Your Quarterly Update on the Financial Markets

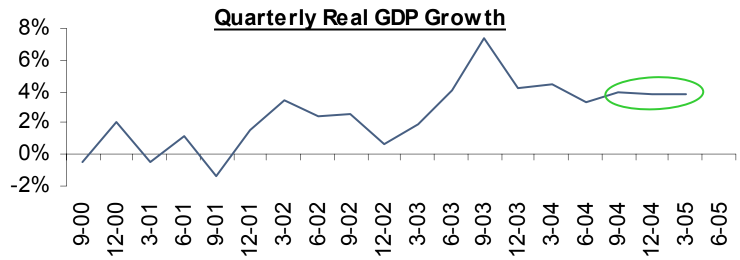
June 30, 2005

2nd Quarter

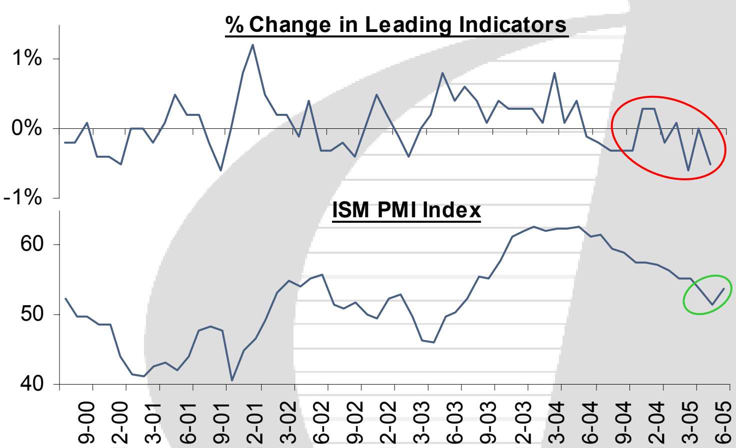
MARKET Recap

The Economy: *"A Summer of Indecision"*

Gross Domestic Product for the U.S. economy grew at a 3.8% annualized pace for the first quarter, matching fourth quarter growth; a preliminary figure of 3.5% was revised upward on June 29th based on more complete data. Exports, residential fixed investment, and private inventory accelerated and imports decelerated compared to the previous quarter, offset equally by decelerating personal consumption expenditures and investment in software & equipment.

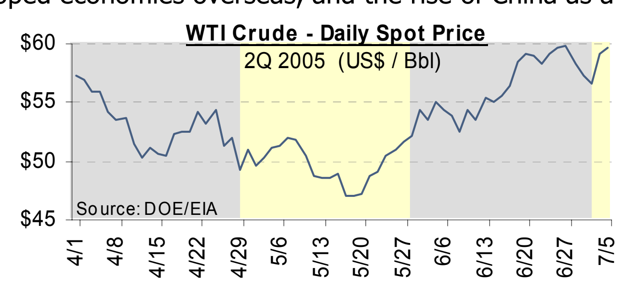


Although GDP lags economic performance, the revision came at a critical time as the Fed deliberated its next rate decision and several leading indicators turned positive. Aside from the final week, virtually every leading indicator was neutral to bearish. The index of leading economic indicators was down 0.6% in May following a flat April and sharply disappointing March. This somewhat volatile index summarizes 10 predictive variables widely believed to indicate growth prospects. Armed with this data and a pessimistic sentiment, many influencers in the investment community began calling on the Federal Reserve to suspend its program of short-term rate hikes. Some even suggested that rates would need to fall by year-end to ward off recession.



Clearly the Fed was not convinced. On June 30 they raised rates by another 0.25% stating "Although energy prices have risen further, the expansion remains firm and labor market conditions continue to improve gradually." Perhaps they focused on the June increase in the Purchasing Managers Index, indicating strength in the manufacturing sector. Perhaps an equally surprising increase in consumer confidence caught their attention, with the Conference Board statistic up for 3 months running despite slowing retail sales. Or perhaps they remain concerned about inflationary pressure; crude oil climbed to $60 per barrel in June after a respite in April and May.

We will of course never know exactly what combination of factors led to the decision to continue hiking rates; nor can we accurately predict when the Fed will be finished. Rather, note that each of the indicators we monitor so closely carry a degree of volatility and outright error. It is important therefore to view any proposed "turning point" skeptically until a trend is confirmed. Through several quarters we have expected slowing growth and gradually increasing inflation, with uncertainty as to whether rising prices will first impact consumers or business sectors. Growth will be limited by the end of effective monetary and fiscal stimulus, structural problems in developed economies overseas, and the rise of China as a manufacturer. Upward price pressure arises from the supply side, as cost trends for land, labor, and capital remain neutral to higher; developing economies are increasingly more competitive in satiating ever-growing demand for goods and services, yet we all compete in a global market for the resources. While viewing the data differently, policy-makers also appear skeptical of sudden changes in the direction of economic data. Barring shock events, expect the Fed to stay the course longer than investors will be comfortable with.



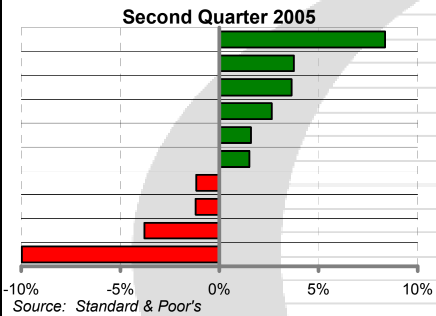
The U.S. Stock Market

Although equity markets were mixed over the course of the second quarter, all major indices closed up. The record-setting crude prices and rising interest rates that combined to challenge the stock market in past quarters continued. But after several quarters of similar conditions, the markets seemed to take these events somewhat in stride. Year to date however, the three major indices were all down, with the Dow losing 4.7%, the S&P 500 losing 1.7%, and the NASDAQ losing 5.5%.

Stock Indices - Total Return Second Quarter 2005			
Largecap Stocks		**Midcap Stocks**	
S&P 500	1.37%	S&P Midcap 400	4.26%
Russell 1000	2.05%	Russell Midcap	4.18%
Growth	2.46%	Growth	3.43%
Value	1.67%	Value	4.70%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	3.07%	S&P Smallcap 600	3.94%
Wilshire 5000	2.47%	Russell 2000	4.32%
		Growth	3.48%
		Value	5.08%

The real estate "bubble" seems unbreakable, although bubbles always do until they break. The Commerce Department reported in mid-June that new home sales rose to the second-highest level recorded, the National Association of Realtors predicted that 2005 would top 2004 records for sales of new and existing homes, and real estate investment trusts (REITs) have out-performed the broad stock market for five years in a row. While conventional wisdom holds that equity portfolios offer little stake in real estate (the seven REITs in the S&P 500 make up less than 1% of its market capitalization), indirect exposure through industries and sectors which play a role in real estate can approach 20% in some diversified stock funds. In extreme cases, assets tied to real estate outweigh exposure to technology or energy stocks. Examples of industries that offer indirect exposure include homebuilders, engineering firms, building products, home-improvement, and financial lenders. According to widely reported Lipper data, more than 4% of the holdings of the average large-cap core stock fund are indirectly tied to real estate. As you move down the capitalization ladder, this amount triples or quadruples. Lipper found mid-cap value funds generally hold more than 13% in industries indirectly tied to real estate, while for small-cap value funds the figure climbed to nearly 17%. With shares of homebuilding companies, for example, up more than 50% in the last five years on an annualized basis, it is no wonder these value sectors are strong performers.

S&P 500 Economic Group Components - Total Return



Sector	2Q05
Utilities	8.35%
Healthcare	3.75%
Financial	3.65%
Telecom Services	2.64%
Information Tech.	1.60%
Energy	1.52%
Consumer Staples	-1.17%
Consumer Discretionary	-1.20%
Industrials	-3.79%
Materials	-9.97%

Source: *Standard & Poor's*

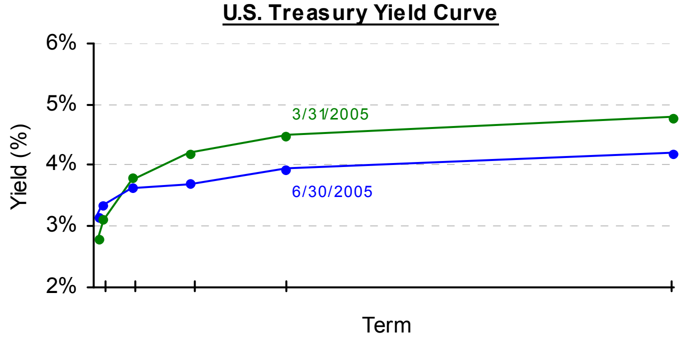
Oil futures hit a 52-week high of $60.52 per barrel, causing energy stocks to fall to the bottom of the gainers when the price level seemed to trigger a number of mechanical sell programs. With the top spot vacated by energy stocks, utility stocks moved up from last quarter's number two spot. Financial stocks were helped directly and indirectly by real estate as noted, while the consumer discretionary sector continued to suffer from rising interest rates. Positive performance by the telecom and technology sectors was the chief driver for the NASDAQ.

With earnings the most important determinant in the price of stocks, the second quarter announcements just around the corner should prove interesting. Analysts have been increasing profit expectations in recent weeks, with some forecasting a growth rate in excess of 10.5%. While this is below the over-20% growth rates seen in 2004, it exceeds the 6% projection for earnings growth for companies in the S&P 500 reported in our last newsletter. And as we all know, on Wall Street, it's all about beating expectations.

The U.S. Bond Market

The yield curve continued to flatten in the second quarter of 2005. But in a change from the first quarter, bond prices generally rose across the curve driving yields lower. The yield on the 30-year Treasury ended the quarter down 56 basis points at 4.19%. The 10-year Treasury, a benchmark for both corporate and consumer borrowing, ended the quarter at a yield of 3.92% (down 56 basis points from the 1Q 2004 close and 66 basis points from the June 30, 2004 close). Only the very short end of the curve saw rising yields.

U.S. Treasury Yield Curve



Source: Bloomberg LP

The flattening of the yield curve is dramatically apparent in the difference between the two- and ten-year treasury yields. As of June 30, 2005 the two-year yield was just 29 basis points below the 10-year yield. One year ago this difference was 237 basis points. (See this quarter's Focus article for implications of a flattening yield curve.) Despite this, there were no surprises from the Federal Reserve, as it raised short-term rates for an eighth and ninth consecutive time. The last increase of 0.25% came on June 30 and pushed the Federal Funds Rate on overnight loans between banks to 3.25%, its highest level since shortly before the September 2001 terrorist attacks.

In the press release accompanying the action, the Fed repeated prior themes stating that "monetary policy remains accommodative" and that "with underlying inflation expected to be contained... policy accommodation can be removed at a pace that is likely to be measured." Anyone looking for an indication that the Fed was nearing the end of their money-tightening campaign was disappointed as the Fed reinforced the case for more rate increases. Although Mr. Greenspan has been reluctant to specify a neutral Fed funds rate (one that spurs growth but also curbs inflation), it is generally considered to be in the range of 3.5% - 4.5%, making a few more Fed increases in the future seem very likely.

Bond Indices - Total Return

	2Q05
Lehman Aggregate	3.01%
Lehman Interm. Gov't	2.31%
Lehman Long Gov't	7.75%
Lehman Interm. Credit	2.76%
Lehman Long Credit	6.35%
Lehman High Yield	2.76%

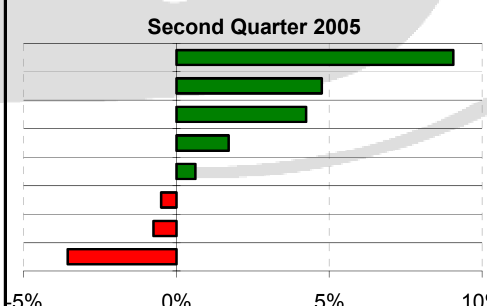
Taking advantage of historically low interest rates, U.S. corporate bond issuance hit $323 billion in the first half of 2005, an 8% increase from the same period in 2004 according to Bloomberg. Strong corporate earnings and improving balance sheets and business fundamentals have contributed to expectations of better performance and greater demand. U.S. corporate spreads continued to widen, albeit slightly, with the spread on investment-grade bonds closing off its peak of 1.11% (hit on May 17) and ending the quarter at 0.96% above treasuries. For junk bonds, the quarter closed with a spread to treasuries of 3.96%, off a quarter-high of 4.58%, also achieved on May 17.

Overseas Markets

Developed global markets were generally flat during the second quarter with slow growth, oil price volatility, and the specter of inflation continuing to hold back performance. Emerging markets again fared better than their developed counterparts, as Latin American markets continue to show strength.

Performance in Europe was mixed with about half of the EU countries performing in the red. The European Commission said the economy of the euro region risks slowing more abruptly than forecast as the currency's gains erode exports and record oil prices undermine investment and consumer spending. An 8.9% unemployment rate in the sector and fragile business confidence combined with high oil prices may drive growth in 2005 below the 1.6% rate predicted earlier this year. The ECB is now considering a rate cut and keeping a close eye on growth rates in the sector. In Germany, first quarter economic growth was the strongest in four years, but growth is expected to slow over the remainder of 2005. The IFO Index of business sentiment fell to 93.3 in April, its third consecutive month of losses. The MSCI German Index was down 1.4% for the second quarter. In France, Finance Minister Brenton reduced the forecast for economic growth to less than 2% from the original forecast of 2.0%-2.5% as consumer spending in France continues to decline. The MSCI France Index was down 0.83% for the quarter.

Gross Total Return of Selected MSCI Regional Indices



Region	2Q05
Latin America	9.06%
Pacific ex Japan	4.75%
Emerging Markets	4.24%
North America	1.71%
World Index	0.61%
Europe	-0.50%
EAFE	-0.75%
Japan	-3.56%

Japanese corporate leaders were more optimistic about their prospects in June than they were the previous quarter despite signs of a slowdown in exports. The Tankan, a benchmark index of manufacturers including about 1,200 of Japan's biggest companies, rose to 18 in June, from 14 in March. The index is calculated by subtracting the percentage of companies that say conditions are unfavorable from those that say they are favorable; a positive score means that optimists outnumber pessimists. Confidence in the economy improved in most categories of businesses, with leaders of large companies more optimistic than most. This unexpectedly upbeat result suggests that the economy continues to recover from a shallow recession as domestic demand grows. Japan's unemployment rate remained at a six-year low of 4.4% in May, unchanged from April. Although news was upbeat, higher oil prices and slowing exports to China held stock performance back. The MSCI Japan Index was down 3.5% for the quarter.

China continues to chug along like a juggernaut. Industrial production in China increased 16.6% in May from a year ago, exceeding the growth forecast of 15.8%, as overseas orders for products like steel, shoes and laptop computers helped drive expansion. Exports of ferrous metals jumped 74%. Exports of shoes, clothing and laptops rose more than 30%. During the second quarter Fed Chairman Greenspan called for China to allow its currency to float versus the dollar on the belief that severing the link would solve some of China's resource allocation issues and excess liquidity problems. The clamor from Congress has been much stronger. The Bush administration has called for an end to the currency peg in response to pressure from US manufacturers and unions over the alleged unfair competitive advantage Chinese products maintain in the world market with the currency fixed at 8.27 yuan to the dollar. The MSCI China Index was up 5.6% for the quarter.

Latin American markets continued to lead global performance as prices for natural resources surged. In Brazil, industrial production rebounded in March, climbing 1.5% from the previous month after two straight months of declines. The result was better than most forecasts, but economists warned that the economy, South America's largest, was losing steam. During the quarter, Brazil's central bank said it intended to hold its benchmark interest rate at 19.7% for a ''sufficiently long period'' to bring down inflation, even if that meant slowing the economy further. Inflation is at about 8%, above the government's year-end target of 5.1%. The MSCI Brazil Index was up 7.3% for the quarter. In Mexico the economy grew at 3.8% for the quarter. Mexican industry has been hurt by slower economic growth in the United States, damping demand for Mexican manufactured exports. However, strong housing demand by US citizens, especially in the area of Baja California, has led to strong housing growth and job creation. The MSCI Mexico Index was up 12.7% for the quarter.

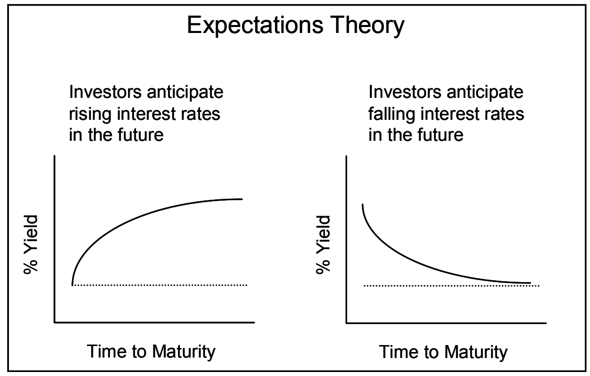
Focus On: *Yield Curve-ology*

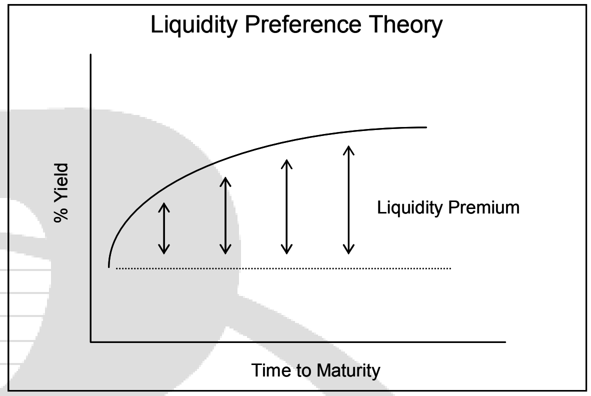
Much focus has been placed on interest rates over the last few years as the Federal Reserve has attempted to shepherd the economy from recession to expansion. Over the last year the Federal Reserve has raised interest rates nine times in an attempt to control inflation as the economy has expanded. Recently, we've seen a downward slide of long-term Treasury yields even as the Fed has raised short-term rates. Alan Greenspan referred to this phenomenon as a "conundrum" when he testified before Congress earlier this year. What is puzzling is the fact that the central bank has been "tightening" credit for a year through increases in the short-term Federal Funds Rate yet long-term rates continue to remain low by historic standards. Yields on 10-year Treasury notes have fallen by more than half a point since last June when the Fed began its tightening stance. We thought it was time to delve into what's happening and to see what impacts changes in the yield curve.

Let's start by defining the term structure of interest rates, also known as the yield curve. The yield curve is a very common method of illustrating the relationship between yield-to-maturity and time, constructed by graphing the yields and the respective maturity dates of benchmark fixed-income securities (see page 2 for the current yield curve). It is a measure of the market's expectations of future interest rates given the current market conditions. Treasuries are normally used as the benchmark securities since they are issued by the federal government and are considered free of credit risk. The term structure of interest rates is graphed as though each fixed-income security "matures" on the graphed maturity date. The exact shape of the curve can be different at any point in time. So if the normal yield curve changes shape, it tells investors that they may need to change their outlook on the economy. There are three basic yield curve shapes: upward sloping, with long-term rates greater than short-term rates; flat, with short-term rates very close to long-term rates; and, inverted or downward-sloping, with short-term rates higher than long-term rates. Different factors contribute to the each of these curve shapes.

A change in short-term rates often causes a parallel shift of the yield curve where rates at all maturities increase or decrease in response. The Federal Reserve has a direct influence on the level of rates by moving the Federal Funds Rate, the rate at which banks borrow from each other, either up or down in response to macroeconomic factors such as inflation or contraction in the economy. Inflation expectations are a key driver of rate levels on both ends of the curve. The Fed affects inflation expectations through its policy actions. If the fixed-income market believes that inflation risks are big enough to prompt the Fed to raise interest rates, short-term interest rates will rise faster than long-term interest rates and flatten the yield curve assuming that the market has confidence that the Fed can deal with inflation before it becomes a problem. Conversely, when inflation expectations are low, short-term rates will fall more quickly than long-term rates. In either case, investors take cues from Fed action and adjust their expectations and portfolios accordingly.

Recently, as the Fed has pursued its current round of tightening, the interest rate market has experienced an unexpected decline in long-term interest rates. There has been much debate over why this is occurring. Is it an aberration, as Mr. Greenspan believed earlier this year, or is it a fundamental change in the way that investors view the fixed-income markets? Two theories are currently being used to explain the current yield curve. The first is that the lower yields are a precursor to slowing economic growth which would, in turn, lead to a reduced demand for credit in the future, driving long-term yields down. A second view is that global investors have lower inflation expectations than in the past which has lowered the risk of holding long-term bonds. In either case, Alan Greenspan's "conundrum" continues to provide investors with long-term investment opportunities, especially in the mortgage market where there is a fear that a "bubble" has been created as investors have taken advantage of the low rates. This bubble has the potential to drive a major economic downturn if long-term rates revert and begin rising in response to movements on the short-end of the curve. However, if either of the aforementioned theories is correct, there would seem to be little impetus for the Fed to continue its course of tightening.

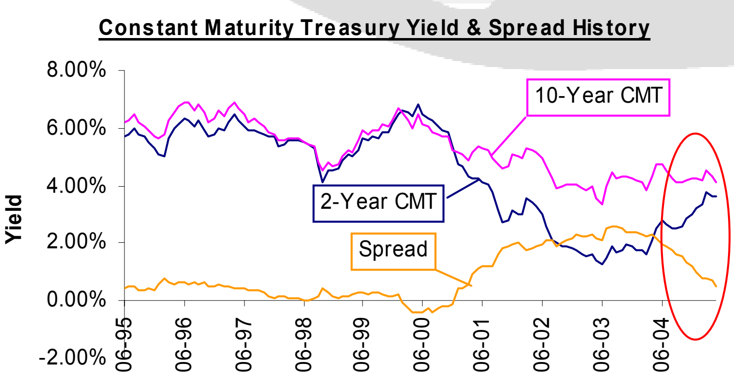




There are also some basic theories that attempt to explain changing yield curves. The *expectations theory* says that long-term rates today will become short-term rates in the future. An upward sloping curve signals that investors expect rates to rise and are bidding down the prices of long-term bonds. Since yield and price move inversely to one another, bidding down the price of long-term bonds leads to a corresponding increasing their yields. Downward sloping curves mean investors expect interest rates will decrease in the future, and are bidding up the prices of long-term bonds, decreasing their yields. The *liquidity preference theory* assumes that an investor would rather invest in short-term investments. Investors expect a liquidity premium (higher returns) for tying money up for longer periods of time because of the loss of all alternative uses of their money (opportunity cost).

The markets utilize these theories as leading economic indicators. Changes in the slope of the curve serve as "cues" to investors as to the future direction of the economy. The slope of the curve for liquidity preference is largely driven by investors' demand to lock up capital; it is a direct function of the trade-off for alternative uses of the funds. When investors believe that the future holds better opportunities for investment this will tend to create an upward sloping yield curve. If investors are pessimistic regarding future investment opportunities the yield curve tends to flatten. In the case of extremely negative opinions for the future the yield curve inverts, signaling that investors are willing to pay a premium not to invest, driving long-term rates lower. Under the liquidity preference theory, the current long-term treasury yield curve might lead us to the conclusion that as spreads have narrowed and long rates have stayed low there is not sufficient compensation to remain in long-term issues. In other words, investors are expecting long-term rates to continue trending down, possibly signaling an economic slowdown. Note that this reading is different than the Fed's as evidenced by their continued policy of credit tightening.

The Fed has far less control over longer-term rates. Investor expectations and investment changes in response to macroeconomic changes give rise to upward or downward sloping yield curves. The artificial lowering of short-term interest rates by the Fed generates opportunities for investors to borrow money and invest in higher yielding longer-term investments. However, to sustain a positively or upward sloped yield curve the Fed must continue to force rates lower. Once a cycle of tightening begins there is a potential for an economic downturn, or recession, as investors realize the impact of rising rates on their investments. In the late stages of an economic expansion, as investors anticipate a tighter monetary stance, a shift from long-term securities to short-term securities occurs. This shift should lift long-term rates and lower short- term rates; although, as we see with current rates this isn't always the case.



While the Fed has a significant amount of control over the level of rates and the shape of the yield curve on the short end, as investors are forming expectations regarding future course of monetary policy they have more control over the shape of the yield curve on the long end. Short-term shifts in the shape of the yield curve are controlled by monetary policies rather than by investors' expectations, but expectations can either reinforce or, potentially, change the overall shape of the yield curve.

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