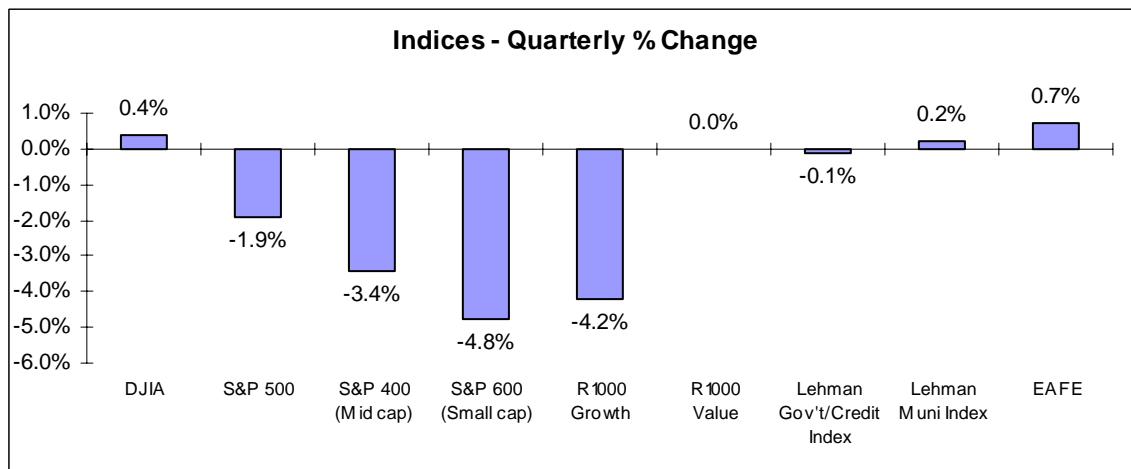




We are pleased to introduce several enhancements to the enclosed quarterly investment reports. These enhancements, which include a new quarterly account summary, a new quarterly performance summary, and additional indices and benchmarks, are intended to provide you with more information, greater clarity, and greater utility. We hope that you find them useful and welcome any suggestions you may have for further improvements. If you have any questions regarding the new format, please do not hesitate to contact your counselor, who will be happy to explain the new reports in greater detail.



The equity markets' erratic behavior was on full display during the second quarter. April's rousing rally in both stocks and commodities was cut short by a precipitous decline in May, which fell short of the technical definition of a "correction" by only a couple of percentage points. Investors abruptly shifted their concerns to out of control inflation and slowing growth. Action in the bond markets also reflected investors' struggles with these two often conflicting economic conditions. We appear to be nearing an inflection point, as both the stock market and economic cycles mature. No doubt the next several quarters will test investors' mettle; however, most factors we monitor are currently benign enough to forestall an adverse outcome.

U.S. Economy

The markets are becoming increasingly concerned with stagflation: a period characterized by high inflation and slow economic growth. Historically, this is a rare condition as the two economic conditions are not complementary. In most cases, strong growth is a precursor to high inflation, and low inflation is typically a consequence of slower growth. We believe the market's concerns about stagflation are unfounded.

Core inflation, as measured by the core consumer price index (CPI), which excludes food and energy, witnessed its biggest monthly gain in three and a half years in April. During the quarter, core CPI rose to 2.4%, well above the Federal Reserve Bank's comfort zone of between 1% and 2%. Ironically, the rise in the core CPI is partly an outcome of the Fed's two-years-old tightening campaign. A statistical quirk in the way the CPI accounts for owners' equivalent rent, which comprises 30% of the core CPI, is the result of rising interest rates depressing home ownership, lifting apartment demand and causing rental rates to jump. We believe that absent this phenomenon, inflation is reasonably tame, especially when considered in the context of a slowing economy.

There has been a lot of attention paid to the housing market and its effect on the rest of the economy. The housing market is softening, as evidenced by both new and existing home sales slowing. Housing affordability reached its lowest levels (i.e., housing has become less affordable) since the fall of 1990, and median home prices are decelerating. A slowing housing market, in combination with rising interest rates and high energy prices, will most likely cause consumer spending to slow. In the past, it has not paid to bet against the U.S. consumer. However, we believe the perfect storm of forces will be too much for the consumer to withstand. Nevertheless, any slowdown in consumer spending should be tempered by solid employment growth and exceptional corporate financials (e.g., profit margins are at all-time highs, debt is at record lows, and cash is nearing historically high levels). We are looking for a mid-cycle economic slowdown (i.e., a soft landing) similar to that of 1994.

U.S. Equity Markets

The U.S. stock markets experienced a painful shakeout during the second quarter. As we've touched upon above, inflationary pressures flared up during the first month of the quarter. Investors, concerned that the Fed will go too far in raising interest rates, refocused their anxieties on slowing economic growth.

It comes as no surprise that the heaviest selling was concentrated in high-beta (i.e., more speculative) assets, given investors' heightened concerns. Specifically, many emerging markets experienced spectacular sell offs, with the MSCI Emerging Market Index declining almost 25% from its peak. Among U.S. stocks, the NASDAQ Composite (-7.2% for the quarter) and small caps (-4.8%) led the way lower.

Fixed Income

The Fed also appears to be having a difficult time making sense of the economy. Commentary from Fed Governors has been inconsistent – vacillating between hawkish and dovish remarks. New Chairman Ben Bernanke has taken more than his fair share of the blame for the increase in market volatility. It is not uncommon for the new Chairman to have to prove himself early on in his tenure. It should not be forgotten that former Chairman Greenspan's first few months on the job witnessed one of the greatest stock market crashes in history. As market participants grow comfortable with Bernanke's more direct communication style, we expect volatility and investors' nerves to settle back down.

In the fixed income markets, investors were bracing for further rate hikes, although their concerns were somewhat alleviated by the FOMC's June 30th policy statement, which hinted at the possibility of a pause. During the quarter, the Fed raised rates two more times to 5.25%, the Fed's 16th and 17th consecutive rate hikes since June of 2004. Meanwhile, the 10-year Treasury increased only slightly, ending the quarter at 5.14%. As a result, the yield curve ended the quarter inverted (a condition whereby short-term rates are higher than long-term rates), which is often a harbinger of an economic slowdown. It is important to note that the yield curve inversion is fairly minimal and, as such, indicative of a slowdown that is likely to be relatively modest.

Elsewhere in the fixed income markets, corporate bonds and riskier assets (e.g., emerging market debt, high yield bonds, etc.) under-performed for the quarter. Although we do not expect a huge re-pricing of risk, the uncertainty among both investors and the Fed about where the economy and inflation are headed has led fixed income investors to demand incrementally more yield per unit of risk. A trend reversal was inevitable as risk aversion reached historically low levels in recent years.

Outlook

The equity bull market and economic recovery are mature. A typical cycle lasts about four years. It should come as no surprise that the current cycle, which started in October of 2002, is showing signs of fatigue. As one would expect, these inflection points are discomfiting for investors. Rational investors are able to look to fundamentals as a beacon guiding us through the tumultuous times.

In this case, the fundamental backdrop appears healthy. We are optimistic that inflation will remain under control and that any slowdown in the economy will be shallow. Outside of these two risks, many of the other factors we monitor are positive. Equity valuations are reasonable, particularly within the context of historically low nominal interest rates. Profit growth is robust – the S&P 500 has recorded eleven consecutive quarters of double digit earnings per share growth, an unprecedented occurrence. Lastly, global monetary policy remains accommodative despite seventeen consecutive interest rate hikes by the U.S. Fed. As such, we believe the market has entered into a corrective phase and that it will not deteriorate into a full blown bear market.