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Investment Outlook Second Quarter 2006

Major trends established in 2004 continued forcefully into the first quarter of this year. As commodity prices raged and oil prices rose to near record levels, the Fed maintained its policy of steadily raising short-term interest rates in quarter point increments from 1% in June 2004 to the current level of 4.75%. With short rates now close to normal levels, the economy near full capacity and inflation stable, financial market participants are projecting that the Fed may soon pause. While rates are almost certain to rise again at the May meeting, Fed officials have signaled that further action will increasingly be data dependent. Though expectations for an imminent slowdown are widespread, recent economic reports have remained strong. Robust readings on retail sales, industrial production, employment and capacity utilization have pushed interest rates to their highest levels in more than four years. After briefly inverting earlier this year, the yield curve has once again returned to a normal upward shaped slope as bond investors no longer expect economic activity to slow sharply. However, conventional wisdom suggests that monetary policy maneuvers act with a big lag. According to this theory, rising rates will result in a slowdown in housing, consumer spending and ultimately GDP growth by the second half of this year. Our fear is that the Fed will once again overshoot and won't stop raising rates until signs of a slowdown are evident, at which time it is typically too late to prevent a spiral into recession. Our convictions are substantiated with core inflation (CPI excluding food and energy) trending steadily higher in the past two years to a current reading of 2.4%, a full 20% above the upper end of the Fed's unwritten target.

In the midst of rising interest rates, commodity prices and geopolitical tensions, stock prices have been flirting with levels not seen since 2001. Consumer spending has remained buoyant as strong employment trends have largely offset the drag on pocketbooks created by higher interest rates and energy prices. And although business spending has been steady, it continues to be sub-par when compared with past expansions.

While the bond market seems to be dreading the worst, stock investors appear to be overlooking many of the clouds looming on the horizon. These investors are likely focusing on the continued strong corporate earnings environment, with double digit growth expected for a record fifteenth consecutive quarter. Impressive as this may be, much of the current growth is coming from the energy and basic materials sectors. Count us as skeptics that powerful earnings growth in these two sectors is enough to propel stocks prices significantly higher. Historically, when the market is driven by its most cyclical components, price earnings ratios typically contract. While it is still possible that all will turn out well for the stock market, we wouldn't assign a high probability to this scenario in the months ahead. Short of a reversal in oil prices and interest rates and a cooling of geopolitical tensions, we believe stock and bond gains may prove challenging until the fall. As money market rates approach 5%, they become difficult competition for both stocks and bonds. Asset allocation decisions will increasingly point to

lower stock and bond allotments and higher cash positions. Only the elusive soft landing, where the Fed is able to engineer a cooling in economic activity and asset prices without pushing the economy into recession, would create the conditions necessary for stock prices to rise precipitously.

Tensions in Iraq, Venezuela, Nigeria and especially Iran are additional areas of concern. We are particularly worried that a peaceful resolution regarding Iran's nuclear ambitions may be unattainable. While military action does not appear imminent, we recall the difficult stock market environment leading up to the Iraq war in 2003. Also, the President's low approval rating has made it hard for him to promote his domestic legislative agenda. Investors are especially uneasy about the inability of a Republican controlled federal government to extend the 2003 tax cuts. A return to capital gains and dividend tax rates that existed prior to this legislation would almost certainly roil stock prices.

Since higher interest rates reduce the value of future earnings when those earnings are discounted to the present, growth stocks have been noticeable laggards as bond yields having risen rapidly in the past six weeks. And while value stocks are more expensive relative to history, until the ten-year US Treasury Note yield stops rising, growth stocks will likely suffer. Surveying the overall investment landscape causes us to lean on the cautious side. Abundant diversification across asset classes continues to be a mainstay of our approach in this environment. In addition, we have been taking the opportunity to upgrade our stock portfolios by eliminating losers and laggards and reinvesting in companies with excellent long-term growth prospects selling at attractive valuation and/or technical price levels.