

Quarterly Market Review

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Summary

2005 was a year full of momentous events, from nearly every aspect. Natural disasters, a new energy crisis, and ongoing war in Iraq - news came at us from every angle. The year started with a tsunami in Asia and ended with flooding in California. The major blows, of course, were the dual hurricanes hitting the Gulf Coast; the reconstruction effort in and around New Orleans could take years. The damage in the Gulf to the oil platforms as well as some of the pipelines on land, the ongoing Iraq conflict, and expansion in China and India pushed crude oil prices over \$60 during the fourth quarter, and they have remained at or near those levels since. This will likely have a significant dampening effect on the U.S. consumer as the winter heating costs rise, reducing disposable income. While some progress was made in Iraq this past year, the cost both in human lives and dollars continues to escalate and put a strain on the U.S. fiscal policy as well as the major military branches.

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Looking forward to 2006, there are three major issues that will have an impact on the U.S. and World markets. The first is the imminent retirement of Fed Chairman Greenspan and his replacement in February. The minutes released from the December Fed meeting show most of the members felt that further rate hikes were going to be limited, if any. How Mr. Bernanke interprets this policy and reacts to a changing environment will be one of the leading indicators for the new year. He faces what might be one of the more difficult environments, with a possible slowdown in the general economy keeping a lid on wage inflation, but with high energy prices and the massive reconstruction effort in the wake of the 2005 hurricanes keeping upward pressure on price inflation. The U.S. housing market, fed for the past four years on low interest rates, has slowed over the last six months as rates have risen. Many feel that the accommodative policies started in 2001 have kept the economy afloat, and turning off the taps now could lead to a "bursting" of the housing bubble. 2006 will also be a mid-term election year. This will likely affect any progress on a balanced budget or deficit reduction package, as both major parties position themselves for summer primaries and fall races. Finally, the outcome of the Iraqi election and the continuing U.S. presence in the region will be one of the lead issues in the November elections here, and will have an effect on consumer sentiment.

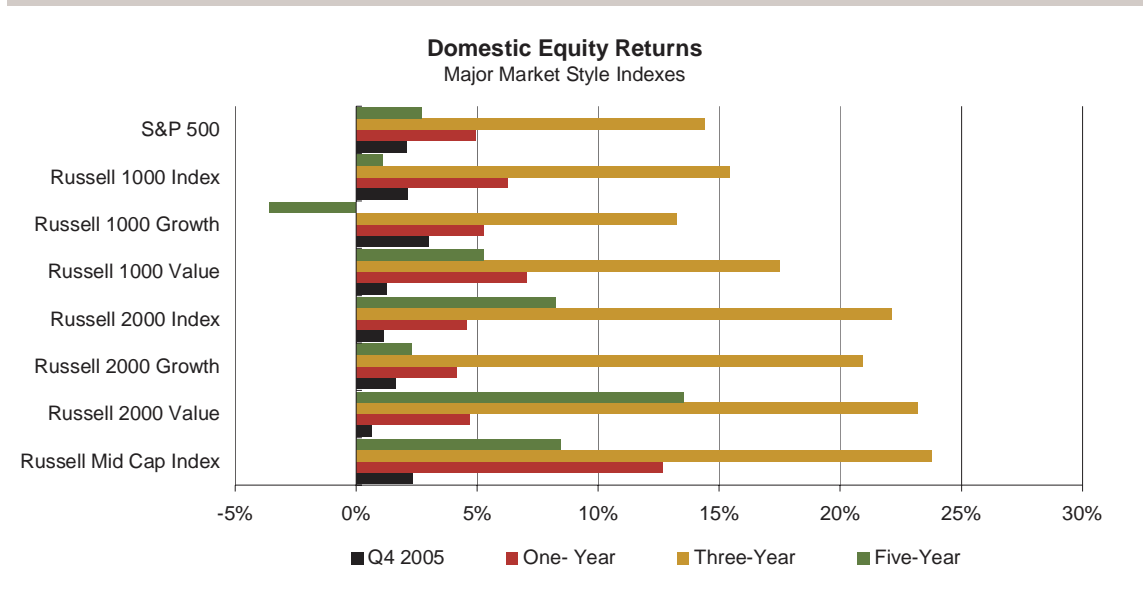
Domestic Equity Markets Overview

2005 could well have been the year of the tortoise for the domestic equity markets. After a disappointing first quarter, most of the major indices were near flat by mid year, and small gains in the third and fourth quarters pushed all of the Russell indexes to average gains for the year. The second half of the year was dominated by the Energy sector, positively in the third quarter and negatively in the fourth. Continuing the trend of the last couple of years, the small cap market outperformed the blue chip indices, but both were overshadowed by the midcap market segment, as midcaps avoided most of the losses during the year's first quarter.

For the fourth quarter, growth outpaced value across all market caps according to the Russell indexes. As it had been all year, the driving factor in the final quarter of the year was the Energy sector. Breaking down the Russell style indices, the biggest drag on performance in nearly every index was the Energy sector. The only exceptions to this were the Russell Midcap Growth Index and Russell 1000 Growth Index; both had a positive return in this sector, and represented the two best performing sub-asset classes. The Financial Services sector was among the leaders in every sub-asset class as virtually every segment of this sector turned in above average returns during the final quarter. A positive stock market boosted the banking and brokerage sector; the REIT segment slowed, but continued to have positive results. Only the insurance segment, hurt by the year's natural disasters, lagged.

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International Markets Summary

The international and emerging markets continued to outshine the domestic equity markets over the course of the fourth quarter, despite the dampening effects of a strengthening U.S. dollar. The MSCI EAFE Index was up nearly 30% for the year in local currencies, though in dollar terms the gain was limited to 14%. Among the developed markets, the biggest gainer was our neighbor to the north, Canada, with a 28% return in dollar terms. The Canadian market was led by the year’s two best performing market segments, Energy and Natural Resources. Japan also turned in a very healthy 2005 gain of 25% in dollar terms.

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As exciting as the gains were in the developed markets, the emerging markets performed even better. The MSCI Emerging Markets Index was free of any significant currency differences and ended the year up more than 35% in local currencies and more than 34% in dollar terms. Latin America, which saw huge gains across the board, was led by Columbia, for which the market doubled over the course of the year in local currency terms, and was up 107% in dollar terms. Venezuela was one of the few markets down for the year, finishing down nearly 25% in both local currency and dollar terms.

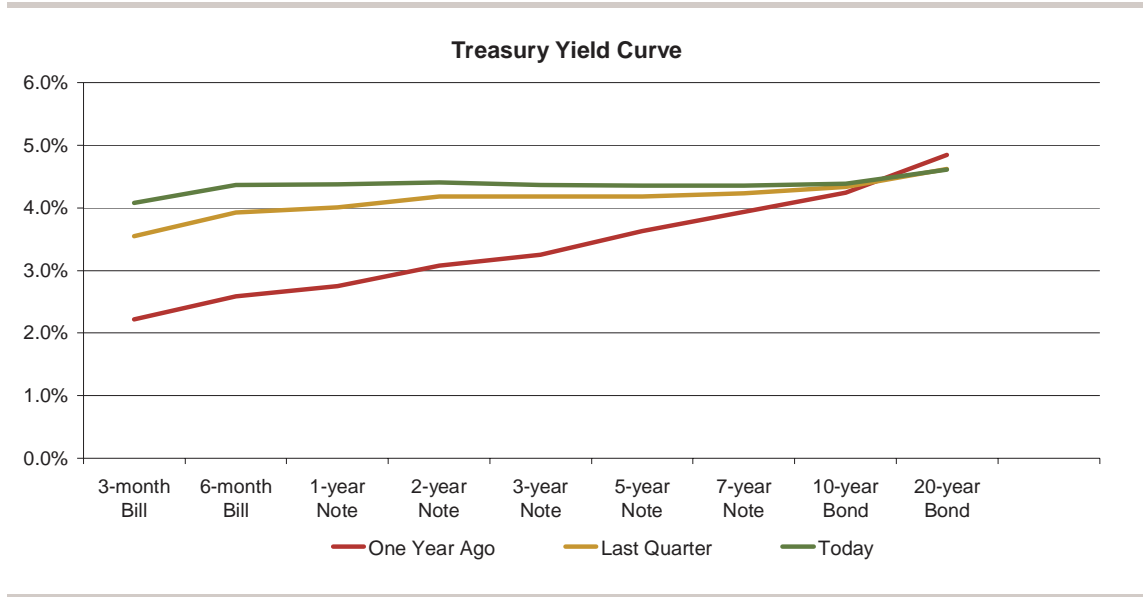
Fixed Income Summary

Fixed income investors ended the year with few clear signals about the future. The dominant story over the course of the year was the ever flattening yield curve. As the Fed continued to raise short term rates, the longer term rates (10 yrs and greater) stayed relatively flat. By the final trading day of the year, the 2-year Treasury was yielding 1 basis point more than the 10-year Treasury, creating an ever so slightly inverted yield curve. An inverted yield curve has presaged five of the last six recessions in the U.S. However, just after the first of the new year, the notes from the December Federal Reserve meeting indicated that most of the members felt that there would be little cause for continuing to raise short term rates in 2006, effectively signaling that the rate hike cycle was at, or nearing, its end.

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The final quarter of the year was relatively quiet, with most of the short and intermediate taxable indices up between 30 and 60 basis points for the quarter. Significantly higher returns were only to be found in the longest maturities, those 20 and more years, or the very shortest, as the 90-day T-bill rate was nearly 1% in the final quarter. The relatively meager returns for the final quarter meant equally meager year end totals. For 2005 the Lehman Brothers Aggregate Index was up just 2.43%, the Treasury Index up just 2.79%, and the U.S. Credit Index up just 1.96%. This compares to the T-Bill Index finishing the year up 3.07%. The general rule for the year was that longer term, higher quality bonds turned in the best results.

The Municipal segment of the market tracked the taxable market closely. For the fourth quarter, the Lehman Brothers Municipal Index, which includes all maturities, was up 0.73%. The best return for the quarter was the 20-Year Index, up 1.05%, and the worst was the 3-Year Index, up just 0.28%. The same pattern was true for the whole of 2005, with the Long Bond Index (22+ years) up 7.06% and the 3-Year Index up just 0.87%.



Outlook

2006 holds the promise of being a year of transition, both here and abroad. There are early signs that the economy is starting to slow, and the Fed is clearly less worried about inflation and more worried about growth. A new Chairman of the Federal Reserve takes over, starting a new era after Mr. Greenspan’s nearly 20 years. He takes over with a very flat yield curve, one that is threatening to invert, raising the specter of a recession during an election year. The U.S. position in Iraq will likely undergo significant change over the course of the year, as talk of troop reductions are now underway. The international markets head into 2006 with substantial momentum after two years of significant outperformance relative to the U.S markets. But the interest rate tightening cycle is just beginning in the Eurozone, and Japan is coming off one of its best years in decades and the Central Bank there is beginning to tighten the money supply as well.