survey by Duke University's Fuqua School of Business, more than 300 corporate executives said they plan to increase capital spending by an average 6.5% in the coming year—up from 4.7% in September, though still lower than a few years ago.

"Forever it seems like we've been waiting for the purse strings to open," says John Graham, a professor of finance at Fuqua. "They're not opening that wide, but they're moving in the right direction."

If sustained, companies' newfound willingness to spend could mitigate an anomalous situation: Ever since the turn of the 21st century, U.S. corporations have been scrupulous savers, in sharp contrast to consumers and the government. Combined with resurgent growth in Japan and Europe, the corporate spending could add fuel to the global economy—or at least help it survive if flagging or falling house prices make U.S. consumers feel poorer, something many economists expect to happen this year.

"The fact that corporations are investing and hiring again is certainly an encouraging sign," says David Mackie, an economist at J.P. Morgan in London. "As long as the household sector holds in reasonably well, this provides something of a cushion for growth."

In recent years, companies and people have started acting in ways that defy conventional economics. Typically, companies recycle a country's savings by borrowing the money to invest in new equipment, software, factories and whatever else they need to expand their businesses. That helps keep interest rates in balance, with companies' desire to invest pushing rates up and people's desire to save pushing them down.

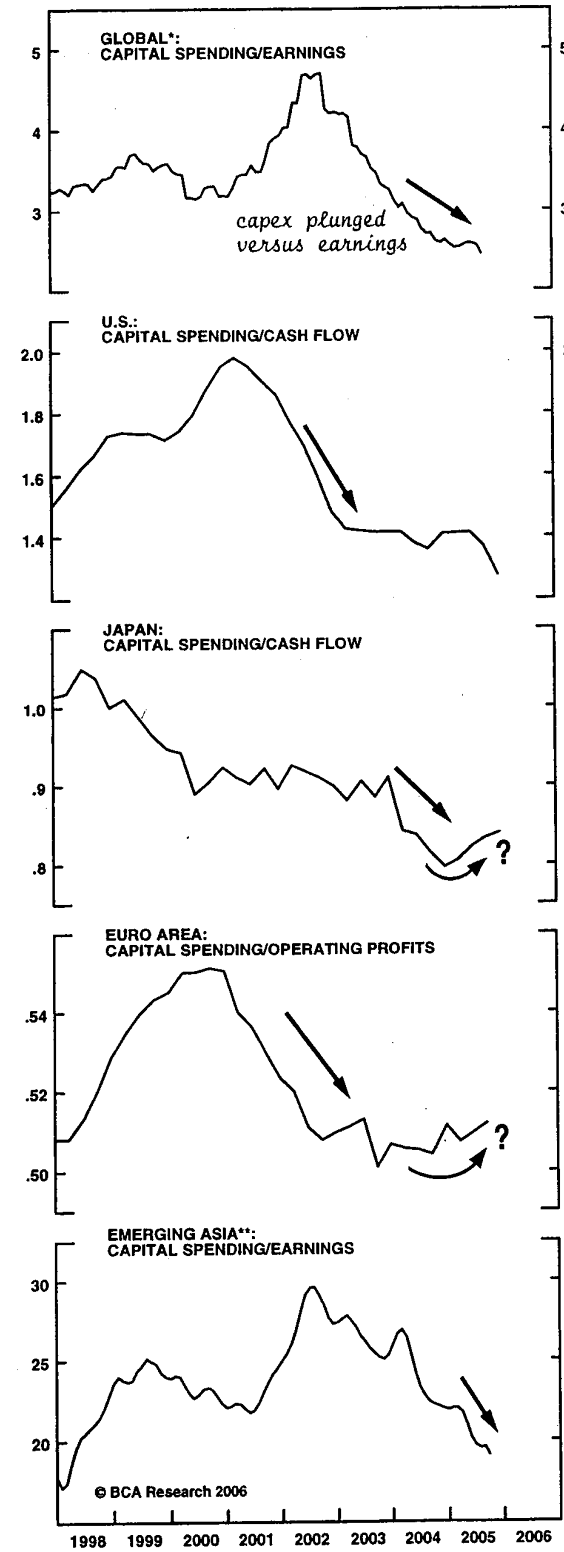
In the past five years, though, people and companies in the U.S. have switched roles. Households have been saving less, to the point where they now spend more than they earn—a profligacy that has helped drive huge corporate profits. Meanwhile, companies have been spending a lot less than they earn, building up huge hoards of cash.

IN THIS WAY, U.S. corporations "saved" about $560 billion in the past four years, according to J.P. Morgan—an often-overlooked contribution to the so-called global savings glut, which some economists believe has helped keep long-term interest rates unusually low. Over the same period, they invested relatively little in their businesses: The total U.S. capital stock increased only about 8% after inflation, just more than half the rate in 1998 through 2001.

Economists offer various explanations for companies' behavior. For one, executives might have been feeling extra cautious after the excesses of the late 1990s, when they borrowed heavily to make huge investments and acquisitions that often proved financially disastrous. "I think there's a much greater level of caution—you could also say it's a much higher level of responsibility,"

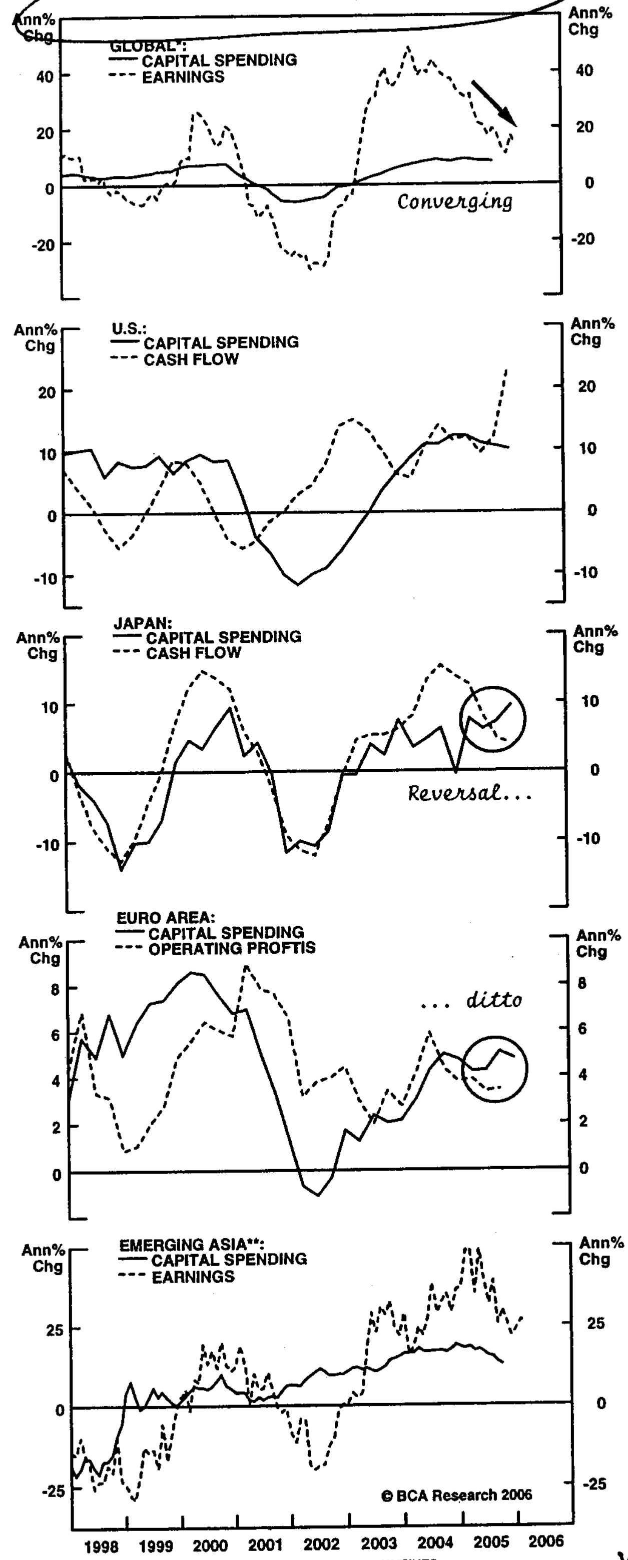
BCA EXPECTS CAPEX TO RISE

CHART 1
Investment And Earnings Trends (Part I)



*GDP-WEIGHTED; INCLUDES G7 AND ASIA-9 COUNTRIES
**INCLUDES CHINA, HONG KONG, TAIWAN, KOREA, SINGAPORE, MALAYSIA, THAILAND, INDONESIA & PHILIPPINES

CHART 2
Investment And Earnings Trends (Part II)



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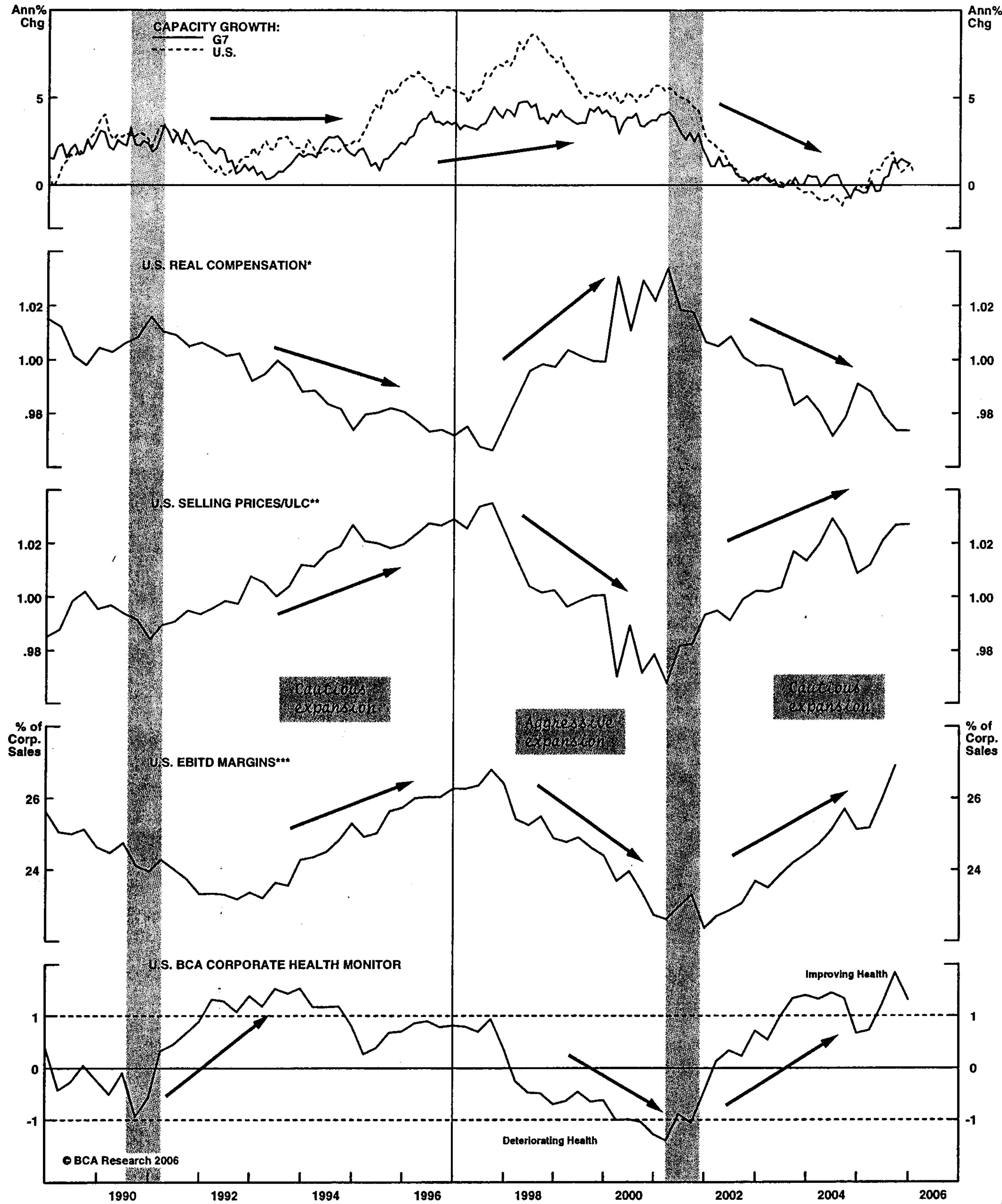
“Corporate Cycle” is poised for increased investment in Plant, property, equipment and other longer-life assets.

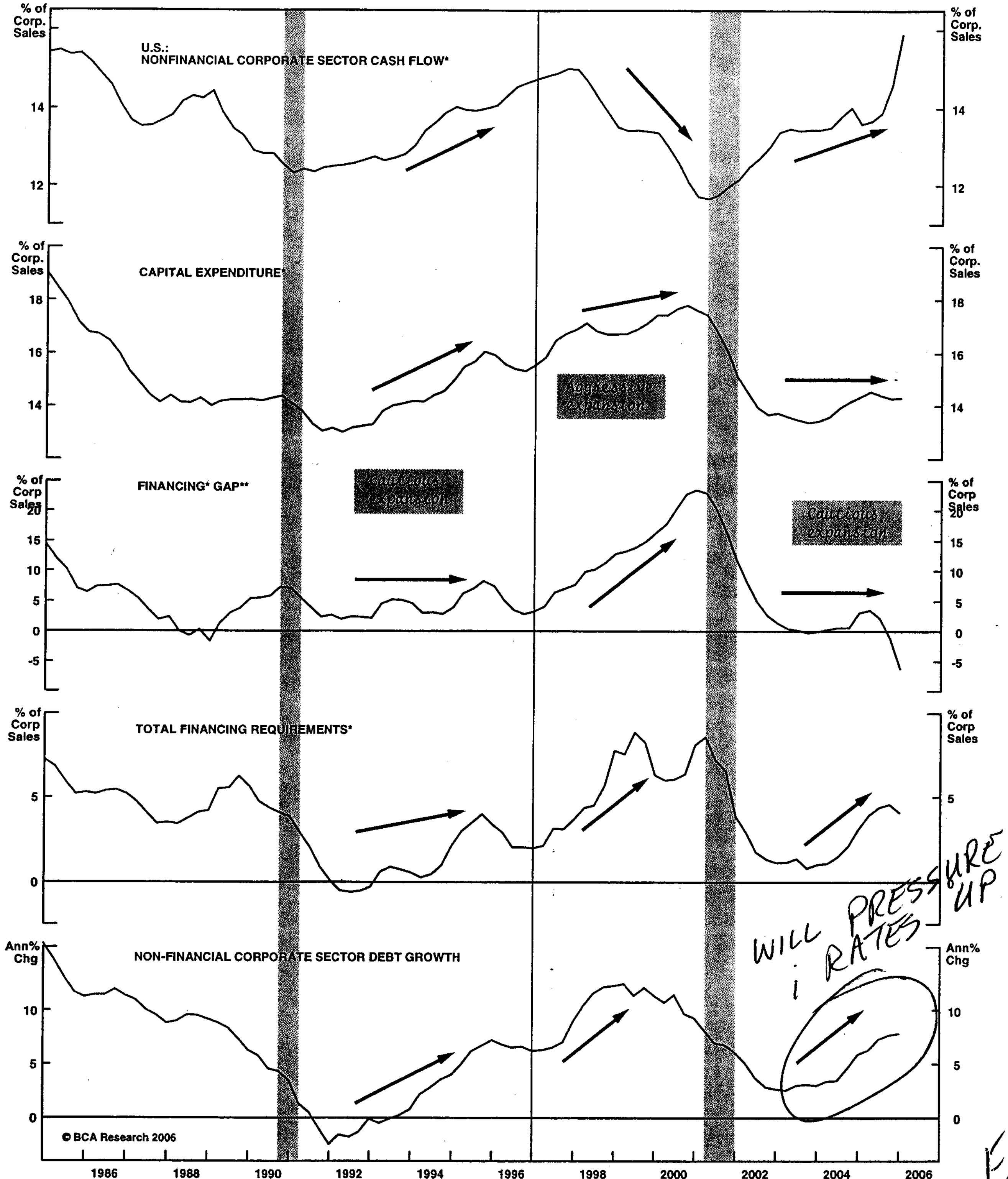
CHART 4
U.S. Corporate Cycle (Part I)



E10

*EMPLOYEE COMPENSATION TO BUSINESS SECTOR SELLING PRICES
**BUSINESS SECTOR SELLING PRICES DIVIDED BY UNIT LABOR COSTS
***NONFINANCIAL CORPORATE SECTOR EARNINGS BEFORE INTEREST, TAXES AND DEPRECIATION
NOTE: SHADING DENOTES PERIODS OF NBER-DESIGNATED RECESSIONS

CHART 5
U.S. Corporate Cycle (Part II)



*SHOWN AS A 4-QUARTER MOVING AVERAGE
**TOTAL BUSINESS INVESTMENT LESS CASH FLOW
NOTE: SHADING DENOTES PERIODS OF NBER-DESIGNATED RECESSIONS

E11

What happens if businesses decide to trim their spending Plans due, perhaps, to a cooling economy?

ABOUT ECRI

Corporate capex spending outlook: How strong is it??

In the Press

Industrial Slowdown Ahead?

03/01/2006

NEW YORK (Reuters) - The industrial sector could prove an unexpected source of weakness for the economy, and one that risks much slower growth in the second half of the year than is currently expected, according to a new report.

Most economists are predicting a gradual easing of economic growth this year as a housing slowdown makes consumers feel a bit queasier about extending their recent spending spree.

But the Economic Cycle Research Institute, an independent research firm that produces and tracks a cross-section of indicators, says those looking for business investment to pick up the slack from consumers could be in for a rude awakening.

"An industrial slowdown could come when consumer spending growth is already slowing, resulting in much weaker overall growth than generally anticipated this year," said Lakshman Achuthan, ECRI managing director.

The latest figures from the Institute for Supply Management showed a pick up in national manufacturing activity, with its index rising to 56.7 in February from 54.8 in January.

But ECRI argues that may be more of a last gasp for manufacturing in the current economic cycle then the start of a sustainable upward trend in activity.

"The not-too-hot, not-too-cold 'Goldilocks' economy envisaged by many economists could turn out to be a mirage," said Achuthan.

ECRI has come to that conclusion by monitoring a number of its leading indicators, which it says have accurately predicted fluctuations in manufacturing in the past.

The firm has also been watching recent declines in prices of commodities like industrial metals, which also tend to presage slower industrial activity.

"The correction in metals prices appears to be in line with earlier signals of a cyclical slowdown in the industrial sector, and may thus be the early stage of a cyclical downswing rather than just 'noise,'" Achuthan said.

more ECRI press quotes

... IF capex is surprisingly weak:

(A) Bonds likely to rally sharply

AND

(B) Soft-landing risks increase.

E12

Business spending plans are declining…

New-Home Sales Rose in April As Capital-Goods Orders Fell

Data Defy Expectations, But Longer-Term Trends Line Up With Fed Outlook

By Mark Whitehouse

The latest readings on U.S. housing and business investment confounded economists' expectations, but the underlying trends still show the economy acting pretty much as Federal Reserve officials had hoped: Perhaps slowing, but not sinking.

In two separate reports, the Commerce Department said new-home sales rose and businesses' orders for capital goods dropped in April. At first glance, that's at odds with the Fed's main scenario for what the economy will do this year: Consumer spending should slow as a weakening housing market makes people feel poorer, but increased business investment—in the form of capital-goods purchases and hiring—should help keep the deceleration from becoming a disaster.

Economists, however, warned against reading too much into the volatile monthly data, saying that longer-term trends still point toward slowing home sales and growing capital spending. "We all agree that the housing market is cooling off, and some other sector of the economy must take the burden of keeping growth healthy," said Ethan Harris, chief U.S. economist at Lehman Brothers in New York. "Capital spending is a prime candidate."

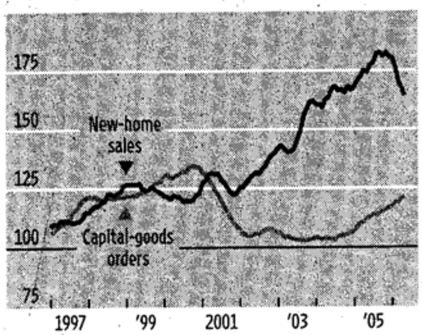
New-home sales rose to a seasonally adjusted annual rate of 1.19 million in April, up 4.9% from the previous month, thanks in part to a surge in Southern states. The number contrasted sharply with expectations of an April drop in home sales, but downward revisions to the previous months' numbers lessened the surprise. After revisions, the rate of new-home sales dropped 7.6% over the first three months of 2006, compared with a previous estimate of 4.2%. April's rate of sales was still 12.4% below the most recent peak in July 2005.

"The overall picture is one of a cooling housing market," said Joshua Shapiro, chief U.S. economist at MFR Inc. a New York consultancy. "It's hard to argue against that." Declining demand, for example, was among the reasons cited by luxury-home builder **Toll Brothers** Inc. when it announced earlier this week that it was lowering its full-year earnings forecast.

Meanwhile, a sharp drop in aircraft business helped U.S. total orders for durable goods, defined as anything intended to last three years or more, fall a larger-than-expected 4.8% to a seasonally adjusted $210 billion in April, after rising

Underlying Trends

Six-month moving average of indexes representing new houses sold and inflation-adjusted orders for nondefense capital goods, excluding aircraft



Note: Jan. 1996 = 100
Sources: Commerce Department; WSJ research

CONSUMER

BUSINESS

an upwardly revised 6.6% in March. One measure of business investment—"core" orders for capital goods such as computers, oil rigs and railroad cars, excluding defense and aircraft—also dropped a larger-than-expected 1.7% in April, compared with a revised 3.6% increase the previous month.

Economists saw April's drop in capital-goods orders largely as payback for the large jump in March. Overall, capital spending remains on an upward trend: In this year's first four months, core capital-goods orders were up 9.7% over the same period last year.

"If we smooth out the vagaries of month-to-month flows, what emerges is a pattern that is wholly consistent with the Fed's belief of how the economy is going to unfold this year," said David Resler, chief economist at Nomura Securities in New York.

Increasing demand for U.S. capital goods might illustrate a second-order effect of globalization, say some economists. The rise of export-oriented producers in China and elsewhere created a flood of cheap consumer goods into the U.S., increasing competition for the U.S. businesses and holding prices down. Now, though, as those same foreign producers invest to boost capacity, they're also boosting demand—and prices—for the kind of capital goods that the U.S. makes.

"We're seeing very strong demand for capital goods in Asian markets," both from Western firms building local facilities and from local firms looking to compete with the foreigners, said Edward Campbell, chief executive officer of Nordson Corp., Westlake, Ohio, which makes equipment that applies paint and other coatings to everything from cereal boxes to washing machines. He said his company's Asian orders were up 48% in the most recent quarter from a year earlier.

will capital spending ramp up if businesses are not optimistic??

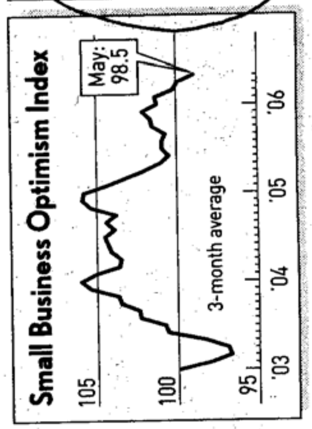
lowest in a year

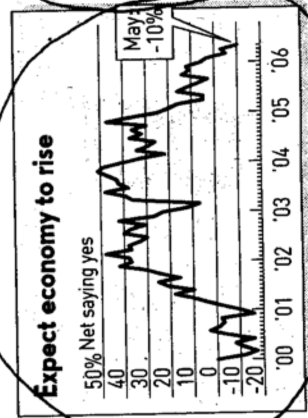
VITAL SIGNS

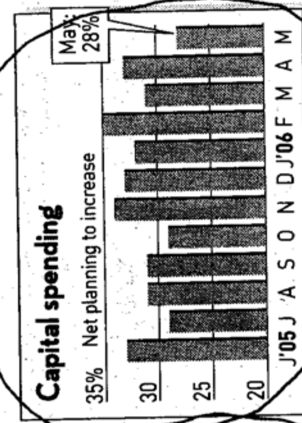
Smaller Firms Foresee U.S. Slowdown

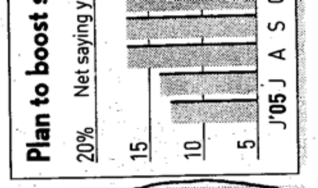
The NFIB's Small Business Optimism Index fell 1.6 points in May to 98.5, dropping below the solid 100 level for the 2nd time in 3 months. A net 10% expect the economy to get worse, the worst reading in 5 years. Capital spending plans and sales outlooks eased. But hiring plans and job openings remain high.

Sources: Nat'l Federation of Independent Business, Datastream









EM

Factory Output Fell Slightly in May

6-16-06

Decline of 0.1% Underlines Signs of Economic Cooling Amid Consumer Restraint

By Christopher Conkey And Greg Ip

WASHINGTON—Factory output fell slightly last month as manufacturers adjusted to milder consumer demand, and Federal Reserve Chairman Ben Bernanke sounded a guardedly optimistic note on inflation.

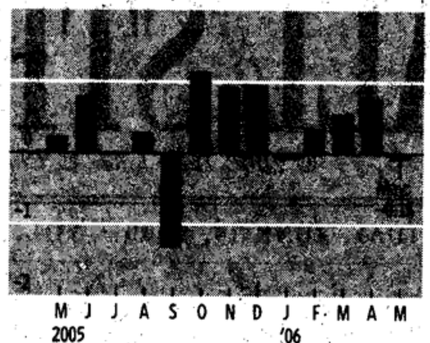
In another sign the economy has entered a period of slower growth, the Fed said industrial production declined 0.1% in May after three consecutive monthly gains, but output at the nation's factories, mines and utilities is still running 4.3% higher than a year earlier. Lower auto production last month spurred a 0.1% decline in the manufacturing sector and mining output dropped as well. Halting a recent upswing, capacity utilization fell to 81.7% in May from 81.9% in April.

The May decline in manufacturing activity was a response to slackening consumer spending after a robust first quarter. "For the first time in more than three years, production of consumer goods, business equipment, construction supplies and business supplies all fell in May," said David Huether, the National Association of Manufacturers' chief economist. "This shows that a broad-based slowdown in the economy is taking place."

After surging at an inflation-adjusted 5.3% annual rate in the first quarter, many analysts say the economy is advancing at a slower pace—around 3%—in the current quarter. Rising interest rates, a gradually cooling real-estate market and elevated gasoline prices are restraining consumer spending, but businesses are picking up some of the slack. Recent trends in exports, investment and productivity all point to further gains in business spending, and economists expect industrial production to resume growth in the months ahead.

Hitting the Brakes

Month-to-month percentage change in industrial production index, seasonally adjusted data



Note: 2002 = 100 Source: U.S. Federal Reserve

"So what if industrial production slid back a shade in May?" said Jason Schenker, an economist at Wachovia Corp. "All major market and industry groups have seen their industrial production rise over the past year...Growth is a go."

Bison Gear & Engineering Corp., based in St. Charles, Ill., is seeing strong demand for the industrial motors it makes for restaurant and health-care equipment. Chief Executive Ron Bullock said a recent investment of "a couple million dollars" in manufacturing gear will enable growth of 15% next year, and exports are accounting for an increasing share of sales. The company's work force, Mr. Bullock added, is up 11% from a year earlier.

Mr. Bernanke, in his speech to the Economic Club of Chicago yesterday, noted that expected inflation, as measured by inflation-protected bonds, had "fallen back somewhat in the past month." He acknowledged that the public's expectations of inflation in surveys and in the bond market had "edged up," developments that "bear watching."

He didn't repeat his stronger warning from a speech last week in which he called recent developments on inflation "unwelcome" and said the Fed would remain "vigilant" to ensure recent increases weren't sustained. That language helped boost expectations for another rise in interest rates later this month and roiled stock markets. But it also appears to have convinced bond investors of his anti-inflation resolve, leading to the recent retreat in their expectations of inflation.

Mr. Bernanke said that while the rise in energy and commodity prices since 2003 hasn't led to the spiral of rising prices and wages of the 1970s, they "have been large enough that they could account for some of the recent pickup in core inflation."

He also said he expects productivity growth—output per worker-hour—to continue at 2.5% to 3% a year "for some years ahead." Such a high rate of productivity growth would enable the U.S. economy to grow at roughly 3% to 4% a year without generating inflation.

Separately, the Labor Department said 295,000 people filed initial unemployment claims last week, 8,000 fewer than the week before. The drop pushed the closely watched four-week moving average of jobless claims down to 315,750, which suggests a robust level of job creation this month.

With the unemployment rate at 4.6%, economists have been searching for signs of wage gains that could add to inflationary pressures. The labor market has been sending mixed signals recently, however, and pay increases are lagging behind the prevailing inflation rate.

Mr. Huether of NAM and other manufacturing groups have called on the Fed to stop raising short-term interest rates, but several Fed officials have recently indicated that the recent rise in prices and inflation expectations are greater concerns than slower growth. Futures markets are all but certain the Fed will opt to raise the federal-funds rate to 5.25% later this month.

"… Factory output fell slightly last month as manufacturers adjusted to milder consumer demand…"

"The May decline in manufacturing activity was a response to slackening consumer spending…"

"This shows that a broad-based slowdown in the economy Is taking place…"