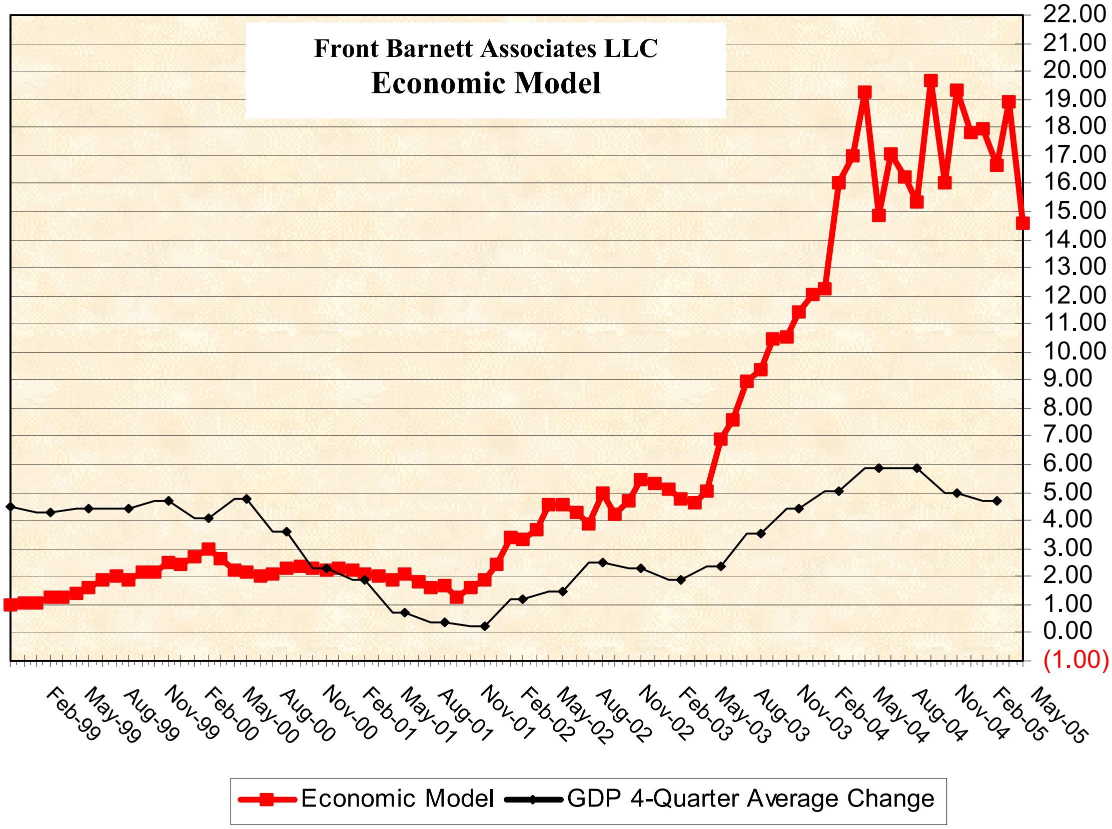
June 28, 2005

THE ECONOMIC OUTLOOK --MIXED SIGNALS

While recently released economic data underscores the now fitful nature of the economic expansion, currently in its forty-third month, the slower overall pace of business is unlikely to deter the Federal Reserve from continuing to raise short term interest rates over the near term. In fact, the Fed is expected to move ahead with another quarter point hike in the Fed Funds rate when it meets on June 30, despite the weak June 4th jobs report, showing only 78,000 jobs created in May after exceptionally strong job growth of 274,000 in April. The economy's seesaw performance, evident in the aforementioned employment data, is well illustrated by our firm's proprietary Economic Model (below) which for months has been signaling the current slowdown.



Other economic data we have parsed this spring is consistent with this choppy pattern. Consider the following:

- Industrial production rose a stronger than expected 0.4% in May and factory capacity utilization rose from 79.1% to 79.4%, according to the Commerce Department. Additionally, the Federal Reserve's May Beige Book report painted a picture of solid economic growth and improving labor markets.

- The Conference Board's Index of Leading Economic Indicators declined 0.5% in May and has yet to post an increase this year, continuing to foreshadow slower growth ahead.

- The University of Michigan consumer sentiment index jumped from 86.9 in May to 94.8 in June, reversing a four-month string of declining readings. And today, the Conference Board reported it's June consumer confidence index rose to a three year high of 105.8, driven primarily by improving perceptions of the labor market.

- The Philadelphia Federal Reserve Bank's manufacturing activity index registered a –2.2 reading in June, it's first contractionary indication since May 2003. This follows a sharp decline from 25.3 in April to 7.3 in May. Additionally, while May durable goods orders showed a 5.5% increase, orders outside of transportation fell 0.2%, the third decline in the last four months.

- Housing starts rose 0.2% in May and remain at elevated levels according to the Commerce Department, despite a full year of Fed tightening. Meanwhile, existing home sales in May, while down slightly from April's record level, remain very robust.

- The Institute for Supply Management's manufacturing index slipped to 51.4% in May from 53.3% in April. While this gauge of factory activity continues to point to further expansion, albeit at a more moderate pace, it marked the sixth straight month of lower readings.

- U.S. retail sales fell 0.5% in May, and were down 0.2% excluding auto sales, according to the Commerce Department. This marked the first decline since last August.

All in all, incoming economic data, while uneven and possibly disappointing to some, gives us little reason to change our late winter forecast of 3.5% real GDP growth for 2005. While May's job gains were short of expectations, the coldest May in 20 years probably exaggerated weakness in apparel sales and leisure and construction jobs. Although factory activity has clearly moderated recently, much of the weakness is traceable to reductions in motor vehicle output to trim bloated inventories. Improving auto sales, spurred by new incentives, point to some sequential improvement in June suggesting manufacturing activity may be approaching a near-term trough. Finally, strong April gains in construction outlays, exports and consumer spending set the stage for continued growth in the months ahead. Clearly, dampening factors such as a strong dollar, weakening economic conditions in key export markets such as the Eurozone and Japan, persistently high energy prices and a less accommodative Fed are likely to preclude a return over the near term to the kind of robust economic activity we experienced last year.

The economy's income-generating capacity, a source of concern to some Wall Street savants, appears to be improving. First quarter corporate profits again ran well ahead of analyst's expectations providing room for further wage gains as this cycle unfolds. Sharp upward revisions to wage and salary growth starting in the third quarter of 2004, unrelated to hourly pay but traceable to bonuses and the exercise of employee stock options, show real disposable income rising a healthy 3.7% in the twelve months ended March 31, creating conditions for solid consumer outlays this summer and fall. Even if the recent rebound in wholesale gasoline prices persists, the constructive income backdrop seems likely to underpin continued healthy gains in consumer spending which accounts for roughly two thirds of GDP.

Inflation

As for inflation, which has been on the rise for the past year, recent readings clearly indicate a moderating trend. In it's May inflation reports, the Labor Department noted the Producer Price Index (PPI) declined 0.6%, while the Consumer Price Index (CPI) fell 0.1% -- the first monthly decline since July 2004. Looking at both the PPI and the CPI on a year-over-year basis, May's inflation readings registered their lowest gains since September 2004. That said, the factors that pushed up inflation over the past 18 months -- higher commodity prices including energy, historically low interest rates and improved business pricing power -- remain in place. Moreover, the recent acceleration in labor costs and moderating productivity gains may serve to reinforce inflation pressures. For this full year, we expect inflation, as measured by the CPI, to approximate 2.4%, hardly a cause for alarm.

Federal Reserve Policy

The view that the Fed may pause in raising rates following the 25 basis point increase likely this week has recently gained some credibility for several reasons.

- With inflation moderating and the Fed tightening, *real* interest rates have finally turned positive after having been negative for two and a half years.

- The weak May jobs report serves as a reminder that employment growth in the current cycle has lagged that of past expansions, probably reducing the need for further aggressive Fed tightening.

- Energy prices, which act as a brake on the economy, have remained stubbornly high, doing some of the Fed's work.

- Economic growth has decelerated from 4.4% in 2004 to 3.5% in this year's first quarter, reducing the risk of an overheating economy.

- With US interest rates already above those of our trading partners, pushing interest rates higher may cause the dollar to strengthen further, hurting US exports.

- The Fed may have been more restrictive during this tightening cycle than the current level of interest rates would suggest given the fact there has been virtually no growth in the money supply this year.

- Dallas Fed President, Richard Fisher, a newly appointed voting member of the FOMC, recently opined that we may be in the "eighth inning" of rate hikes.

On the other hand, a sizeable group of Fed watchers remain convinced the Fed has more work to do if it is to achieve it's goal of a "neutral" policy position. They cite the need to quell housing speculation, where evidence suggests 25% of all new home purchases have been made by financial buyers who have no intention of actually assuming residence. Furthermore, outsized housing price increases in key markets have far outstripped the income gains to which they have historically been tied. And, an alarmingly high percentage of home buyers have elected to take very short term mortgages, many with interest only and floating rate terms, which will require refinancing in the next few years, potentially at higher rates, increasing the risk to the financial system. By raising rates now, the Fed is hoping to drive these short term borrowers into longer term fixed rate financing, serving to increase the stability of the financial system.

Weighing these considerations, we have shaved our Fed Funds rate target from 4% to 3.75%, implying three additional 0.25% rate increases. Clearly, another geopolitical shock, a significant spike higher in energy prices or a string of notably weaker economic reports could cause the Fed to pause sooner.

Fixed Income Investment Policy

The financial community's overriding debate during the past year has been over the reasons for historically low long term US interest rates in the face of tightening Fed policy. We, among others, had expected rates to rise as the economic cycle matured and investor fears shifted from deflation to inflation. Even Fed Chairman Alan Greenspan described this question as a "conundrum". There are three principal alternative theories to explain these low rates. One view is that the bond market has overshot and is wrong. All major markets occasionally move to extremes on both the upside and the downside. A second explanation is that the consensus economic forecast for the balance of this year and 2006 is overly optimistic and that a weaker economy will emerge to justify current rates. A flat yield curve, such as we currently have, has often been a precursor to weak economic activity. The third explanation involves the savings glut outside the US which must be invested and which usually flows into fixed income securities. With rates abroad well below ours and anemic growth in Europe and Japan, excess foreign liquidity has flowed into US debt instruments. This is one aspect of our overall financial picture which is both new and carries a significant impact. It is, therefore, a more likely explanation of the conundrum than an overshooting bond market or an overly pessimistic consensus economic forecast.

We believe this unprecedented phenomenon will continue to keep US interest rates low, but not indefinitely. At some point, foreign investors' holdings of dollar-based fixed income securities will rise to a point beyond any prudent standard of diversification, causing them to stop adding to these holdings and to seek out other more compelling investments. With many investors skittish over the outlook, 4% yields may now be sufficient to attract investors' capital. If we are right, and business conditions remain favorable, investor perceptions may shift causing them to reallocate from bonds toward investments with greater potential returns. We are currently maintaining a defensive position in bond portfolios awaiting opportunities to extend durations as higher yields become available.

Equity Investment Policy

Despite record corporate profits and expectations of further profit gains of 8% to 10% this year, rapidly rising dividends, share buybacks, benign interest rates and strengthened corporate balance sheets, the US stock market has been locked in a narrow trading range as fears of excessive Fed tightening have dominated investor sentiment. The attached exhibit shows that, since 2002, the stock market has moved in a stair-step pattern, only reflecting the strong underlying profit growth once a major uncertainty upon which investors became fixated, was removed. Recall that in 2003 investors remained cautious until it became clear the US invasion of Iraq would not spawn a wider Mideast war. Last year, uncertainties over the Presidential election capped the market's advance until the returns were tabulated. This year, investors' preoccupation with Fed rate increases has kept a lid on stock prices. We continue to believe investors are unlikely to add to stock commitments until they are able to see with greater clarity an end to the Fed rate hikes. Meanwhile, stocks are priced at an average of 15 ½ times projected earnings for the next twelve months and, based upon the Fed Model (a copy of which is also attached), remain roughly 35% more attractive than bonds. We expect stocks to provide returns generally in line with the 8% to 10% growth forecast for corporate profits.

Equity portfolios under our supervision continue to be tilted toward large cap *growth* shares which have underperformed the market as a whole for the past 5 years. We maintain overweighted allocations in the undervalued technology and healthcare sectors. We recently added modestly to holdings in the financial sector and plan further additions to financials as the current interest rate cycle plays out.

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Fed Valuation Model

The Fed stock market valuation model, which incorporates the yield on 10 year US Treasury Notes and estimated S&P 500 profits, shows stocks remain undervalued.

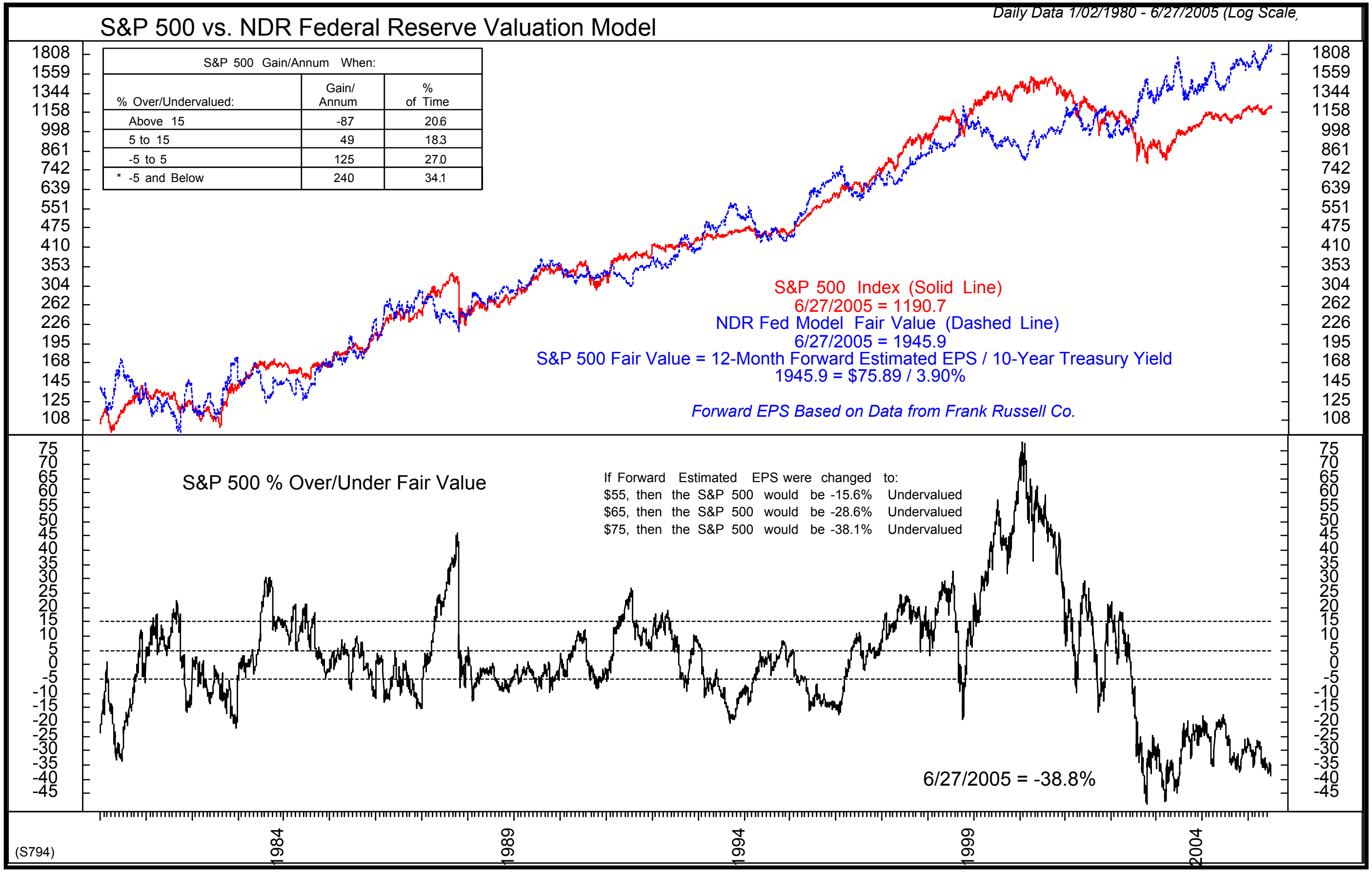

Chart Courtesy of Ned Davis Research

S&P 500 vs. Consensus Earnings Estimate for the S&P 500