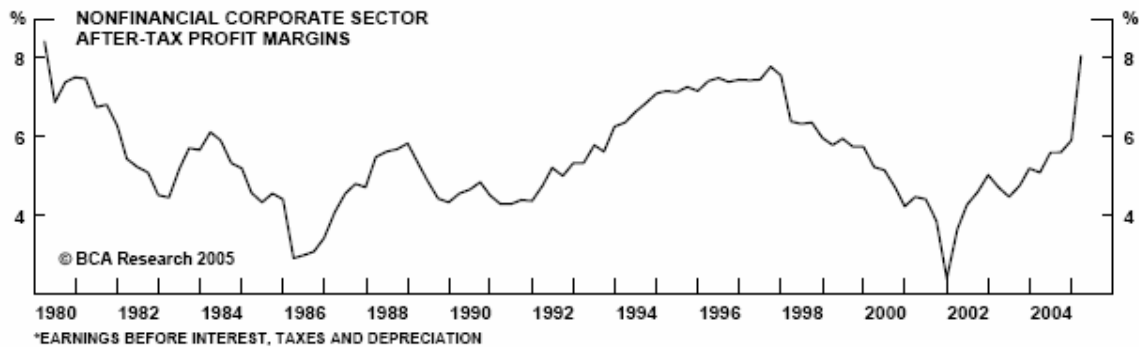




## Economic & Market Commentary July 2005

In the face of oil prices that reached more than \$60 a barrel, a slowing global economy and rising short-term interest rates, the U.S. stock market managed to post a small gain in the second quarter. While we believe there could be a pullback in energy prices from their recent highs, there are enough headwinds that we are maintaining our modest, beginning-of-the-year expectations for the stock market (8-9% total return). However, we do not expect a major downturn either, in part because of the tremendous financial improvement that has occurred in the U.S. corporate sector, which we think has been under-appreciated by many observers.

Over the last four years, corporations have continued reducing their cost structures, by only hiring workers perceived as absolutely necessary or when laying off large numbers of employees. The tight focus on costs has caused profit margins to widen to historically high levels.



Excess global capacity in a number of industries and lack of conviction about the outlook for growth has restrained capital spending. As a result, corporate balance sheets are in their strongest position in years, with approximately \$1 trillion in cash. Corporations have chosen to use some of their excess cash to initiate or increase the dividends they pay, buyback their stock or make acquisitions. We expect the dividends paid by companies in the Standard & Poor's 500 index to increase approximately 8% this year. At the same time, these companies are buying back significant amounts of their outstanding shares, which increases the existing shareholders' interest in the company. Companies are also making acquisitions, as in the case of Bank of America buying MBNA and Washington Mutual buying Provident.

Another ongoing source of demand for equities is coming from various alternative asset managers, such as private equity and hedge funds, that have raised large pools of capital. To produce attractive returns for the funds' clients, this capital must be invested. Some of the notable recent public market transactions that have been initiated by alternative asset managers are Sears/Kmart, SunGard Data and Maytag. In an environment of modest economic growth, low interest rates, and reasonable stock market valuations, we believe the large amount of cash on corporate balance sheets and in the hands of investors will provide an ongoing source of demand for stocks.



We believe the U.S. economy is experiencing a mid-cycle slowdown similar to what occurred in 1985 and 1994. If true, this could prove to be “the pause that refreshes” by prolonging the current economic cycle. You may recall that the U.S. economic cycles of the 1980's and 90's were both historically long in duration. While we do not expect stock and bond market returns to achieve the high rates of those periods, a longer economic cycle should be a beneficial backdrop for equity investors, in particular.

We continue to believe that stocks are undervalued compared to bonds. The ten year U.S. Treasury Note is currently yielding approximately 4.25% and we do not expect significant upward pressure on that rate in the foreseeable future. By contrast, the Standard and Poor's 500 index is currently trading at 16 times 2006 estimated earnings and therefore the market's earnings yield (the inverse of the price/earnings ratio) is 6%. Generally, when the stock market's earnings yield exceeds the U.S. Treasury yield, the stock market produces better returns.

Given its resilience in the face of higher oil prices and interest rates so far this year, we believe the U.S. stock market could experience a nice second-half rally, if energy prices pullback, corporate profits continue to grow and investor's confidence about a peaking in the Fed Funds rate materializes.