

## Quarterly Market Review

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### Financial Markets and Economic Analysis, Second Quarter 2006

#### Summary

The financial markets were largely unsettled and posted negative returns in the second quarter. Much of the instability stemmed from investors' inability to decipher the Fed's policy with respect to interest rates. Though this was the same uncertainty investors faced in the first quarter when equity markets rallied, there were a few key differences that help explain performance. Unlike the first quarter, there was more evidence that growth in the economy was decelerating and inflation was picking up. Consequently, the new Fed Chairman, Ben Bernanke, signaled that the Fed may not be finished raising rates in order to combat rising prices. This announcement led to significant volatility in the equity markets worldwide, as many investors had incorrectly anticipated the end of the Fed's tightening cycle in May.

At the Fed's meeting in late June, the federal funds rate was raised a quarter point for the second time during the quarter to 5.25%. Based on comments at the latest meeting, the Fed is in a "data dependent" mode, but appears to be ready to take a break from raising rates if inflation is under control. This boosted equity returns in the final days of the quarter, helping to offset what was a tumultuous period since the Fed's last meeting on May 10<sup>th</sup>. In addition to "stagflation" fears (rising prices at the same time as a slowing economy), investors were busy digesting other macro-economic data relating to consumer spending, housing market values, and commodity prices. In both the equity and fixed income markets, there was a general "flight to quality" with the strongest, most fundamentally sound securities the most favored.

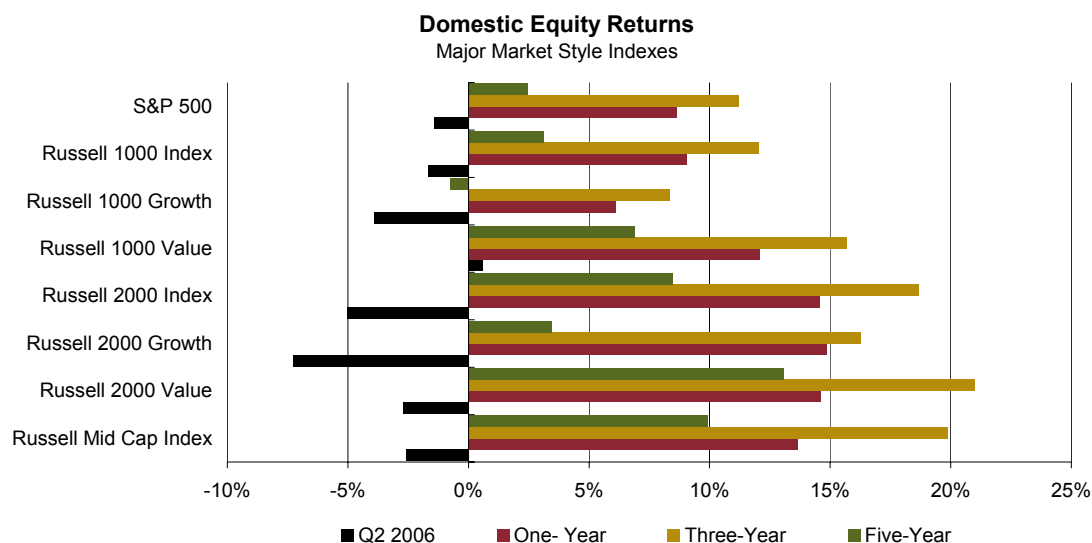
#### Domestic Equity Markets Overview

The equity market's gains in the first quarter were not extended into the second quarter, as many of the major indices were in negative territory, though not enough to offset first quarter positive returns in many cases. The lack of clarity surrounding inflation and the economy, in addition to the Fed's policy on these matters, heavily influenced market performance last quarter. The S&P 500 Index was down -1.9%, and the technology heavy Nasdaq gave back all of its positive return in the first quarter with a negative -7.2% return in the second. Market volatility also made a comeback, with a string of 100 point declines and advances in May.

There was a near complete reversal in market conditions from last quarter. In the second quarter, absolute returns of the major indices were negative, large cap beat small cap, and more defensive areas of the market outperformed more aggressive areas. The only trend that continued from last quarter was that large cap value beat large cap growth. In fact, value outperformed growth by about 450 basis points in both the Russell 1000 and 2000 indexes, continuing a multi-year trend. Defensive sectors performed the best, including Utilities and Consumer Staples. Conversely, Technology and Healthcare (particularly Biotechnology) stocks suffered the steepest losses. The Home Construction industry, as represented in the Dow Jones Wilshire Index, was off -26.25%, which was the worst performing industry in that index for the quarter.

*The financial markets were dominated by inflation and economic growth concerns. Uncertainty regarding Fed policy added to volatility.*

*There was almost a complete reversal in market leadership for the second quarter compared to the first quarter of 2006. Larger companies and those in more defensive industries held up better in the challenging market conditions. However, value continued to outperform growth.*



### International Markets Summary

Stocks worldwide suffered from the fears of inflation and higher interest rates in the U.S. Emerging market and Japanese stocks were hit particularly hard, as investors anticipated slower economic expansion. Prior to last quarter, stock prices had risen sharply in many foreign markets, and those with the highest valuations were hit the hardest in the second quarter. India, for example, was off -9.48% in U.S. dollar terms, partly contributing to the MSCI Emerging Market Index's downturn of -4.27% in the second quarter. The U.K., and to a certain extent the U.S., experienced smaller losses as investors turned to those stronger economies.

The dollar weakened during the quarter, primarily due to the widening deficit in the U.S. current account. Therefore, U.S. investors' returns in foreign securities benefited greatly from the relative strength of foreign currency. The euro strengthened by 5.5% and the yen by 2.9% against the dollar. The MSCI EAFE Index actually posted a positive return of 0.94% in U.S. dollars, despite being down -4.02% in local currency. An overweight in the European countries would have been favorable portfolio positioning for the quarter because moderate negative returns were largely offset by the positive currency exposure. Japan however, was down -7.5% in local currency terms, and was still in negative territory (-4.5%) after the currency adjustment.

### Fixed Income Summary

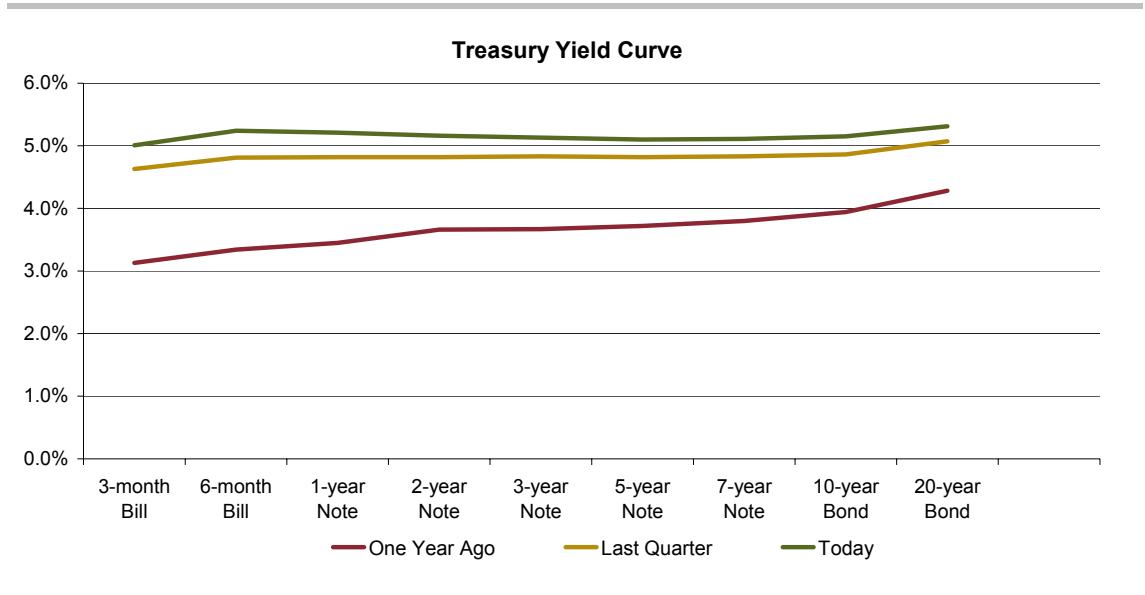
The Fed raised rates twice during the quarter, lengthening the streak of consecutive increases to 17 since 2004. The yield curve steepened in the first part of the quarter, as Mr. Bernanke hinted at easing the interest rate increases; then it became slightly inverted when the Fed changed its mind and became "data dependent." Over the course of the full quarter, Treasury note and bond yields increased by about 30 bps at all maturity ranges three years and out, and a bit higher at the one year (39 bps) and two year (34 bps) maturities. The yield curve remains flat, but due to higher interest rate sensitivity, the long end of the curve experienced negative three month total returns. The Lehman Brothers Aggregate Index returned -8 bps during the quarter.

Corporate bond issuance (investment grade and high yield) was brisk in the second quarter, as companies were trying to lock in low rates before yields increase due to potential Fed increases. Corporate bonds, in general, trailed their government-related counterparts during the quarter, resulting in slightly wider spreads. High yield bonds performed slightly better than investment grade securities, partly because their

*Performance in foreign stocks mirrored that of the U.S. market, but a weakening dollar helped buffer U.S. international investors from negative results as a whole.*

*The yield curve remains flat and corporate bond issuers took advantage of the relatively low yields that still exist in the market.*

higher yields helped absorb the price impact of rising rates. Municipal bond investors fared a little bit better than taxable investors and the municipal yield curve maintained a more normal curvature.



**Outlook**

In the near term, all eyes are on inflation and economic growth indicators. Those factors and the Fed’s interest rate policy will likely dictate short-term market performance. Other, and in some cases corollary, macro-economic issues at the present time include the waning strength of the consumer, an overextended housing market, and the direction of commodity prices. Once there is clarity around these issues, fundamental factors like earnings growth may take center stage again. A softening of what has been very healthy profit growth is a concern that could further dampen market returns for the year. Lastly, geopolitical risks have the potential to influence market performance through commodity prices, as has frequently been the case since 2001. Given these risks, higher volatility should persist, and more conservative areas of the market are well positioned to build on the second quarter’s outperformance.