Your Quarterly Update on the Financial Markets
June 30, 2006

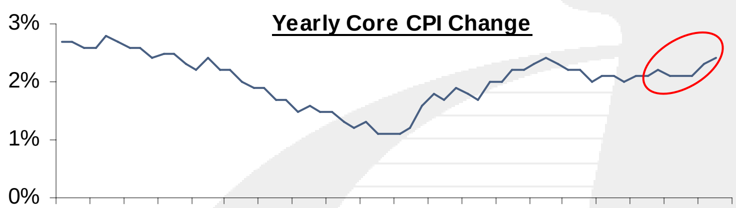
2nd Quarter

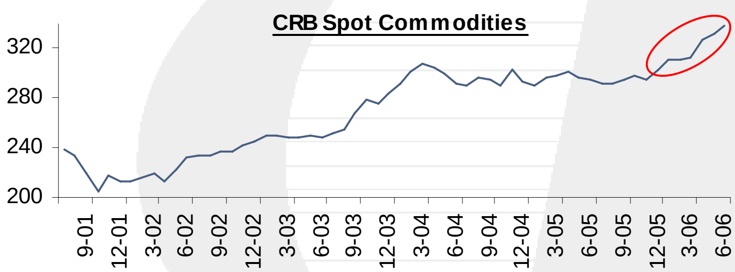
MARKET Recap

The Economy: *"Still Inflating"*

GDP growth in the first quarter was unexpectedly strong at an annualized 5.6% pace, exceeding forecasts of about 4.7%. Following the hurricane-depressed fourth quarter performance, upturns in personal consumption expenditures for durable goods, exports, federal spending, and equipment & software exceeded a downturn in private inventory spending.

Following release of the revised report on GDP, investors and regulators focused on inflation as an increasing threat to the economy. The Core Consumer Price Index (CPI excluding food and energy) continued to climb in the first quarter, reaching a 2.4% annual pace in May not seen since August of 2002. Factors of production (land, labor, and capital) continued to increase in price; oil and other commodities measured by the CRB Spot Commodities Index continued to climb, average hourly earnings rose by 8 cents in June and 19 cents for the quarter, and the Federal Reserve raised rates twice. Simultaneously the index of leading economic indicators declined 0.6% in May after a smaller decline in April, and the yield curve remained very flat.





Markets reacted negatively to data that simultaneously signaled increased inflation and slowing economic growth ahead. At some point the Federal Reserve will likely face a dilemma, a forced policy choice between stabilizing prices and promoting growth. Much of the volatility in the financial markets is due to the simple fact that we have not seen the "new" Fed perform under stress, and it's very difficult to predict which direction they will tilt. Simply reviewing Bernanke's published record suggests that he will focus on inflation control, a course that in our opinion leads to the best long-term outcome for the economy, but that would not be welcome news in the short run for markets depending on low rates for support of P/E multiples and robust consumer spending. However, this Open Market Committee is defined as much by the absence of Greenspan than the presence of a new chairman; the mix of influence exerted by the other governors is changing in ways that we do not yet understand, and we will only gain insight into the "personality" of the Committee through experience. That leaves little choice but to push through this period of uncertainty and hope for the best.

The U.S. Stock Market

Stocks finished a rocky second quarter with broad market indices moving lower. A number of issues including ongoing inflation, $3.00 per gallon gasoline, rising commodity prices, a slowing housing market, a tightening labor market, Iran and North Korea's nuclear efforts, and future interest rate hikes weighed heavily on investors' minds. Investors breathed a collective sigh of relief at the Fed's most recent policy statement, but this coupled with improving consumer sentiment from wage gains and increased disposable income did little to ease the pain of the market adjustment that took place. The Dow Jones

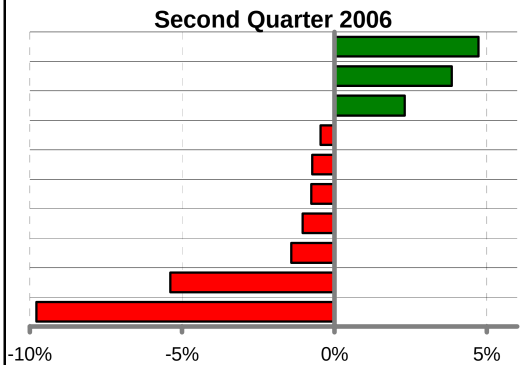
Stock Indices - Total Return
Second Quarter 2006

Largecap Stocks		**Midcap Stocks**	
S&P 500	-1.44%	Russell Midcap	-2.58%
Russell 1000	-1.66%	Growth	-4.69%
Growth	-3.90%	Value	-0.56%
Value	0.59%		
		Smallcap Stocks	
Broad Markets		Russell 2000	-5.02%
NASDAQ Comp.	-7.01%	Growth	-7.25%
Wilshire 5000 FC	-1.91%	Value	-2.70%

Industrial Average climbed as high as 11,709 in mid-May and then fell back to 10,653 in the subsequent four weeks, representing a drop of over 9%. Most S&P 500 index sectors were in negative territory as the S&P 500 fell 1.4%, closing at 1,270. The NASDAQ had a particularly tough quarter, falling 7% with both technology and telecom issues challenged.

Large capitalization issues fared best for the quarter (having the lowest negative returns!) as the market experienced an equity "flight to quality", with investors rotating out of smaller cap issues. For the past few years, small and mid-cap stocks have been on a tear; until early May the Russell 2000, an index of the 2000 smallest companies in the Russell 3000, had outperformed all other sectors. However, small- and mid-cap issues tend to be more volatile than their large-cap peers. And with the focus on the aforementioned economic and geopolitical risks, investors reconsidered their risk tolerances, demanding lower current prices and higher expected returns to accept those risks. In mid-May, Treasuries had their largest one-week gain in a year, highlighting the resulting investor appetite for higher quality and lower risk.

S&P 500 Economic Group Components - Total Return



Sector	2Q06
Utilities	4.73%
Energy	3.85%
Consumer Staples	2.31%
Industrials	-0.46%
Consumer Discretionary	-0.73%
Financials	-0.76%
Materials	-1.04%
Telecom Services	-1.42%
Health Care	-5.39%
Information Technology	-9.78%

Source: Standard & Poor's

Value issues continued to outpace their growth peers during the quarter. Largecap value was the only sector able to eke out positive returns, finishing up 0.59%. We continue to see high market volatility as sector performance rotates frequently. Utilities, last quarter's worst performing sector, led all S&P sectors this quarter finishing up 4.7%. Telecom, the best performing sector last quarter dropped to third worst after gaining over 13% in the first quarter.

Market consensus appears to be that, while the correction experienced in the second quarter gave investors pause, it is not the portent of a bear market. In fact, corporate profits seem to have remained strong during this time – a sign that investor perceptions, rather than corporate fundamentals, have been adjusted. According to Thompson Financial, S&P 500 companies are set to report a 12th straight quarter with at least 10% earnings growth. It remains to be seen whether this quarter is a short-term correction or the start of a long-term adjustment to risk tolerance that will lead to further down markets ahead.

The U.S. Bond Market

On June 29th, the S&P 500 achieved its biggest daily gain in three years (2.2%) on optimism that the Federal Reserve had nearly finished tightening interest rates. That day, central bank policy makers raised short-term rates for a 17th consecutive time, pushing the Federal Funds Rate to 5.25%. The Fed's statement acknowledged the "moderation in the growth of aggregate demand" as limiting inflation, but said that "the Committee judges that some inflation risks remain," and future firming action to address these risks "will depend on the evolution of the outlook for both inflation and economic growth."

Bond Indices - Total Return

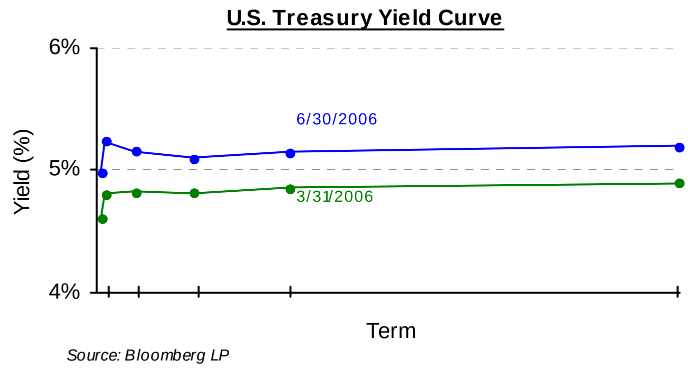
Index	2Q06
Lehman Aggregate	-0.08%
Lehman Interm. Gov't	0.30%
Lehman Long Gov't	-1.22%
Lehman Interm. Credit	0.06%
Lehman Long Credit	-1.84%
Lehman High Yield	0.25%

The market's reaction may have been overly optimistic. In remarks at the June 5th International Monetary Conference, Bernanke stated that, "... core inflation measured over the past three to six months has reached a level that, if sustained, would be at or above the upper end of the range ... consistent with price stability and the promotion of maximum long-run growth," adding that this was an "unwelcome" development. Later Bernanke promised vigilance "to ensure that the recent pattern of elevated monthly core inflation readings is not sustained."

Bond yields ended the second quarter roughly 30 basis points higher across the curve (except for a 42 basis point spike at 6 months). The yield curve remained flat, with 4 basis points separating the 2-year and 30-year yields. Compared to the first quarter close, the second quarter ended with the 3-month bill up 37 basis points at 4.98% and the 10-year and 30-year Treasuries up 29 basis points at 5.14% and 5.19%, respectively.

At this time last year, we were commenting on a dramatically flattening yield curve as the difference between the two- and ten-year Treasury yields dropped to 29 basis points. At 6/30/2004 this difference had been 237 basis points. Now the difference is a mere 1 basis point – with 2-year yields on top. Last year, we pointed out that a flattening yield curve signals that investors believe the economy is headed for a slowdown, with uncertainty about future interest rates favoring short-term issues. A year ago, Alan Greenspan's "conundrum" was a 30-year Treasury yield dropping each quarter even as he consistently telegraphed and executed short-term rate increases. Since then, the yield on the 30-year Treasury has halted its descent (30-year yields are now +100 basis points), but the yield curve has remained stubbornly flat. This causes us to wonder, would Mr. Greenspan once again be expressing concern that relatively low long-term rates are feeding inflationary pressures if he were chairman today?

Major bond indices were generally flat for the quarter with the exception of long durations. While these results were slightly better than 1Q2006, many analysts don't hold out much hope for good bond market conditions in the months ahead. At the end of June, Bloomberg reported that in the first half of 2006 corporate bonds posted their worst declines since 1998, that Deutsche Bank, Morgan Stanley, Barclays Capital and Credit Suisse Group were predicting corporate bonds to under-perform government securities, and that Standard & Poor's expected defaults to double by year-end.



Overseas Markets

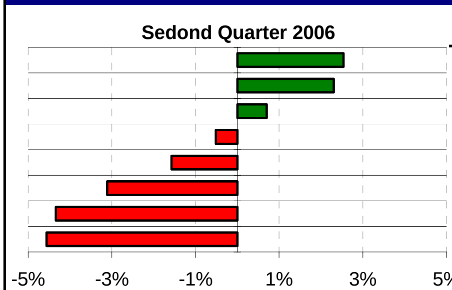
The second quarter saw a geographic sector rotation as high flying emerging markets experienced a downturn for the first time in eight quarters. Latin American markets, which had led emerging market performance, finally showed signs of a cool-down. Surprisingly, Europe was among the better performing areas as confidence returned and economic strengthening led to increased corporate investment. North American markets continue to show lackluster performance, although they are no longer the laggards, finishing down but in the middle of the pack for the quarter.

In Europe, consumer and business confidence jumped to a five-year high as the quarter ended. Inflation, which has been on the rise, increased faster than expected leading many to believe that the European Central Bank may accelerate the pace of interest rate increases. The ECB held short-term rates steady in early April, but raised them to 2.75% in early June; consensus expectations are that the ECB will raise the benchmark to over 3.25% by the end of the year. In Germany, dissonant data showed consumer confidence rising to a five-year high as the quarter closed while retail sales decreased. Higher oil prices have had an impact in the region, in addition to crimping consumer spending; Germany's metalworking labor union is seeking a 5% wage increase to reflect higher energy prices which, if approved, may lead to even higher prices as companies pass along the cost through price increases. The MSCI Germany Index was down -0.3% for the quarter. In France, consumer confidence was also on the rise. Official reports showed that confidence levels rose to -28 from -30 during the quarter. Price increases are also being felt as Euro-Zone reports show that consumer expectations of price increases have also risen. The MSCI France Index was up 2.5% for the quarter.

Good economic news continues to come out of Japan. In May, Japan's unemployment rate fell to an 8-year low fueling expectations of wage growth which should eventually translate into increased consumer expenditures. The unemployment rate dropped to 4%, its lowest level since early 1998. Competition for hiring is starting to push up wages, although economists worry that it won't be significant enough to create long-term consumer spending increases; sluggish consumption has been the bane of the economy for the past decade. In May, consumer confidence slid as households showed concern that inflation would cause prices to rise faster than wages. Household spending fell 1.8% year-over-year in May. The MSCI Japan Index was down -4.6% for the quarter.

In China, performance moderated during the quarter. A number of structural issues continue to face the Chinese economy. China's monetary policy has created a gigantic excess of liquidity which has, in-turn, created speculative bubbles in the real-estate and consumer credit sectors. The risks of oversupply in the monetary sector and the related speculative investing may lead to a hard landing if the banking sector does not take strong preventive measures. A surprise 27 basis point increase in short-term lending rates and a recent increase in the reserve requirement (the amount that banks need to keep on deposit with the central bank) to 8% are not strong enough measures for dealing with the overarching structural issues. However, any steps that China takes to deal with its serious structural problems should be viewed as positive. The MSCI China Index was up a modest 1.9% for the quarter.

Net Total Return of Selected MSCI Regional Indices



Region	2Q06
Europe	2.54%
Pacific ex Japan	2.30%
EAFE	0.70%
World Index	-0.51%
North America	-1.58%
Latin America	-3.11%
Emerging Markets	-4.34%
Japan	-4.56%

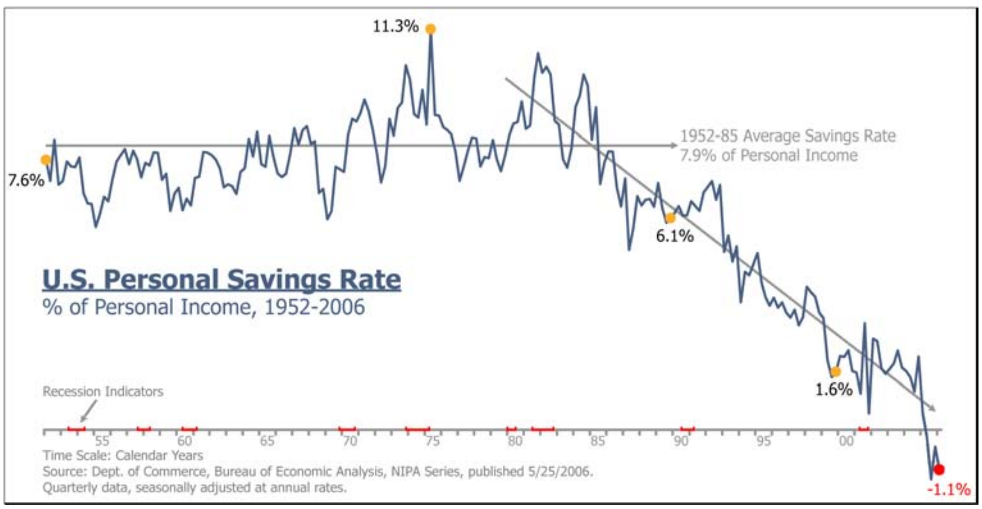
Latin American emerging markets cooled off significantly during the quarter. Brazil's credit rating increase by the Fitch agency from BB- to BB was welcomed by world markets. Inflation in the country remains in-line with expectations, below target for both 2006 and 2007. These positive developments have lead to appreciation of the Brazilian real. Brazil's 1Q GDP growth of 1.4% was the fastest in over a year. The MSCI Brazil index was down -2.5% for the quarter. In Argentina there was cause to celebrate as the jobless rate in May fell to 9.8%, falling below 10% for the first time in 13 years. This news comes along with the additional positive news of economic expansion. The economy is expected to grow by 6% this year after growing more than 8% the previous three years. The MSCI Argentina index was up 5.1% for the period.

Focus On: *A penny saved ... makes Jack a dull boy?*

Personal savings are an integral part of preparing for retirement and maintaining overall financial health. Mr. Franklin understood this well, and he would likely be shocked to learn the degree to which Americans have been increasingly neglectful of their savings accounts since the mid 1980's. There are a number of possible causes for such a decline in the personal savings rate; however, the downward trend of personal savings is a cause for concern, and an attempt should be made to reinforce good savings habits.

Calculating the Savings Rate

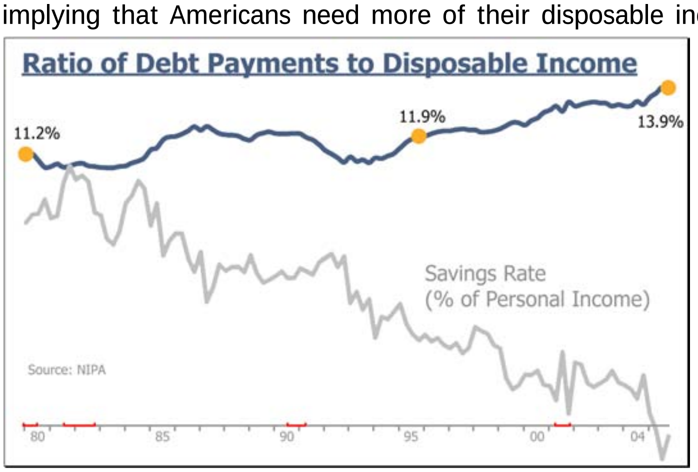
The standard calculation for personal savings comes from the National Income and Product Account (NIPA) data series which defines personal savings as personal income less taxes and personal consumption expenditures. According to this measurement, the average savings rate has been slowly declining since 1985; currently, the savings rate is -1.1% of personal income. A negative rate means simply that consumers are spending more than they earn; by definition, they must be relying on a combination of past savings and debt to support current spending.



That is not to say that Americans are becoming less wealthy; returns on investment assets and real estate holdings have driven a 71.6% increase in per capita household wealth from 1992 to 2001, according to Commerce Department statistics. However, two troubling observations can be made. First, not all Americans are asset-rich; for example, the 2000 Census Bureau survey reported that the lowest quintile of Americans by income had a median net worth of $7,396. Increasingly many people are relying on debt to finance their lifestyles. Second, those Americans with assets are relying on unprecedented levels of investment returns to cover not only their future spending needs, but also a portion of their current spending. Market returns have been, in turn, a function of an economy that has been driven by very strong consumer spending. The dangers in such a system are obvious.

Causes of a Negative Rate

It is difficult to determine the exact cause of the negative rate, but a correlation between debt payments and the savings rate provides interesting insight. Since 1980, the ratio of debt payments to disposable income has shown a net increase, implying that Americans need more of their disposable income to pay off debt. Clearly a low interest-rate environment incents spending over savings; debt is cheaper, and returns on risk-free savings vehicles (e.g., savings accounts, CDs) are unattractive. However, it is important to recall the statistical golden rule: correlation does not mean causation. The data shows coinciding fluctuations, but do not imply that a high ratio of debt payments to disposable income *caused* a decline in the savings rate. Rates alone do not explain increased reliance on debt financing. Another factor is increased *availability* of consumer credit, in many forms. This is not unique to low-income consumers bombarded with an array of offers from credit cards to tax refund loans; wealthier consumers have turned their houses into a source of revolving credit with increasingly liberal loan terms.



Lack of financial education is also contributing to the negative savings rate. Financial prudence is rarely covered in the scope of normal education, so many people learn from their parents or by trial and error. As a result, many people simply don't know how much they should save, or even how to save. Movement away from the ethics of saving and acquiring wealth over time towards a new attitude of instant gratification and irresponsible spending plays a role in causing the negative savings rate. According to Roger W. Ferguson, the Vice-Chairman of the Federal Reserve Board, Americans are saving less and spending more, depending largely on their projections of future income. However, future earnings could be negatively affected by fluctuations in the job market and the economy.

Some economists propose a different idea for the cause of a negative savings rate: the calculation itself. The theory is that the NIPA savings rate is not an accurate representation of the savings of the population due to several key factors.

Issues with the NIPA Statistic

The NIPA calculation does not include asset gains such as appreciated value of real estate or investments in non-tangible capital which may be a source of retirement saving. The Bureau of Economic Analysis estimates that the current definition of investments may underestimate growth in wealth by as much as 500%. Retirement plans aggravate the effect, since funded DB and DC plans pay a large portion of participant benefits with asset gains from investments that aren't included in NIPA. The Bureau of Economic Analysis has suggested that a new set of economic standards be used to calculate savings that incorporates asset returns. A new comprehensive calculation that includes pension savings and capital gains on equities shows an average growth rate of 25% for the 1990's.

Of course we don't object to additional statistics that provide greater insight into retirement security. However, as we've noted, growth in wealth is not the same as savings discipline. The source of wealth generation is important; savings discipline is available to almost everyone, and leads to predictable wealth generation over time. Capital gains are not available to many consumers as they have little in net assets to start with, and in any event such gains are much more speculative than recent market performance would suggest.

Other experts argue that the NIPA calculation is dependent on the entire population, and retirees who are no longer contributing to their savings accounts are skewing the data in a negative direction. In order to combat skewed data due to retirees, an age-adjusted calculation of personal savings has been proposed. The new calculation would include the working age population and filter out retirees. This kind of adjustment to the savings calculation will become even more important in the future; the Social Security Administration estimates that approximately 16% of the population will be over the age of 65 in 2020, compared to the current ratio of approximately 12% as of July 2005.

While one would expect an age skew in the savings rate, clearly the aging of the "baby boomers" does not explain the precipitous decline in the savings rates. The boomers are, in fact, not currently in retirement – they are in their peek earnings years, and should be saving a greater percentage of their current income. As they eventually move into retirement, the savings rate should naturally fall further.

Promoting Better Savings

Although you may pick nits with the calculation method, the implications of declining personal savings are very real. Consumers are relying more and more on capital gains and personal debt to fund their retirements and current spending. However, the trend is not sustainable; if dis-saving continues, Americans will not have sufficient funds to retire.

One important tool to combat poor savings habits is to promote a well designed 401(k) or other defined contribution plan that encourages participants to save for their futures. Automatic enrollment and automatic increases in deferral rates help greatly. By making savings automatic, people are more likely to contribute to the account; participation in savings plans often sees an upward trend when automatic deposits are implemented.

However, better savings vehicles are not enough; the importance of financial literacy education cannot be overstressed. In order to increase real savings, people must learn to control their spending habits. Without financial literacy education, employers may actually do their employees a disservice by encouraging plan participation. If an employee contributes $1,000 to a retirement plan and simultaneously adds $1,000 to credit card debt, they are arguably not better off. Helping employees better manage their personal finances seems to us a valuable benefit program, resulting in a more secure future and fewer distracting personal problems in the present.

Bellwether Consulting LLC
P.O. Box 140, Montclair, NJ 07042
www.bellwetherconsulting.net