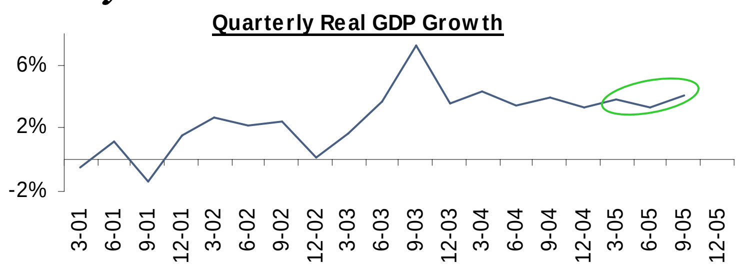
Your Quarterly Update on the Financial Markets
December 31, 2005

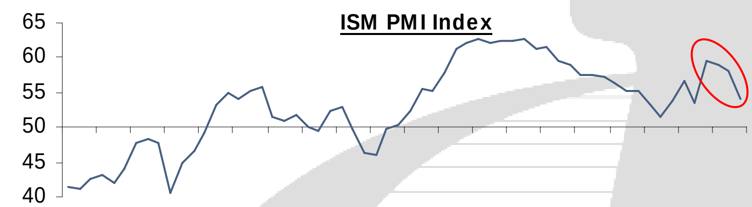
4th Quarter

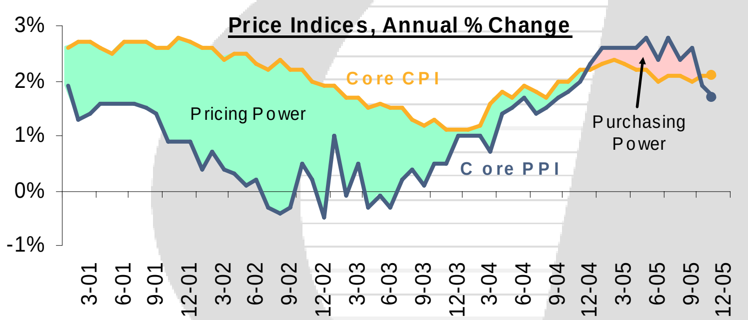
MARKET Recap

The Economy: *"New Fed Boss at the Cycle's Turn"*

U.S. economic growth continued to exceed expectations, posting a 4.1% pace for the third quarter driven by increasing personal consumption expenditures, equipment and software, federal spending, and residential fixed investment. Primary effects of hurricanes Katrina and Rita are now known, and are not as substantial as feared outside of the regions immediately affected. The potential secondary effect of curtailed natural gas supplies has not contributed significantly to inflation to date, as average temperatures for December were milder than expected. Consumer sentiment, momentarily driven sharply lower by the hurricanes and related political fallout, rebounded to mid-summer levels; the Conference Board statistic rose to 103.6 in December, from a low of 85.2 in October.



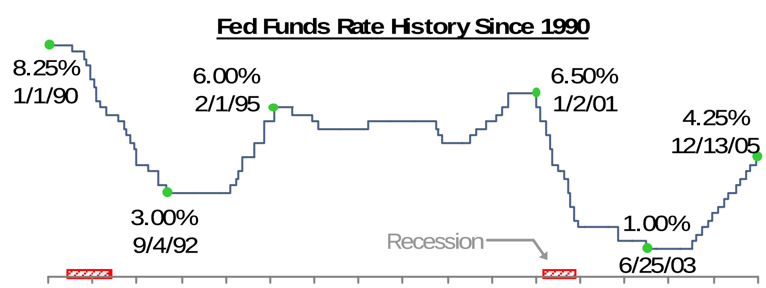




All eyes are now on the Fed, as Ben Bernanke assumes the role of Chairman on January 31. The timing is ironic, as Fed watchers have been intensely speculating as to when the cycle of tightening will end. Clearly the hurricanes deferred any possible insight on the matter, as they represented a potentially serious supply shock and short-term driver of inflation. With that largely behind us, signs of an impending slowing continue to persist; among them falling manufacturing activity (indicated by the Institute of Supply Management's statistic) and a flat yield curve which briefly inverted in December.

Consider also the pattern of consumer and producer inflation rates shown in the accompanying graph; while core consumer price inflation has remained fairly steady in the 2.0 – 2.2% range, core producer price inflation has accelerated over the past two years. During the 2001-2002 recession and recovery, business profitability was supported by pricing power; since 2003, the relationship has narrowed and reversed, creating purchasing power for consumers. Ultimately this will increase pressure on corporate profits, and contribute to slowness. Corporate profits for the third quarter of 2005 decreased $54.4 billion, compared with an increase of $41.7 billion in the second quarter.

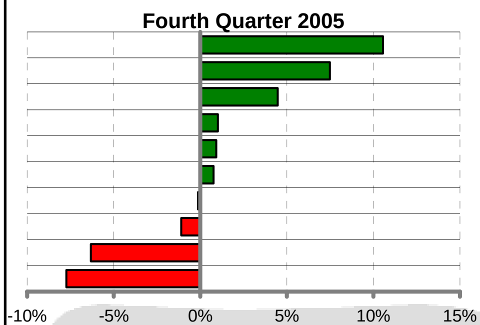
Chairman-elect Bernanke is well known for his support of "inflation targeting" as a policy framework (see this quarter's focus article for a more complete discussion). With the CPI hovering right at levels typically chosen by other countries that employ inflation targeting strategies and signs of slowness ahead, the consensus on Wall Street is that the end of Fed tightening is in sight. In fact this sentiment was confirmed with the release of minutes from the December 13th Federal Open Market Committee meeting, which noted: "Although future action would depend on the incoming data, this characterization of the outlook for policy was seen by most members as indicating that, given the information now in hand, the number of additional firming steps required probably would not be large." Consensus expectations currently call for one or two additional rate increases.



The U.S. Stock Market

Despite a general fizzle in the final weeks of December, equity markets finished up for both the quarter and the year. This was no small feat when natural disasters, high energy prices, and rising short term interest rates (to a four-year high) are taken into consideration. The fears of an economic slowdown spurred by a flattening yield curve challenged the stock market as in recent quarters, but by the end of the quarter, consumer confidence had risen to a four-month high. The Dow ended the quarter at 10,717.50 down 0.6% for the year and the NASDAQ closed out the year at 2,205.32, up 2.5% from September 30, 2005 and 1.4% for the year.

S&P 500 Economic Group Components - Total Return



Sector	4Q05	2005
Materials	10.56%	2.16%
Financials	7.49%	3.72%
Industrials	4.47%	0.36%
Health Care	1.02%	4.85%
Information Technology	0.92%	0.38%
Consumer Discretionary	0.77%	7.35%
Consumer Staples	-0.13%	1.34%
Telecom Services	-1.10%	-9.05%
Utilities	-6.32%	12.76%
Energy	-7.73%	29.14%

Source: Standard & Poor's

Mid-cap stocks were the place to be for the quarter and the year, turning in results that bested both the large-cap and small-cap sectors. This is no surprise given the level of mid-cap fund investment in two out-performing sectors: real estate (through real estate investment trusts or REITs) and energy. These sectors represented about 6% and 8%, respectively in the Russell Midcap Index, a common proxy for mid-cap stocks. According to Lipper, during the first three quarters of 2005, inflows to mid-cap mutual funds exceeded $21 billion. By comparison, less than $3 billion was invested in small-cap funds. While the small-cap sector found great favor in 2003 and 2004 as stocks emerged from a bear market, the shift by investors to mid-cap stocks signals a new stage in economic recovery. (A further shift in leadership to the large-cap sector would be a sign of decelerating profit cycles.) And while mid-cap stocks are generally more liquid than small caps, the significant asset flow has already started to take its toll through fund closures. (For more on issues associated with fund capacity, see "Focus On: Fund Capacity – When the Party's Over" from our March 31, 2005 edition of *Market Recap*.)

While growth stocks had the better fourth quarter, value stocks led for the year, particularly in the large cap sector. And although they were the worst performing sectors for the fourth quarter, energy and utility stocks had solid, double-digit years, with the energy sector turning in the best full-year performance at a very competitive 29.14% (no shock to anyone who bought gasoline in 2005). Telecom and technology were two of the worst-performing sectors for the year, driving a mediocre performance by the NASDAQ for 2005.

Stock Indices - Total Return

	4Q05	2005		4Q05	2005
Largecap Stocks			**Midcap Stocks**		
S&P 500	2.09%	4.91%	S&P Midcap 400	3.34%	12.56%
Russell 1000	2.12%	6.27%	Russell Midcap	2.35%	12.65%
Growth	2.98%	5.26%	Growth	3.44%	12.10%
Value	1.27%	7.05%	Value	1.34%	12.65%
Broad Markets			**Smallcap Stocks**		
NASDAQ Comp.	2.73%	2.13%	S&P Smallcap 600	0.39%	7.68%
Wilshire 5000	2.32%	6.32%	Russell 2000	1.13%	4.55%
			Growth	1.61%	4.15%
			Value	0.66%	4.71%

As fourth quarter reports start coming in, corporate earnings are expected to outpace the rise of the market. According to Thomson Financial, the forecast for year-over-year earnings growth for the quarter is 13.3%. Price-to-earnings ratios have fallen, although the ratio for the S&P 500 is still higher than its historic norm, according to Merrill Lynch. The S&P 500 price-to-earnings ratio is 16.4, compared to a norm of 14, suggesting that investors are still expecting some above-average earnings growth.

The U.S. Bond Market

The fourth quarter ended with all eyes on the yield curve, which inverted in the last week of 2005. Although bond prices continued their slide in the fourth quarter and drove yields (which move inversely to prices) higher across the curve, two-year yields exceeded 10-year yields for the first time since 2000. And while not always predictive, an inverted yield curve has preceded the past four recessions.

The yield curve was the focus of an unusual amount of interest in 2005 as the Federal Reserve raised short-term rates in consistent, measured steps but long-term rates refused to budge for most of the year. This resulted in a flattening curve and speculation of an impending economic slowdown as increased costs of borrowing potentially inhibited future growth. The yield on the 3-month bill ended the quarter at 4.08%, up 56 basis points form the 3Q 2005 close and 186 basis points from the close of 2004. In contrast, the 10-year Treasury ended the quar-

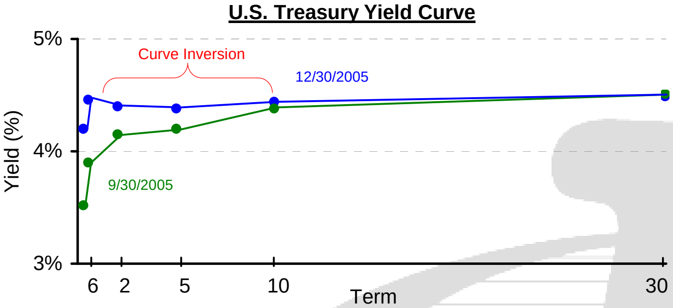
Bond Indices - Total Return

	4Q05	2005
Lehman Aggregate	0.59%	2.43%
Lehman Interm. Gov't	0.59%	1.68%
Lehman Long Gov't	1.01%	6.61%
Lehman Interm. Credit	0.39%	1.42%
Lehman Long Credit	0.84%	3.76%
Lehman High Yield	0.68%	2.74%

ter at a yield of 4.39%, up only 1 basis point from the September close and 17 basis points from the end of 2004. Finally, the yield on the 30-year Treasury ended the fourth quarter at 4.49%, down 2 basis points from the third quarter close and 33 basis points from the close of 2004.

During the fourth quarter of 2005, the Fed raised short-term rates for a twelfth and thirteenth consecutive time. The last increase of 0.25% came on December 13 and pushed the Federal Funds Rate on overnight loans between banks to 4.25%. For consumers, the increases are most visible through higher rates on consumer debt (e.g., car loans, credit cards balances) and adjustable-rate mortgages. While the actions themselves were not a surprise, for the first time, the Fed did not characterize its monetary policy as "accommodative." However, it did indicate that "some further measured policy firming is likely to be needed" to maintain a balance between sustainable economic growth and price stability. In the release accompanying the action, the Fed noted that "[d]espite elevated energy prices and hurricane-related disruptions, the expansion in economic activity appears solid." And while "possible increases in resource utilization" (i.e., declining unemployment) and "elevated energy prices have the potential to add to inflation pressures," the Fed noted that "[c]ore inflation has stayed relatively low in recent months and longer-term inflation expectations remain contained."

U.S. Treasury Yield Curve



Source: Bloomberg LP

All major bond indices turned in a positive performance for the fourth quarter of 2005, and largely based on the strong second quarter, even better performance for the full-year. At the outset of the 2005, the Bond Market Association predicted that total U.S. bond issuance would fall by 15% with corporate bond issuance declining by 3.4%. Having already taken advantage of the low interest-rate environment, the association noted that rising interest rates and improving corporate balance sheets would be incentive for companies to find other means of raising funds. In fact, total U.S. bond issuance through the third quarter of 2005 was only off slightly from 2004 rates, totaling $4.18 trillion (down 0.7% from third quarter 2004 totals). An increase in asset-backed and mortgage-related issuance is largely responsible for this small decrease, as these markets were buoyed by continued growth in the housing market and home equity sector. New corporate bond issuance through 3Q 2005 saw a 5.3% decrease from one year ago, as companies tapped stronger balance sheets for funding instead of seeking external financing as predicted.

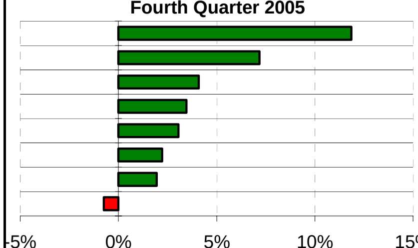
Overseas Markets

Emerging and developed global market performance moderated over the quarter, but the positive performance seen all year in most sectors continued. Latin American emerging markets were the clear winners for the year as strong performance in Argentina and Brazil attests. In Europe inflation, continued high oil prices, weak consumer confidence and socio-political unrest did not interrupt the solid performance experienced during the year. Most developed and emerging foreign markets significantly outpaced the US domestic market in 2005.

In Europe, good performance was seen across the board. The ECB raised short-term interest rates by 25 basis points in early December, with the expectation that growth will remain modest as evidenced by the 0.6% quarterly rise in Euro-zone GDP. Germany's IFO index of business climate fell from 98.8 in October to 97.8 in November. The retail climate index also dropped sharply as concerns over a hike in the value added tax (VAT) took its toll. However, as the quarter came to a close industrial confidence did improve as the VAT increase was tabled until 2007. The MSCI Germany Index was up 4.4% for the quarter and 9.9% for the year. In France, fourth quarter growth got off to a slow start, and was further diminished as rioting by immigrants in Paris dealt a blow to the country's collective psyche, just as employment trends were beginning to strengthen. Near double-digit unemployment continues to be a drag on consumers. Market consensus was that the country would be lucky to achieve flat growth for the quarter. Amid all of the turmoil the MSCI France Index managed to eke out a 0.6% return for the quarter and a 9.8% return for the year.

Net Total Return of Selected MSCI Regional Indices

Fourth Quarter 2005



Region	4Q05	2005
Japan	11.85%	25.51%
Emerging Markets	7.18%	33.99%
EAFE	4.08%	13.54%
Latin America	3.46%	50.00%
World Index	3.06%	9.49%
North America	2.23%	6.36%
Europe	1.94%	9.42%
Pacific ex Japan	-0.75%	13.82%

The year saw resurgence in the Japanese markets. As 2005 came to a close, Japan had achieved a milestone as its core CPI edged toward 0.0% meeting one of the conditions required by the Bank of Japan to lift its quantitative easing policy. In December, the Tankan business confidence survey reached a 12-month high of 21, up from 19 the previous quarter. Consensus estimates are that the deflationary period is about to end and the Bank of Japan will rotate to an expansionary stance some time in the first or second quarter of 2006. The MSCI Japan Index was up nearly 12% for the quarter and over 25% for the year.

Strong growth in China continued throughout 2005, although many cautionary signs appeared as China's domestic market remains flooded with liquidity. Interest rates were driven down to low levels accordingly, forcing the central bank to focus on downside risks and draining liquidity from the system. Low rates have had the effect of drying up speculative foreign inflows as China has kept its revalued floating exchange rate "stable" – the yuan has climbed just 0.5% against the dollar since being revalued in July. However, growth in China remains strong with FY 2005 GDP expected to come in close to 9.8% for the year. In fact, things are so good in China that tax revenues increased by 20% as strong growth has led to increased corporate profits. The MSCI China Index was flat for the quarter and up almost 20% for the year.

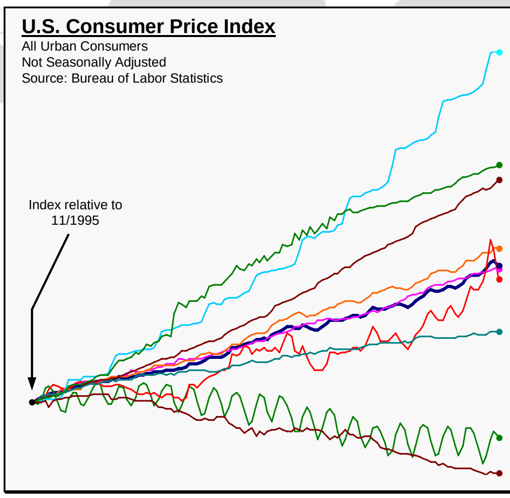
Latin American emerging markets were where all of the action was in 2005. Both Argentina and Brazil demonstrated strong growth. In Brazil the central bank lowered its key interest rate by 50 basis points to 18%. Foreign capital continues to flood into the country. As U.S. tightening policy draws to a close, expectations are that dollar flows to Brazil will pick up significantly into 2006. Brazil had net inflows of $18.8 billion in 2005, the most since 1992 and nearly triple that of 2004. The MSCI Brazil Index was up 1.4% for the quarter and 56.4% for the year. In Argentina consumer prices rose 1.1 percent in December crimping performance for the quarter and bringing 2005 inflation to 12.3%, the highest annual rate since 2002 when the currency was devalued. The big news in Argentina was a mid-December announcement that the country would pay off its $9.5 billion IMF debt with reserves that have grown to over $27 billion on continued strong growth. The MSCI Argentina Index was down 13.0% for the quarter, but up over 62% for the year.

Focus On: *Inflation Targeting*

Management of inflation has been an important function of the Federal Reserve since its establishment as the central bank of the U.S. economy. Few functions of government carry greater long-term responsibility. Unchecked inflation is harmful to a broad swath of the population by eroding the purchasing power of savings. The elderly and others on fixed incomes are particularly exposed to rising prices, but more generally, successful middle-class people have been forced to take on greater investment risk as traditional savings vehicles fail to maintain their purchasing power. Alternatively, falling price levels pose a different set of risks to the economy. While deflation is rare on a system-wide basis in the modern era, we need only consider the past two decades of malaise in Japan to understand the stakes. Deflationary cycles tend to spiral, with falling profits leading to unemployment and reduced spending, leading to further profit compression.

Since the final departure from the gold standard in 1971, monetary policy has been our primary tool to regulate inflation. Indeed, it has been argued that inflation is the only economic outcome that can be influenced by monetary policy in the long run, although there is general consensus that growth, employment, securities prices, and other outcomes are affected by Fed actions in the short term. Since our political system encourages a short-term view, the central bank has come under tremendous pressure at various points in the cycle to prioritize growth and employment over price stability.

So what is the objective of the Federal Reserve? The organization has traditionally been cagey about specifying particular objectives, stating rather the goals of promoting "sustainable growth and price stability" with some degree of balance. Through the Federal Open Market Committee, the bank's rate-setting arm, the Fed communicates a sense of direction based on current data; but they are careful not to reveal a specific target for inflation, growth, or any other variable. It's not due to lack of forecasting –Fed governors consider data from a robust set of models, at and between each meeting – but forecasts are generally not released to the public until five years after the meeting.



Sector	10-Year	Annualized	Weight
Education	+73.6%	+4.7%	2.93
Other (incl. tobacco)	+49.8%	+3.4%	3.75
Medical Care	+46.6%	+3.2%	6.13
Housing	+32.6%	+2.4%	41.99
ALL ITEMS	+28.7%	+2.1%	100.00
Food & Beverages	+28.3%	+2.1%	15.29
Transportation	+26.2%	+2.0%	17.41
Recreation	+14.9%	+1.2%	5.73
Apparel	-7.0%	-0.6%	3.84
Comm. & Technology	-14.7%	-1.3%	2.91

The Fed's mysterious ways are good politics; after all, who wouldn't want a job without measurable performance goals? There is, however, a school of thought implemented by many other countries that the central bank should focus on managing inflation to a *specific* target range. Ben Bernanke, the incumbent chairman of the Federal Reserve, is of that school; over time, it is likely that inflation management will become the Fed's primary decision-making framework.

Measuring Inflation (Or, Sizing Up the Target)

The Consumer Price Index is the workhorse of inflation measurement statistics, widely used by private industry and governments to develop cost-of-living adjustments and inflation-indexed investment securities. This statistic measures the price level of a basket of goods and services representative of spending patterns for broad population groups. The version most cited is the CPI-U, which covers all urban consumers or about 87% of the U.S. population. The Bureau of Labor Statistics attempts to maintain the quality of the index by adjusting its composition to reflect current spending patterns and allow for changes in the quality of goods purchased. As a practical matter these adjustments are difficult to develop, leading to a common criticism that the CPI is a subjective measurement of price inflation.

Other issues exist with the CPI as well; of current concern is that the index does not reflect the value of assets including real estate. Rents are reflected in the index as is "owner's equivalent rent", which attempts to adjust for housing prices. However, during periods where real estate prices inflate substantially faster than rents, the index tends to understate the cost of living for homeowners. This is in fact a special case of the more general problem – the basket of goods in the index does not reflect the spending patterns of any one individual. Note the graph on the previous page showing the weighting and inflation patterns for nine major constituents of the CPI. While overall inflation has paced at a historically modest 2.1% level for the past 10 years, medical and educational costs have grown much more rapidly. These sectors only compose about 9% of the overall CPI, but exposure for many families is much greater. When a politically powerful group is systematically over-exposed to an inflationary segment (e.g., seniors exposed to healthcare costs), pressure mounts on the government to alter the index.

Characteristics of "Inflation Targeting"

- Policy framework for central banks
- Low and stable inflation is the overriding goal of monetary policy
- Specific point-targets or range-targets developed for an inflation rate or price index
- Increased communication with the public regarding policy-making objectives
- Increased accountability for the central bank
- Short-run management of other economic outcomes (e.g., employment, growth, exchange rated) is de-emphasized
- Discretion available, especially in response to supply shocks

Derived from "Inflation Targeting: A New Framework for Monetary Policy?"; Ben S. Bernanke and Frederic S. Mishkin; National Bureau of Economic Research; January 1997.

While imperfect, the CPI offers compelling advantages to other alternatives such as the GDP Deflator. The Deflator measures the ratio of nominal GDP to real GDP, and is therefore a direct measurement of inflation distributed throughout the economy. This statistic is free of selection bias, since no particular basket of goods is developed as a basis; however it is much more difficult to explain conceptually to the public, and is derived from a statistic (GDP) that is relatively untimely and subject to greater measurement error. To date, most regional economies that manage to specific inflation targets utilize some variation of their local CPI statistic.

Inflation Targeting in Practice

Inflation targeting is a framework for monetary policy where the central bank sets and announces a specific target range for inflation. Maintaining a low and stable rate of inflation becomes the primary objective, and the public can continuously evaluate the bank's success and hold its officers accountable for their performance. Increased transparency and accountability is the primary benefit of formal targeting; consistent policy decisions through cycles of political pressure are a secondary benefit.

An inflation targeting scheme can be implemented in a fairly rigid fashion, with advanced commitment to policy action based only on current inflation levels, or it can allow for discretion in implementation. The latter methodology is far more common, as it tends to be more palatable to the public and provides a mechanism for handling supply shocks. Typically, the inflation target is defined to exclude at least the primary effects of shock events; for example, food and energy price inflation immediately following a major natural disaster.

It appears likely that Bernanke will advocate a gradual transition to a low inflation target, a task made easier by two important facts. First, as mentioned, the Fed already practices a weaker form of inflation targeting internally, as evidenced by relatively stable inflation rates delivered under Greenspan's tenure. Second, aggregate inflation is already running right about the 2% level widely expected to be the center point for Bernanke's target range. The first test will come when pressure mounts to cut interest rates in response to short-term weakness, particularly near election time. That said, we view the notion of inflation targeting positively. If it accomplishes nothing else, it will increase the public's awareness of the long-run costs associated with easy money.

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