

Quarterly Market Review

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Summary

The U.S. equities market bottomed during 2002 after peaking at the end of the first quarter in 2000. As the third quarter of 2006 closed, the Dow Jones Industrial Average was once again closing in on its record high. The S&P 500 Index and the Nasdaq Index are still well below those levels however. A big part of the late summer rally was due to the Fed decision to at least pause, if not end, the current interest rate hike cycle. After holding rates steady at both the August and September meetings, the bond market rallied. Also providing some momentum to the rally was the drastic fall in crude oil prices over the second half of the quarter. After peaking at \$80 per barrel in July and nearly reaching that level again in early August, crude prices fell below \$65 per barrel by the end of the quarter.

But the macroeconomic picture is not all positive, and there are hints that the economy could turn south in the near future. The final estimate of GDP growth was revised downward to just 2.6% from 2.9%, and consumer prices for the year ended August rose 3.2%, the highest rate in more than 11 years. Housing sales are starting to fall, along with average prices, as unsold inventory has started to rise. A weakening housing market is a two-fold danger for the economy; not only will it limit further home equity borrowing for most consumers, but a substantial portion of the limited number of jobs created in the last five years is either directly (construction) or indirectly (mortgage financing, real estate agents) related to the very strong housing boom. A severe slowdown in the housing market could be a major obstacle for the economy going into 2007.

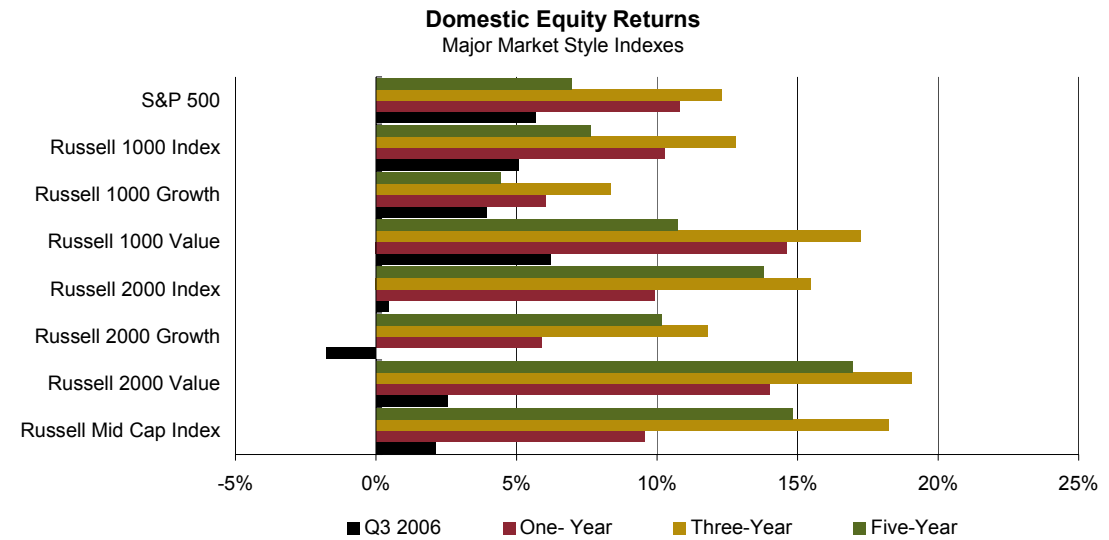
Domestic Equity Markets Overview

Despite a slow start, the domestic equity markets, as measured by the Russell indexes, showed gains in almost every category; the small cap growth index was the lone exception. Overall, the larger cap stocks outperformed the smaller caps, especially at the top end of the market cap spectrum. The Russell 2000 Index was up just 0.44% while the Russell 1000 Index was up 7.95%. But the Top 200 Index was up 8.31% and the Top 50 Index was up 9.81%. Continuing the trend from the second quarter, the value style indexes sharply outperformed the growth style indexes across all market caps. The biggest surprise of the quarter was in Real Estate. Despite negative press and a general bearish sentiment on the sector, the average REIT mutual fund added more than 8% to an already robust year.

There was a sharp reversal in leadership during the quarter. Looking at the Russell 1000 Index, the Energy sector, driven by rising crude oil prices, drove much of the return during the first half of the year, but was among the worst performing sector during the third quarter. The Technology and Healthcare sectors (both had negative returns in the first half) were the strongest performers in the third quarter and are now both in positive territory for the year. However, among the small caps, the Energy sector was relatively flat, like most of the sectors, and it was the Industrials sector that kept the Index down.

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Like the domestic markets, the international markets were up across the board during the third quarter.

International Markets Summary

The developed markets were positive during the third quarter as well, at about the same levels as the domestic indexes. One change from the first half of the year was the slightly negative effect of a strengthening dollar. The Dollar gained strength against most of the major currencies during the quarter, resulting in slightly lower returns for U.S. investors. Europe, in general, and the Eurozone, in particular, led the way during the quarter, as the region was up 6-7% in Dollar terms. Leaders in Europe included Spain, Belgium and the Netherlands. On the other side of the globe, the MSCI Far East Index ended the quarter up nearly 3% in local terms but down 0.03% in Dollar terms, making it the only negative return for the quarter. Japan was the primary driver of the poor return as Hong Kong, Singapore and New Zealand all turned in strong quarters.

The emerging markets were a reversal of the developed markets. The currency fluctuations, in general, had little effect in most countries, and Asia far outperformed Eastern Europe. The MSCI Emerging Markets Asia Index was up 7.6% in Dollar terms, while the EM Eastern Europe Index was up just 1.4%. India (+18%) and the Phillipines (+27%) led the Asian markets during the quarter but China (+8%) still leads the region through the first nine months. The Latin American Index was up nearly 5%, but Argentina and Brazil, two of the region’s largest markets, were both down for the quarter.

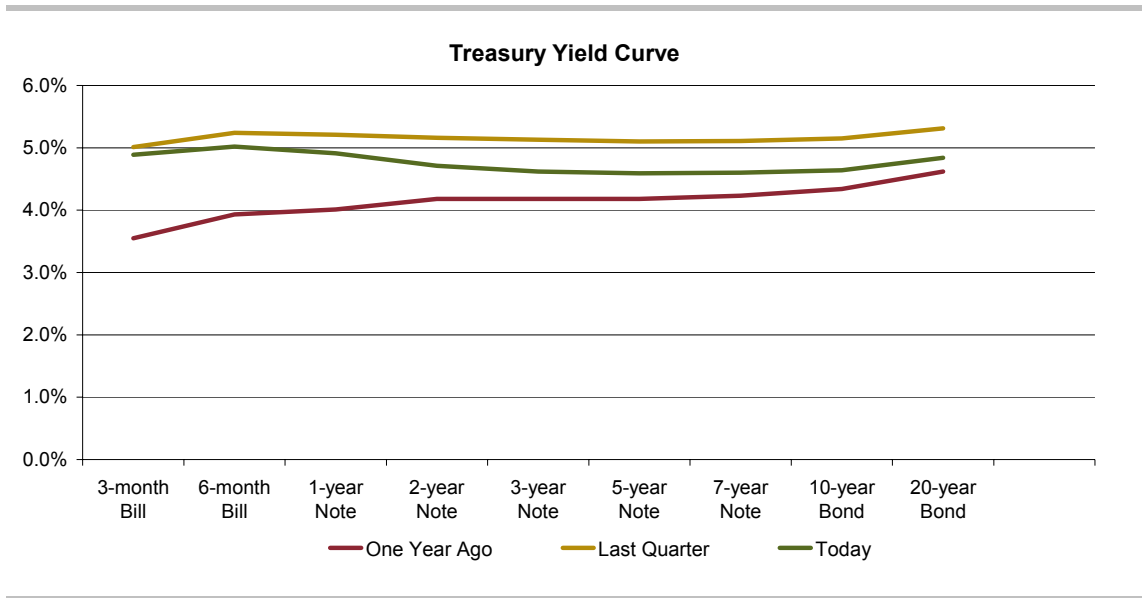
Fixed Income Summary

As mentioned, the Fed held the Fed Funds Rate steady at both the August and September meetings at 5.25%. This followed rate hikes at an unprecedented 17 consecutive meetings. As a result, the Treasury yield curve shifted downward, but the shift was far more pronounced at the long end of the curve than the short end. The shift was 45-50 basis points at two years and longer, but only 30 basis points at one year, and less than 15 basis points on the three-month bill. This is reflected in the quarter’s returns for most of the taxable indices, i.e. the longer the maturity, the higher the returns. The Lehman Brothers 20+ Year Treasury Index was up nearly 8% for the quarter and pulled that index back into positive territory for the year. Virtually all of the taxable indices are now positive for the year after having been negative across the board for the six months ending June 30. Investment grade corporate bonds generally outperformed both Treasuries and mortgage-backed securities.

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The story was similar for municipal bonds as well. Longer maturity issues outperformed the shorter in the quarter, and in a large enough magnitude that the long issues have surpassed the shorter for the year to date as well. The municipal market continues to offer significant value relative to Treasuries. As of

the end of the quarter, the weighted average coupon of the Lehman 10 Year Municipal Index was 5.06% and represented a yield of 3.82. The yield was 82% that of on the Lehman 7-10 year Treasury Index, providing additional after tax return for investors who are not in the bottom tax bracket.



Outlook

The outlook for the first half of the fourth quarter is relatively positive at this point. With energy prices retreating and interest rates stabilizing or falling, the markets should continue to rally. However, the picture for the second half of the quarter and the first quarter of 2007 will remain clouded until after the mid-term elections in November. While there would likely be little or no immediate actual change in the economy should the Republicans lose their majority in one or both houses of Congress, there would likely be the perception of change. Other issues facing the markets in the fourth quarter include: engineering a soft landing (if possible) in the housing market, stimulating or at least holding GDP growth steady without touching off additional price inflation and the long term direction of energy prices.

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