

Quarterly Market Review

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Financial Markets and Economic Analysis, First Quarter 2006

Summary

One of the key factors anticipated for 2006 that we mentioned in our last review was the introduction of the new Fed Chairman in February, after the retirement of Alan Greenspan, and the potential for change. While there have so far been no dramatic changes in policy, the Fed raised rates as expected at both meetings during the first quarter, there has been a change in how that policy is being implemented. While Chairman Bernanke has indicated that he wants to continue Greenspan's policy of being transparent (i.e. letting the market know with relative certainty what is coming), his first few months have not exactly followed that pattern. With the Fed Funds rate now at 4.75% and a slightly higher rate being priced into the market before the end of the year, there is more doubt in the market today as to when the rate hike cycle might end than there was under Greenspan. However, the threatened inversion of the yield curve has not yet materialized, at least not during the first quarter.

The first quarter did benefit from a convergence of factors that first quarter GDP growth, currently estimated to be between 4.5% and 5%, will likely reflect. Part of that jump in growth is due simply to the relief of the pressures that kept fourth quarter GDP growth at 1.6%, namely the recovery from the hurricanes. Also, coming into the quarter, energy prices were lower than they had been for most of the previous year and some forecasts were calling for even lower prices. However, those forecasts were quickly changed as violence in Iraq increased and winter stocks began to dry up. In addition to higher rates and energy prices, the housing market, the main underpinning in the markets for the last two years, began to soften, with seasonally adjusted sales dropping during the final part of the quarter. 2006 started quickly out of the blocks, with the U.S and international equity markets up sharply and the fixed income markets flat to down in the first three months. Fourth quarter earnings reports were robust, even if forecasted earnings for 2006 have not been increased much.

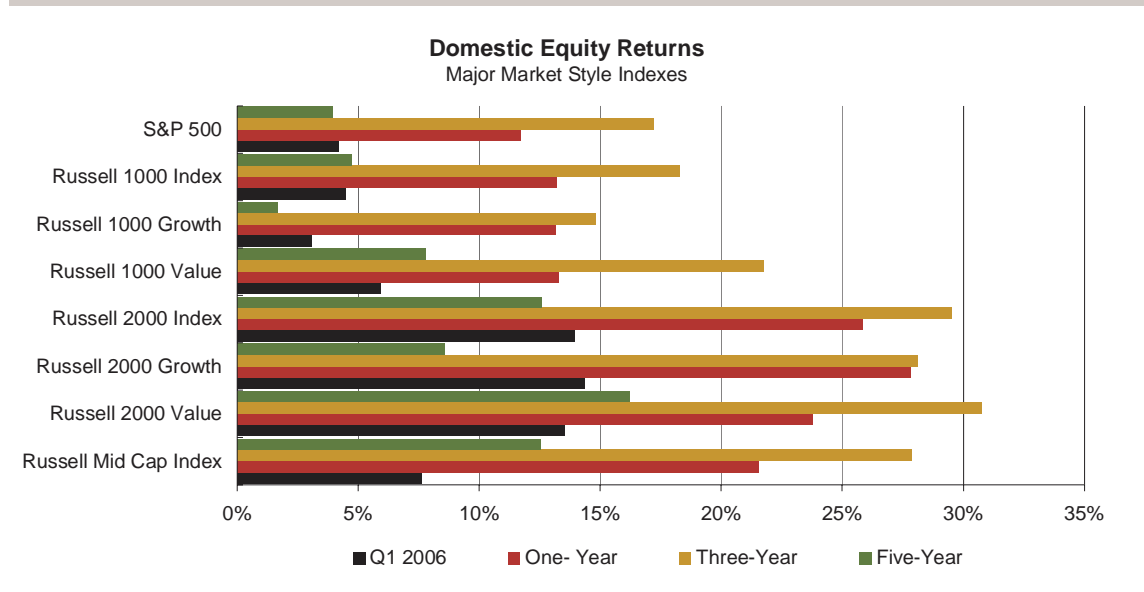
Domestic Equity Markets Overview

The conventional wisdom coming into 2006 was that small cap stocks had seen their best days and large caps would begin to dominate as the economy began to slow. However, the small cap market, as measured by the Russell 2000 (up 13.9%), more than doubled the return of the Russell 1000 (4.5%) and more than quadrupled the Russell Top 200 Index (3.2%). Another piece of conventional wisdom was that the REIT market had run its course and, with rising interest rates, was due for a below average year. That was clearly not the case, at least in the first quarter, as the Wilshire REIT Index was up more than 15% for the period and more than 42% for the last 12 months.

The U.S. equity markets were dominated by the Energy sector in 2005, positively for the first three quarters and negatively in the last quarter. The first quarter of 2006 was widely dominated by the most cyclical sectors, Materials and Industrials/Durables. Raw materials prices continued to increase during the first quarter, bringing higher expectations to many of the natural resource companies, especially the gold mining companies. The difference between the value and the growth portions of the market were less clear, as growth outperformed value in the small cap segment of the market, while the reverse was true in the large cap segment. There was virtually no difference between growth and value in the midcap segment. The overall market during the first quarter had some similarities to 2003, in that the market was led by companies with lower earnings stability.

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International Markets Summary

The international and emerging markets continued to outshine the domestic equity markets over the course of the first quarter, and a weakening dollar only added to the substantial gains. The MSCI EAFE Index was up nearly 9.50% for the quarter in dollar terms. Among the developed markets, the Scandinavian countries led the way with Norway and Finland both up more than 20% for the quarter in dollar terms. In fact, none of the developed countries had negative returns in their own currencies for the quarter, and only New Zealand (the one country with a loss in dollar terms), underperformed the S&P 500.

The emerging markets showed much the same story, with gains in almost every segment of the market. The MSCI Emerging Markets Index was up more than 12% for the quarter. Venezuela, with its large exposure to the energy markets and a booming economy, led the way with a 46% gain in local terms and more than 50% gain in dollar terms. The Asian portion of the Index was led by India and China, both up more than 20% for the quarter in dollar terms. Only the Middle East portion of the Emerging Markets Index showed a loss, led by Israel and Jordan.

Fixed Income Summary

The Fed upped the Fed Funds rate twice during the first quarter, on top of the eight increases in 2005. Since the tightening cycle began in mid-2004, the Fed Funds rate has steadily risen from a low of 1.00% to 4.75%. The change seen in the first quarter was that the increases finally began to have an effect on the long end of the curve, as it shifted nearly parallel between the 3-year and the 20-year, just less than the 50 bps increase in the short term rates. While the yield curve was ever so slightly inverted at the end of 2005, the dominant feature of the curve at the end of the first quarter was the flatness of yields. The spread in yield was just 0.05% from the 6-month T-bill to the 10-year bond.

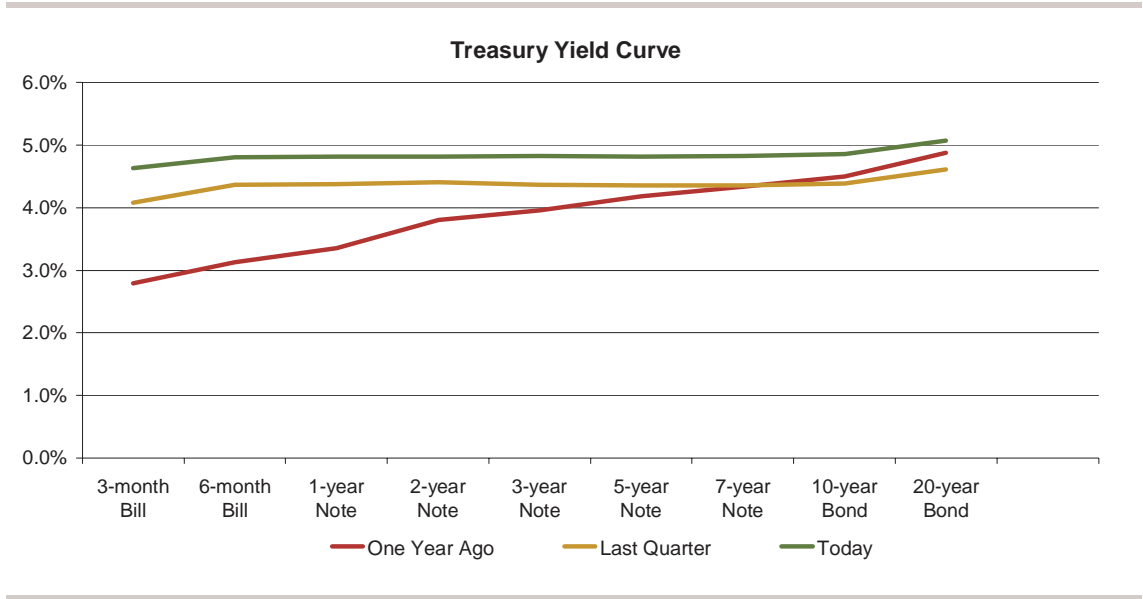
Not surprisingly, given the environment, only the very shortest maturities turned in positive performances for the first quarter, according to the Lehman Brothers Indexes. The Lehman Aggregate Index, which includes all the major investment grade sectors, was down 0.65% during the first quarter. The U.S. Treasury Index was down 1.23%, with only the 1-3 year segment of the Index showing a positive return, 0.35%. The U.S. Corporate Index was also down 1.17% for the quarter. The only exception to this rule on the taxable side was the high-yield market, which was supported by another quarter of strong corporate earnings and overall even economic growth. The Lehman High Yield Index

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was up 2.89% for the quarter. Gains in the Index were increasingly higher, the lower the quality and the longer the maturity.

The tax-exempt portion of the fixed income market has not suffered from the same flat yield curve as the taxable market. However, issuance of new municipal bonds has been very slow during the first quarter coming off back-to-back record years for new issuance. The Lehman Municipal Index was up just 0.25% for the first quarter, with slight gains coming from the very short (1-2 year) and very long (20+ year) portions of the market and slight losses in the 6-12 year segment.



Outlook

While the first quarter of 2006 was a very good one for investors, there are a number of clouds looming on the horizon. Tensions have been increasing in Washington as work has yet to be completed on the 2007 budget and little or no progress has been made on reducing the \$400 billion plus deficit. The budget deficit, combined with the trade deficit, is now requiring more than a \$1 trillion per year in foreign financing, more than \$3 billion per day. The possible consequences of this increasing need for foreign capital include a weakened dollar or higher interest rates. For second quarter growth to exceed expectations, it will likely have to come from increased business and government spending rather than from the consumer, who is currently struggling with oil prices that have returned to mid-2005 levels, rising interest rates, and exceptionally weak wage growth.