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Investment Outlook First Quarter 2006

The gloomy atmosphere overhanging US financial markets in 2005 appears to have brightened as we turn the calendar page to 2006. Economic conditions are strong, corporate balance sheets are as sound and liquid as they have been in many years, profit margins and return on equity are near all-time high levels and corporate earnings are poised to continue an unprecedented string of double digit gains. Also, stock buybacks are happening in record amounts, dividend hikes persist at historic levels and merger and acquisition announcement trends are favorable. Even last year's devastating hurricane season, once expected to knock economic growth for a loop, doesn't seem to have pushed it off pace. Third quarter gross domestic product grew at a rate of 4.1% while enduring the impact of hurricanes Katrina, Rita, and Wilma. Consumer spending rose 4.2%, while capital spending on equipment and software climbed at a robust 10.8% pace. In addition, core inflation and interest rates remain low and energy prices have stabilized. And perhaps the principal reason to be optimistic is that corporate profit growth has outstripped stock price gains for the third consecutive year, pushing price/earnings ratios to their lowest levels in ten years.

Although these trends were in place most of last year, investors shrugged them off as the Fed continued its seemingly unending string of twenty-five basis point fed funds rate hikes. With the Fed now signaling that their mission to raise short-term rates to a "neutral" level is nearly complete, market participants have focused on many of the positive indicators enumerated above. Yet, before we get carried away with enthusiasm, there are still plenty of reasons to be cautious. Although energy prices have stabilized, they continue near record high levels and we still have a number of months of winter before us. And even though core inflation (CPI ex-food & energy) remains tame, overall inflation is at the highest level in almost fifteen years. This trend, coupled with higher short-term interest rates, has led to an undeniable slowdown in the housing market and perhaps the initial signs of softening in consumer spending. The recent flirtation with an inverted yield curve (when short-term interest rates exceed longer-term rates), in conjunction with the aforementioned slowing in housing and consumer spending, has led some economists to be concerned that an economic slowdown may develop by the second half of 2006. In past business cycles, inverted yield curves frequently foreshadowed recessions. The chance of a recession tends to rise as the ten-year Treasury yield drops further below the two-year's and approaches the three-month Treasury bill's rate.

The consensus view of the economy, interest rates and the stock market this year calls for GDP growth of approximately 3.5%, ten-year US Treasury Note yields approaching 5% and US stock market indices achieving high single digit growth. Our own view differs to some extent, as we believe economic activity may very well slow below consensus as the year progresses, amid the delayed effect on consumer spending patterns of higher energy prices and higher short-term interest rates. We anticipate at most two more 25 basis point Fed funds rate hikes in the months ahead and are becoming increasingly convinced that the Federal Reserve Bank may raise rates only once more, at the January 31 meeting, before stopping. This action would leave the Fed funds rate at 4.5% and the prime rate at around 7.5%. We also believe that incoming Fed Chief, Ben Bernanke, may differ stylistically, but will largely maintain the policies of the Greenspan Fed. As far as the US stock market is concerned, unlike the past few years, we foresee a stronger first half as investors anticipate the end of Fed tightening followed by an uncertain second half, particularly if economic activity begins to slow. Investors will be keeping a close eye on the long-simmering tensions between Iran and the West with regard to Iran's nuclear aspirations. Should this or other geopolitical events re-emerge on the center-stage of investor's minds, stock prices will be pressured and bond prices are likely to rally.

We were very fortunate to achieve well above average investment results in 2005, as financial markets continued to return to a more normal environment. The accounting scandals and geopolitical events which drove market conditions in the early part of this decade have begun to subside and investors have returned to valuing stocks on the basis of the traditional factors of earnings growth and interest rate expectations. The year just ended was one in which stock selection was vital to achieving superior results. It is probable that the early part of 2006 will continue this experience, but as earnings growth begins to slow as the year progresses, a premium will likely be paid for growth in industries and companies which are less economically sensitive. Regarding bonds, with short-term interest rates now above 4%, we are more willing to invest in high-grade short and intermediate bonds than we have been in several years.

The past few years, we have encouraged greater diversification across additional asset classes. In light of our persistent conviction that energy and commodities prices will remain in short supply even as demand pressures remain, we will continue to opportunistically migrate toward hard assets and markets considered deep in natural resources. This directive will largely remain in the form of exchange trade funds (ETFs), mutual funds, and structured principal protected securities. We look forward to meeting or discussing our views in the near future. Please accept our wishes for a happy and prosperous year.