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THE ECONOMIC OUTLOOK -- SLOWER GROWTH AHEAD

Newly released economic data showing the economy added fewer than expected jobs over the past three months confirms our long standing forecast of slowing business growth under the combined weight of high energy prices and rising interest rates. The Labor Department's June employment report, issued last Friday, also hoisted inflation warnings with hourly wages increasing at their highest rate in five years and unemployment remaining at an historically low 4.6%. This disparate data highlights the uncertain economic situation facing the Federal Reserve as it wrestles with the question of whether to continue raising rates to slow the economy further to quell future inflation, or to pause.

In our view, the weak payroll growth recorded in the past quarter is yet another harbinger of a cooling economy, weighed down by a slower housing market, and moderating consumer borrowing and spending. Added to lackluster job growth in April and May, weak hiring in June brought the pace of monthly job growth to about 108,000 in the second quarter, down from 176,000 in the previous period. Also of interest was the loss over the past quarter of 80,000 jobs in retailing which in past economic cycles was a reliable precursor of slowing growth. So, despite wage and other inflation pressures which are likely to continue to creep up in the short term, it is only a matter of time, as we see it, before slower growth tamps these down.

Other forward looking indicators, while somewhat mixed, confirm a loss of economic momentum cutting GDP growth from an annualized 5.6% in the first quarter to about 2.8% in the last quarter as gasoline prices soared. Second half growth is expected to average about 3%, close to the long-term trend. The most prominent weakness is evident in housing:

- US house construction averaged an annual rate of 1.931 million units in the second quarter, the lowest since the three months ended

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November 2004. Building permits, a sign of future construction, fell 2.1% according to the Commerce Department.

- The National Association of Realtors reported a 1.2% decline in home resales to an annual rate of 6.67 million, the slowest in four months. Meanwhile, the supply of homes for sale rose to the highest level in over nine years increasing 5.5% to 3.6 million, bringing inventories up to 6.5 months worth at the end of May.

- Confidence among US homebuilders dropped to an eleven year low in May with the NAHB/Wells Fargo index declining to 42, the lowest level since 1995. A reading below 50 signals pessimists outnumber optimists.

Other data confirm the slowdown:

- Retailers led by Wal-Mart and Federated Department stores reported slower sales growth in June as a 32% jump in gasoline prices from a year earlier curbed spending and flooding discouraged shoppers on the US east coast. The International Council of Shopping Centers index rose only 2.6% last month compared with a gain of 5.5% a year earlier.

- The Conference Board's index of leading economic indicators fell in May, the most in nine months, signaling the robust pace of growth earlier this year will give way to a slower expansion.

- US vehicle sales dropped 11% in June -- the fifth straight monthly decline -- as rising energy prices, acting as a tax on consumers, have blunted demand for trucks which account for a majority of sales at the three US based automakers.

- Personal Consumption expenditures averaged only 1.7% higher in the April-May period than in the first quarter when they grew 5.1%.

Nevertheless, despite signs of slowing, there are indications of continued growth.

- Projecting continued expansion, albeit at a slower pace, the Institute of Supply Management's (ISM) index of non-manufacturing

businesses including banks, builders, and retailers, fell to 57.0 in June from 60.1 in May. Readings above 50 indicate growth in the index, which includes industries that account for almost 90% of the economy.

- Also portending continued expansion, although at a more modest rate, the ISM's factory index fell to 53.8 in June from 54.4 the previous month and the 6-month average of 55.4.

- While durable goods orders ex-transportation equipment fell for the third consecutive month in May, they remain in a broad uptrend suggesting the factory sector should continue relatively strong.

- May US trade figures show the deficit may be leveling off as faster economic growth in Europe and Asia spurs exports at the same time a slowdown in the US keeps a lid on US imports. The dollar's 4% decline in the last year is making US goods cheaper abroad.

The dilemma facing this Federal Reserve is typical for a central bank in the middle of a robust economic expansion. Strong growth has caused it to abandon a long period of low interest rates designed first at averting deflation and then stimulating the economy by making money cheap and easy to borrow. The steady rise in rates has cooled the economy. Further increases will bring rates to a level we see as a brake on growth. With inflation, as measured by the Personal Consumption Expenditures index, only slightly above the Fed's "acceptable" 1-2% range, we believe the end to Fed rate increases is at hand, although another 25 basis point increase in August would not be surprising.

Despite slower growth in consumer spending and a generally weak housing environment, we see strength in manufacturing and export demand as drivers of the economy over the balance of the year. The dollar is likely to weaken as foreign central banks raise rates improving opportunities for US manufacturers to sell their goods abroad.

S&P 500 profits, which have increased at double-digit rates for 14 consecutive quarters, probably grew at better than 11% in the last three months and are expected to rise at an 8-10% per quarter rate over the balance of this year assuming 3.0% real GDP growth in the period. All in all, despite the slowdown, the outlook remains favorable but less buoyant.

FIXED INCOME STRATEGY

The bond market remains a mystery to many investors who continue to wait for inflation worries to drive bond yields higher. There are, though, good reasons rates have remained historically low:

- There is a widespread belief the Fed has the commitment and capacity to do what is necessary to control inflation.

- We continue to experience massive demand for dollar-denominated fixed income assets as a result of surplus global savings and our own Current Account deficit.

- There is a global hunger for yield.

- The issuance of new corporate bonds has been meager.

- The US economy is entering a period of slower growth due, in part, to weaker consumer spending. This softening will reduce labor cost pressures and diminish the ability of corporations to raise prices eventually muting inflation. Market based indicators such as commodity prices, including gold, and the inflation rate implied on inflation protected US Treasury Bonds (TIPS) all signal an easing of inflation.

- Higher short term rates and reduced liquidity as central banks work to control inflation are dampening economic strength through a number of avenues including weaker stock prices, deteriorating housing prices and activity, and wider credit spreads in the emerging market sector. A consequence of these developments is a reversal of the wealth effect and consumers' willingness to spend.

Until recently, we have held the view bond investors were not being adequately compensated for the inflation and market risks of intermediate and longer dated maturities. Now, given the likelihood of moderating inflation, continued fierce global competition and high productivity gains, we believe the potential for further significant increases in bond yields has become limited. We, therefore, began to increase portfolio durations as rates on five-year US Treasury bonds rose to the 5%

level late this spring and we have continued to add to medium term maturities each time rates have taken a modest turn upward. Since we remain concerned credit spreads could widen considerably as the cycle matures further, we have limited our purchases to US Treasury notes in taxable portfolios.

EQUITY INVESTMENT STRATEGY

While there is certainly a risk the Fed could overshoot causing a greater than expected slowdown, we are most likely witnessing a re-run of the 1994-95 period, which was characterized by an aggressive Fed, a sharp drop in global risk assets, including emerging markets, and a US stock market that went nowhere until it was clear to investors the Fed was done. Growth and inflationary pressure slowed by 1995 creating the conditions for an end to Fed tightening and a better stock market.

Given the fact the S&P 500 has enjoyed 14 consecutive quarters of double-digit earnings growth (which has occurred only one other time since the early 1920s, between 1Q93 and 2Q96), a slower pace in earnings growth and a tightening of global liquidity could trigger a material shift in how investors position their portfolios, including a distinct shift to larger capitalization stocks and less emerging market exposure. It could also force Wall Street firms to cut their leveraged proprietary positions in several areas including higher volatility parts of the market. We are, therefore, comfortable with clients' core positions in large, stable growth stocks, including those in developed countries, and believe the rotation toward companies with steadier, more predictable earnings streams is likely to continue. Financials, which comprise 22% of the equity portfolio, should also benefit as investors will view them as beneficiaries of an end to Fed rate increases. Our current equity sector concentrations are as follows:

SECTOR CONCENTRATION %		
	Portfolio	**S&P 500**
Technology	15.37	13.16
Industrial Capital Goods	10.00	8.69
Discretionary Consumer Goods	9.60	6.88
Service & Media	6.47	7.84
Telecom Services	3.36	2.30
Consumer Staples	6.25	8.62
Healthcare	15.68	11.66
Energy	8.13	10.17
Financial	22.19	20.71
International Equities	2.93	NA

During the past quarter we made additional investments in international equities, specifically in developing countries. We view this as one of several steps we are likely to take in order to broaden portfolio diversification.

Overall, stocks in the portfolio are reasonably priced at 14.8 times 2006 earnings compared with 15.4 times for the S&P 500. And the Fed Valuation Model, a copy of which is attached, shows stocks to be 28% undervalued when compared with bonds.

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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.

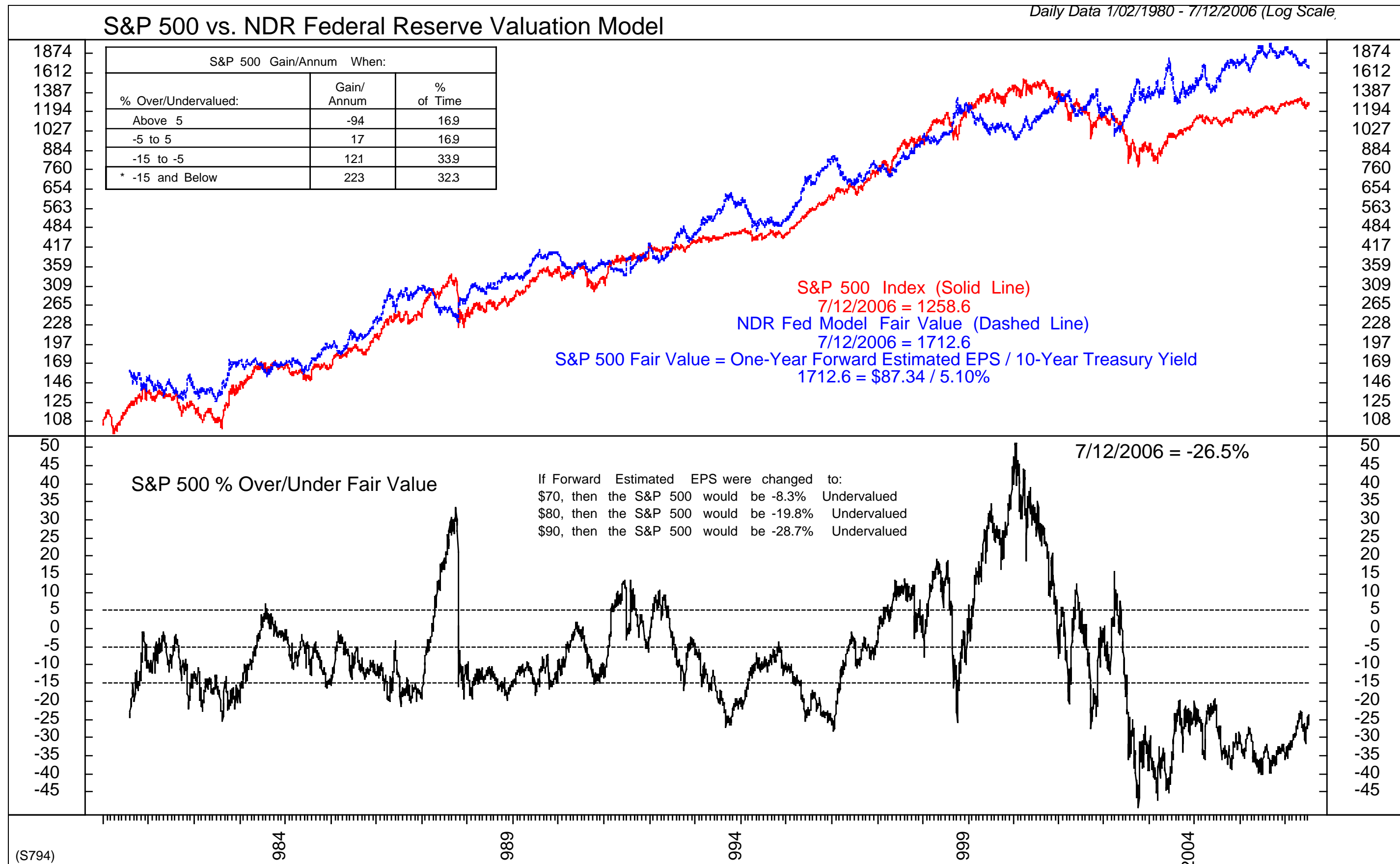

Chart Courtesy of Ned Davis Research