Market Commentary

U.S. Bond Market Outlook First Quarter, 2007

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Executive Summary

We find bond yields to be unattractively valued relative to underlying inflation and other assets. However, given our optimistic outlook for the economy and inflation, we see limited upside or downside potential for bond prices. Unless we are wrong in our economic outlook and the U.S. slips into a recession, bonds should do little more than earn their coupon. We believe other assets offer better return potential and recommend a minimum weighting to bonds.

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U.S. Bond Market Valuation

We believe bond yields remain unattractive relative to other assets and underlying inflation expectations. We estimate the fair value yield on ten-year U.S. Treasury bonds to be around 5.50% compared to the current yield of 4.80%. Other measures suggest the fair value yield is close to 5%. Based on these measures, there is not much downside risk to bonds. However, compared to stocks, bonds are extremely unattractive.

Bond yields and valuations are driven primarily by inflation expectations. These expectations are usually based not only on where inflation is but where it has been. For example, if we are currently in a low inflation environment, investors often will not just extrapolate that forward but will be influenced by what kind of inflation environment we have recently experienced. Market memory can keep inflation expectations and interest rates higher than current inflation might suggest. The Bailard Bond Model estimates the fair value yield on ten-year Treasury bonds based on front weighted measures of historical inflation. As with all our valuation measures, we look for extremes in valuation that indicate potential opportunity or risk. At extremes, we are more comfortable deviating from our long-term strategic neutral position and overweighting or underweighting an asset class. Valuation extremes reflect broad trends in investor psychology, indicating extreme optimism when the market is overvalued and extreme pessimism when the market is under-valued. In the long run, prices should revert to underlying intrinsic value. Significant deviations from intrinsic value can create high and low risk opportunities.

While we rely primarily on our Bond Model to evaluate the attractiveness of bonds, we also monitor other measures of valuation. Over time, bond yields tend to move in line with nominal GDP (NGDP). When bond yields are above the growth in NGDP, bond yields tend to trend lower. When bond yields are below NGDP, yields tend to rise. Other measures of relative value include bond yields relative to the S&P 500 earnings yield (E/P ratio), bond yields versus real estate capitalization rates, U.S. Treasury yields relative to foreign government bond yields and U.S. Treasury yields versus municipal bond yields. When Treasury yields are high relative to other assets, bonds offer stronger competition for investor capital and yields tend to move lower.

U.S. BOND MARKET VALUATION MONITOR

Indicator	Current Bias
Bailard Bond Model	Negative
Current Real Bond Yield (Deflator)	Neutral
Yield vs. Nominal GDP Growth	Negative
10-yr. Treasury Yield vs. E/P Stock Ratio	Negative
Bond Yield vs. Real Estate Capitalization Rate	Negative
Real Treasury to Foreign Bond Yield Spread	Positive
Municipal Yield vs. Treasury Yield	Neutral
Ned Davis Research (NDR) Normal Valuation Line	Negative

Sources: Bailard Research, Ned Davis Research, Yardeni Research

U.S. Bond Market Environment

Given our expectation for trend GDP growth and contained inflation, we don't anticipate much downside risk in bonds. Most of the economic indicators we monitor are consistent with around 3% growth. Our inflation indicators suggest inflation has peaked and will be heading lower over ensuing months. The next most likely scenario is one of stronger economic growth. Given tight resource utilization, inflation fears could be heightened and bonds more at risk. In either scenario, we prefer stocks over bonds.

The direction of interest rates is set primarily by shifting inflation expectations. We monitor a number of economic and inflation indicators to help evaluate these shifts. When the economy is growing rapidly and above potential, inflation expectations tend to rise. As the economy slows and grows below capacity, inflation expectations and interest rates tend to fall.

We also monitor changes in a number of actual price measures. Acceleration or deceleration in these measures influence expectations of future inflation. These measures include the price of oil, industrial material prices, average hourly earnings, the dollar and money supply, as well as various inflation composites.

Finally, the Bailard Fed Policy Monitor is used to assess the Fed's policy bias. The general rule is, "Don't Fight the Fed;" however, bond yields typically anticipate changes in Fed Policy.

U.S. BOND MARKET ENVIRONMENT MONITOR

Indicator	Current Bias
Economic Indicators	
Bailard Base Economic Scenario	Neutral
Nominal GDP (y-y)	Neutral
Leading Economic Indicators Diffusion Index	Neutral
Unemployment Claims (26 week)	Neutral
Commodity Prices/Claims Ratio	Neutral
Factory Orders (y-y)	Neutral
Ned Davis Research (NDR) Leading Economic Index	Negative
NDR Economic Timing Model	Neutral
RGDP Growth above Potential	Neutral
Consumption above LT Trend	Neutral
Business Conditions Survey (y-y)	Neutral
Small Business Optimism (y-y)	Positive
Coincident-to-Lagging Indicator	Positive
ISM Service Sector Index	Neutral
Industrial Materials Price Diffusion Index	Negative
Inflation Indicators	
Inflation Pressure Index	Positive
ISM Price Index	Positive
CPI vs. 5-year Trend	Neutral
Core CPI vs. 5-year Trend	Negative
CPI (y-y) less core CPI (y-y)	Neutral
Money Supply Growth	Positive
Average Hourly Earnings vs. 3- year Trend	Negative
Oil Price (y-y)	Neutral
Trade Weighted Dollar	Neutral
Bailard Fed Policy Monitor	Neutral

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns.

U.S. Bond Market Trend, Momentum and Sentiment Indicators

After a brief period of rising prices last year, bond market momentum and trend indicators have turned down. With the decline, investor sentiment has dropped but not enough to indicate excessive pessimism and a potential reversal. In addition, volatility as measured by the standard deviation of weekly returns is very low, this tends to be bearish for bond prices. Outside of a very short-term oversold condition, there is little to warrant a move toward bonds.

Value measures tell us where opportunities and risk may lie. Market environment analysis tells us whether or not the market fundamentals are conducive to recognizing value. Price and sentiment measures help determine when to buy. We like to stay on the right side of market trends and monitor long-term trend, momentum and moving averages. If value and market fundamentals are telling us to buy, we prefer to wait until the price action confirms. Deterioration in trend and momentum act as warning signs and call for a reevaluation of our fundamental assumptions. Frequently, markets move ahead of fundamentals.

At times, markets move away from the underlying trend and become temporarily overbought or oversold, creating opportunities to add to or reduce positions. Significant deviations from the underlying price trend, excessive rates of change or relative strength, and shifts in volatility can be indicators of market turning points.

Sentiment Indicators are also useful in identifying potential market turning points. Sentiment indicators attempt to measure investor psychology by looking for periods of extreme optimism or pessimism. As good news is discounted, optimism drives bond prices higher and yields lower. When optimism becomes excessive, the market becomes vulnerable to bad news. During periods of pessimism, the reverse is true. Sentiment indicators are contrary indicators. The general rule is, "Go opposite the crowd at extremes". Sentiment indicators we track include Bullish Sentiment on Bond Futures, the T-Bond Put/Call Ratio, the Baa/AAA Yield Ratio versus its three-year moving average, the Conference Board Interest Rate Expectations Survey and the net long/short position of commercial trades, large speculators and small traders.

U.S. BOND MARKET TREND, MOMENTUM AND BREADTH MONITOR

Indicator	Current Bias
Trend	Bearish
Momentum	Bearish
Futures Bullish Sentiment	Neutral
Put/Call Ratio	Bullish
Baa/AAA Yield Ratio vs. 3-yr MAV	Neutral
Conference Board Interest Rate Expectations	Neutral
Commitment of Traders	Bullish
Over bought/ Oversold	Oversold
Volatility	Bearish
Ned Davis Research (NDR) Intermediate Bond Timing Model	Bearish
NDR Benchmark Model	Bearish

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

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