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ATTACHMENT 1

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Bond Strategists: Top Forecaster Sees U.S. Recession (Updatel)

Jan. 2 (Bloomberg) -- The U.S. bond market's most accurate forecaster, who plies his trade 500 miles from Wall Street on Tobacco Road, says yields are sending ominous signs about the economy.

While economists at the biggest bond-trading firms wrongly predicted that the benchmark U.S. 10-year Treasury yield would end last year at 5 percent, a professor at the University of North Carolina came a lot closer to getting it right.

"It was luck, partly," said James F. Smith, 67, who teaches finance at the school's Chapel Hill branch. "The other reason is the anticipation that inflation would be contained and that continued rate increases from the Federal Reserve would keep longer-maturity investors enthused about their returns".

Smith turned out to be the top forecaster in Bloomberg's January survey of 66 economists. He predicted the benchmark 10- year yield would end the year at 4.49 percent. At the time, the yield was about 4.27 percent and the median estimate was for it to climb to 5.04 percent by Dec. 31. It finished 2005 at 4.39 percent. Yields move inversely to bond prices.

"Those Wall Street gurus have bigger expense accounts than I have total income," Smith said.

Smith said the bond market is waving a caution flag on the economy. Two-year Treasury yields last week rose above those on 10- year notes, creating a so-called inverted yield curve for the first time since December 2000. An inversion preceded the last four U.S. recessions.

"When the curve inverts, run for the exits," said Smith, who served as an economist for the Fed from 1975 to 1977. "It will stay that way until the Fed realizes it caused a recession in 2007. Investors should start planning for a recession."

2006 Forecast

The lo-year yield will climb to 4.53 percent this year, Smith predicts. His forecast is again below the median estimate of economists, which is for the yield to end 2006 at 5 percent, according to a survey from Nov. 30 to Dec. 8.

Core inflation, which excludes food and energy prices, "remains under control," he said, tempering any rise in yields. Inflation erodes the purchasing power of a bond's fixed payments. The median estimate in the last Bloomberg survey is again 5 percent.

Smith is a professor at the Kenan-Flagler Business School at UNC. He received his bachelor's, master's and doctorate degrees in economics from Southern Methodist University in Dallas, making him the only person to graduate from the school with all three degrees, according to Smith.

He edged out three others who were forecasting 4.5 percent: Ken Goldstein, a Conference Board economist; Jeff Speakes, chief economist of Countrywide Financial Corp.; and Hugh Johnson, chairman of Johnson Illington Advisors, which has $642 million under management.

Fed Outlook

Smith expects the Fed to raise its target rate for overnight loans between banks three more times to 5 percent from 4.25 percent. The U.S. central bank has raised rates by a quarter- percentage point at

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every meeting since June 2004, when the target was at a 46-year low of 1 percent.

"That's three more times than we need," said Smith, who has also served as the chief economist for the Society of Industrial and Office Realtors since July 2002.

In the January survey, Smith expected the Fed to only raise rates to 3 percent last year, compared with the median estimate of 3.50 percent.

Prices for personal consumption expenditures excluding food and energy rose 1.8 percent in November from a year earlier, down from 1.9 percent in October, the government said on Dec. 22. The Fed uses the PCE index in making its semi-annual forecasts. In July, the central bank said it expected the core rate to rise 1.75 percent to 2 percent last year.

Lower Yields

David Berson, chief economist at Fannie Mae, the biggest U.S. mortgage finance company, isn't surprised that Smith ended the year as the top forecaster.

The two, who worked together at the consulting firm Wharton Econometric Forecasting Associates in 1986 and 1987, both serve on the National Business Economic Issues Council.

"Jim has done well," said Berson. "Jim's basic view on interest rates is that they will remain low as inflation remains low. Given that rates have remained low for the last five years, his forecasts have worked out well."

Ten-year Treasury yields have dropped 29 basis points, or 0.29 percentage point, since reaching a seven-month high of 4.68 percent on Nov. 4 amid speculation inflation is in check.

None of the economists surveyed by Bloomberg expect a recession this year, or two consecutive quarters of a decline in gross domestic product. The economy will likely grow by 3.4 percent in 2006, based on the medlan of 71 forecasts in a survey conducted from Nov. 30 to Dec. 8. Smith's forecast from last month is for the economy to expand 3.8 percent.

Fed Chairman Alan Greenspan said on Nov. 3 that the yield curve "used to be one of the most accurate measures we used to have to indicate when a recession was about to occur," though "it's lost its capability of doing so in recent years."

Last year was the fifth in a row that 10-year yields finished below economists' year-end forecasts from the start of the year, making Smith's prediction even more noteworthy.

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