Credit Risk / Duration Risk?

Two weeks ago market commentators were warning us about credit risk and the dangers of tight corporate spreads. Last week many of the same commentators started warning us about duration risk and the dangers of rising interest rates. Greater credit risk is usually linked to a weaker economy and duration risk to a stronger economy. Which is it?

We believe fears of significant downside pressure due to either credit or duration risk are greatly exaggerated. It is certainly very possible, indeed probable, that at some point credit spreads widen and that interest rates trend higher.

It is very unlikely that we shall witness a recession scenario similar to 2000-2002 when default rates hit 11% and high yield bond spreads approached 1,000 basis points. Although, it is certainly true that excess liquidity has led some market participants to take on too much risk, corporate balance sheets and cash flows, on the whole, remain very strong. Default rates will remain low. We do not expect to see any sharp deterioration in corporate credit fundamentals in the U.S. or Europe at least through 2008.

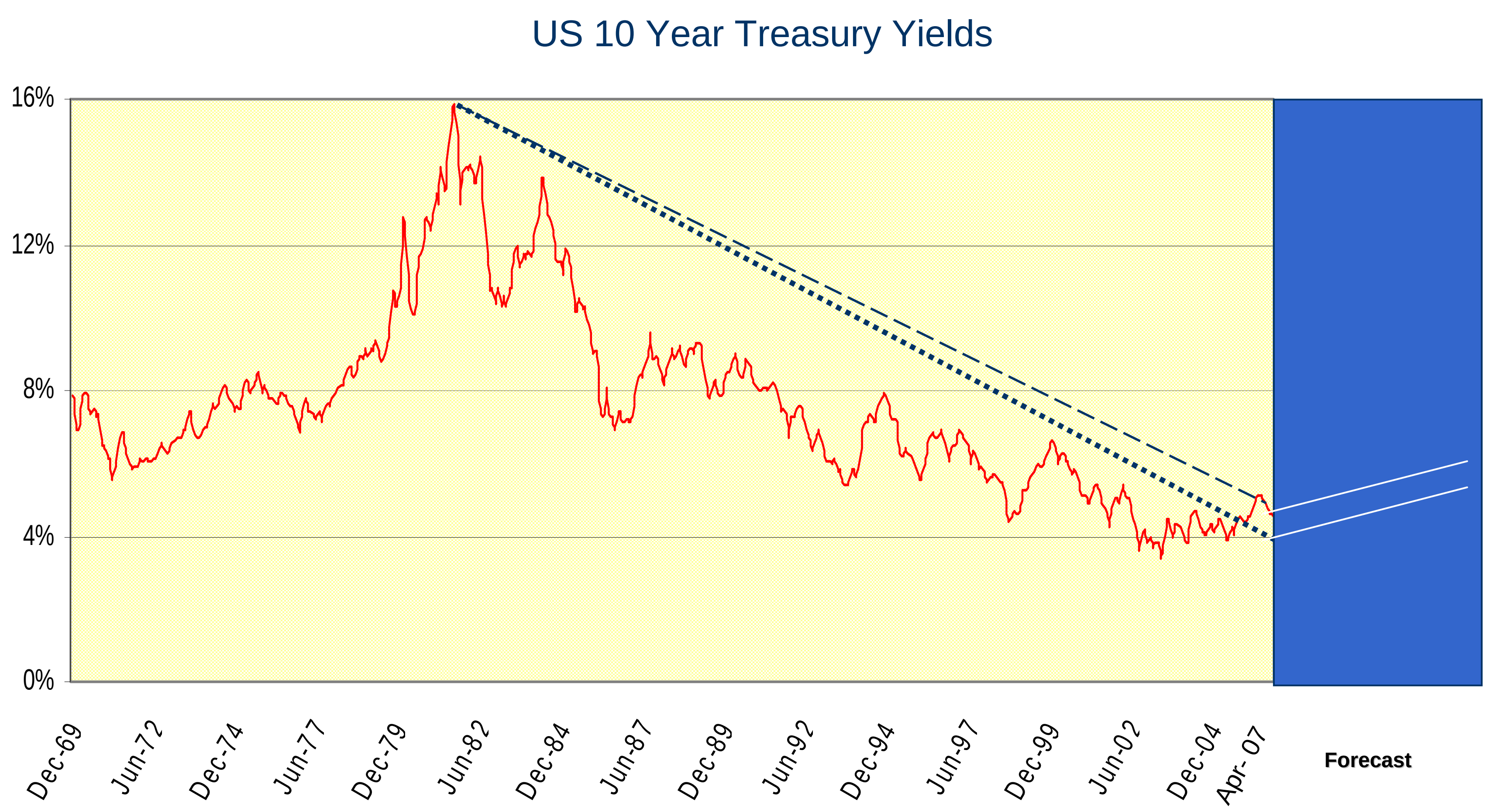
It is also unlikely that the U.S. or Europe is on the brink of a major surge in economic activity. Housing market related uncertainties and overly indebted consumers will, in all likelihood, prevent any particularly strong upward movement in the U.S. economy. We have consistently been of the opinion that the Fed would not lower rates and exacerbate a situation of excess market liquidity. Inflationary factors such as higher wage costs, higher capacity utilization and high commodity prices are, however, gradually seeping into the economic system. The 25 year long downward trend in interest rates is now behind us and there is a good chance that interest rates gradually drift upward. Please see the attached graph.

If one is worried by either of the extremes, that is recession or inflation, one should either sell equities or longer dated government bonds. Our corporate bond portfolios are constructed to withstand the pressures of both extremes. They are built on the strong fundamentals of solid credit research, diversification of risk and relatively short duration. We preserved capital and made a total return of nearly 13% gross in the 2000-2002 market when the S&P registered a decline of over 37%. We also did not lose money in years such as 1994 and 1999 when the 10 year Treasury registered losses exceeding 8%.

We believe that our prudently managed bond and bank loan portfolios composed of well-positioned companies provide a reliable path between the anxieties of market extremes.

June 12, 2007

Interest Rate Trends



Data through April 30, 2007
Data source: Bloomberg

Muzinich & Co.