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Investment Outlook Third Quarter 2006

Investors displayed the ultimate in fickleness during the second quarter, alternating between worrying that the economy was too strong or slowing too quickly. The Fed and its new chairman Ben Bernanke share much of the blame for this behavior by awkwardly articulating a change in policy. The inconsistent messages communicated by Mr. Bernanke and the other Fed governors had the dual effect of creating uncertainty in the financial markets and calling into question the credibility of the new Fed chief. Simultaneous to the Fed's mixed messages, other world central banks appeared to be coordinating interest rate increases, reflecting strong global economic conditions and rising commodity prices.

These actions had the intended effect of driving commodity prices lower. However, they also had the unintended effect of decapitating the stock market leadership and causing prices to tumble. At least one major US stock market index, the NASDAQ, suffered its first correction in over three years, dropping 12% from its April peak to its low reached in mid-June. Growth stocks were especially hard hit as investors became increasingly nervous about future earnings growth. Other indices suffered meaningful, albeit less severe, declines ranging from 6-8% from peak to trough. The behavior of investors during this period strongly suggests that risk reduction was foremost in their minds as former leaders in emerging markets were amongst the worst decliners with indices in Brazil, India, Russia and other Latin American and Asian indices down as much as 35% from their highest levels in April. Also, other leadership groups such as industrials, transports and energy all witnessed price declines exceeding 10%. In periods of uncertainty, it is typical for investors, particularly fast money traders and hedge fund managers, to sell first and ask questions later. These investors react to changing momentum and to technical price action as opposed to taking the time to fully evaluate economic or corporate fundamentals.

Our own view is that while the economy is basically healthy, it is indeed beginning to slow from the torrid pace in the first half as higher interest rates and energy prices finally take their toll. Consumers in particular appear to be feeling the effects of higher minimum credit card payments, increased borrowing costs and high energy prices, which have all combined to reduce their ability to spend as vociferously as they have the past few years. But a slowdown in consumer spending does not necessarily mean economic activity will fall off a cliff. In fact, expectations are for GDP growth to slow from 4.2% in the first half to approximately 2.8% in the second half as the industrial and capital spending parts of the economy continue to pick up for the slackness of the consumer. We also believe that irregardless of the Fed's mixed messages, they truly are close to the end in their rate tightening actions. At most, we foresee one more 25 basis point rate increase, at the August 8 FOMC meeting, and it is conceivable that we've already seen the last rate hike during this phase.

Escalating geopolitical issues and fears of a precipitous slowdown in economic activity have beset the stock market the past several weeks. Anxiety on Wall Street has risen as conflicts with Iran, North Korea, Iraq and now renewed fighting between Israel and Arab extremists all compete for front page headlines. Combine this angst with weaker than expected employment reports the past two months, a slowdown in the housing market and a disappointing start to second quarter earnings reports and many investors have become convinced that decelerating economic growth is inevitable. We believe that when all is said and done, corporate earnings will once again come in at the high end of expectations led by energy, transportation and basic materials companies. And while inflation trends bear watching, we expect that vigilance by the world's central banks and the free flow of capital and human resources globally are likely to prevent inflation from spiraling materially higher. In this environment, interest rates should be range bound, with the ten-year US Treasury Note hovering around 5% throughout the balance of this year and the yield curve remaining relatively flat.

Oil prices have continued to weigh heavily on investors minds and pocketbooks driven by strong global demand trends and heightened security risks in many oil producing countries. Given our belief that global economic activity will cool down but not contract, and that geopolitical tensions will remain elevated, high oil prices are likely for the foreseeable future. In addition, China and India continue to drive demand for oil and other raw materials, even as near-term supply constraints linger. Unfortunately, high energy prices act as a tax on the consumer and consequently, future spending on other goods and services will likely be more restrained.

With all the economic and geopolitical uncertainty, it is hardly surprising that investors have been looking to reduce risk in this environment and have chosen safe havens such as US Treasury securities and money market funds, as yields approach 5%. Nervous stock market participants, in addition to raising cash, have been rotating out of economically sensitive and consumer cyclical sectors such as technology and retail and into more defensive and less economically sensitive sectors such as consumer staples and healthcare. Stocks have a chance to stabilize over the next few weeks on favorable earnings news and soothing comments from the Fed that imply a pause or end to Fed Funds rate hikes. Beyond these potential near-term catalysts, the dual headwinds of slowing growth and heightened international conflicts are likely to keep investors on the sidelines until there is enough economic data suggesting growth has stabilized, albeit at a lower level, and that geopolitical tensions have eased.

While the risk of recession has clearly increased with the Fed's actions and still rising energy prices, an economic slowdown as opposed to contraction is more likely. Should the Fed make a monetary policy error, or one of the world conflicts draw in the US militarily or if energy prices rise significantly more, all bets are off. So as not to end on an overly pessimistic note, we are reminded of the many positive factors that should prevent a severe or long-lasting downturn in stock prices from current levels. Although interest rates have risen, they remain low on a historic basis and productivity remains high. In addition, the Fed does appear to be aware of the tight-rope they are walking between allowing inflation to spiral upwards by ending their rate hikes too soon vs. overshooting on the upside and causing an unwelcome recession. Although nothing is assured, they seem determined to avoid any monetary policy mistakes and to engineer the elusive "soft-landing" where the economy slows to a sustainable pace while inflation settles down within an acceptable range. In large measure, corporate financial conditions are quite healthy with strong and liquid balance sheets and record earnings and profit margins. Finally, unlike previous downturns, stock market valuations are quite reasonable and could serve to limit further declines.

We wish to reiterate our advice to remain well-diversified across various asset classes and not to be tempted to become overly aggressive in this environment nor to run for the hills, as history has taught us that when fear is rampant on Wall Street, stocks are due for a rebound. As always, we look forward to discussing our views with each of you on an individual basis and addressing any of your concerns.