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Economic & Market Summary
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The U.S. economy continues to grow at a steady, above average pace. Contributions to economic growth are well-balanced between consumption and investment with only net exports acting as a drag. Additional increases in energy costs, a sudden acceleration of inflation and excessive regulation represent the most visible risks to the economy, although we ascribe a low likelihood to any of these issues slowing the economy's strong momentum anytime soon. The Federal Reserve has increased the federal funds rate from 1% to 2.75% over the past nine months, still low relative to inflation and still considered stimulative to economic growth. The federal budget deficit appears headed lower as spending growth is slowing and tax receipts are rising thanks to strong economic growth. The U.S. dollar has weakened over the past three years, but on a trade-weighted basis, is at roughly the same level as in 1995. Although there has been a lag, which is normal, the weaker dollar is supportive to U.S. economic growth. The real story with the dollar is not how weak it is now, but how strong it was in 2000. The expensive dollar was a significant contributor to the 2001 recession and the unusually weak recovery in jobs during the current expansion.

Inflation, currently at 2.9% (2.3% excluding food and energy) has been very well-behaved given vigorous worldwide economic growth over the past couple of years. We expect some further increase in inflation as a result of high materials and energy prices and strong economic growth, but not to levels that would create significant concern by long-term investors. We continue to believe that the bond market is over-extended, although we're encouraged by the orderly sell-off that has occurred so far this year. The Federal Reserve has signaled its intention to gradually shift monetary policy from extreme accommodation toward neutral, which we now estimate is a federal funds rate of 4-4.5%. Corporate profit growth is decelerating and we've detected an increase in profit warnings. Rising material, labor and regulatory compliance costs combined with continued pricing pressure from overseas competition have cut into operating margins. Investors continue to favor stocks of cyclical companies in the industrial and materials sectors where strong pricing power has resulted in powerful earnings growth. It is just a matter of time before the supply of commodity materials and manufacturing capacity catches up with demand, pricing power is lost, earnings deteriorate and investors return to quality companies with predictable and consistent earnings growth.

Equity valuations seem attractive, particularly in comparison to other major investment classes such as fixed income and real estate. The PE ratio on the S&P 500 is a modest 16.2 times 2005 estimated earnings and 15.0 times 2006 estimated earnings while bond yields and real estate capitalization rates are near generational lows. Despite higher interest rates year-to-date, our dividend discount model indicates that the stock market remains about 20% undervalued. Fundamental underpinnings such as steady economic and corporate earnings growth, low inflation and interest rates, underleveraged corporate balance sheets, and increased acquisition activity provide good support for stocks.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.