TALKING POINTS

A Recap of July 2006

The Economy

Judging by most financial commentary, the noteworthy economic event in July was the release by the Bureau of Economic Analysis which showed real GDP growing at a 2.5% annual rate in Q2. This was below consensus estimates of 3.1% growth and a significant pull back from the Q1 growth rate of 5.6%. Many pounced on this data to fit their forecast of a slowing economy and concluded that Fed rate hikes are a thing of the past. Yet, real GDP has been noticeably volatile since Hurricane Katrina. Removing this volatility shows GDP increasing 3.5% in the past year - a rate slightly above the long-term average of 3.2%. Moreover, industrial production increased 0.8% in June and initial unemployment claims fell back to near 300,000. These are reliable leading indicators, as each of the past seven recessions have been preceded by a weakening of industrial production and a significant increase in initial claims. Ironically, the mot worrisome part of the GDP report was quickly passed over by most analysts. The "core" PCE deflator increased 2.9% at an annual rate in Q2. This is the fastest quarterly growth since Q3 2004 and is well above the Fed's comfort zone for inflation (1%-2%). The Fed, and many market participants, made the assumption that a slowing economy will keep inflation in check, but inflation is a monetary problem that cannot be tamed by a slowing economy. Moreover, there is little evidence to suggest that the economy is substantially weakening. Certainly, there are many who disagree, but as John Adams said, "facts are stubborn things." The predominant facts of the current situation point to robust growth and building inflation. As a result, any pause in Fed rate hikes is likely to be short-lived.

Indicator	Current	Prior	Direction
Real GDP	**2.5%** (Q2)	5.6% (Q1)	⇩
Industrial Production	**0.8%** (June)	0.1% (May)	⇧
Domestic Auto Sales (units)	**13.0M** (Jul)	12.4M (Jun)	⇧
"Core" PCE Deflator	**2.9%** (Q2)	2.1% (Q1)	⇧
Initial Claims	**308,000** (Jun)	303,000 (May)	⇧

The Stock Market

The three major indices were mixed in July with the DJIA, S&P 500 and Nasdaq Composite returning +0.5%, +0.6% and -3.7%, respectively. Small-cap stocks, as measured by the Russell 2000 Index, fell 3.3%. Some of the top performing S&P 500 groups in July were as follows: Gas Utilities (+10.7%); Airlines (+9.9%); Home Entertainment Software (+9.5%); Tobacco (+9.1%); and Health Care Facilities (+8.0%). In July, the dividend-payers (385) in the S&P 500 (equal weight) posted a total return of -0.62%, vs. -4.31% for the non-payers (115). Y-T-D through July, the dividend-payers gained 4.29%, vs. -3.26% for the non-payers. For the 12-month period ended July 2006, payers gained 7.00%, vs. -1.22% for the non-payers. The number of dividend increases (S&P 500) year-to-date totaled 200, nearly matching the 207 registered over the same period in 2005, but still well above the 173 increases registered in 2004. The dividend yield on the S&P 500 was 1.93% at the end of July. A quarterly survey (Q2) of U.S. money managers by Russell Investment Group (Investment Manager Outlook) found that **69%** had a bullish outlook for **large-cap growth stocks** over the next 12 months, according to Russell. Bullishness for small-cap stocks **plunged 30 percentage points** to 27%, the largest quarter-on-quarter decline in the history of the survey.

Indicator	Current	Prior	Direction
S&P 500 (**Equal Weighted/Price-Only**)	**-1.5%** (Jul)	-0.4% (Jun)	⇩
AAII Sentiment Index	**34.9% Bullish** (7/31)	38.6% Bullish (6/30)	⇩
Short Interest (NYSE)	Jul: **9.30B** (+2.3%)	Jun: 9.09B (+5.6%)	⇧
Margin Debt (NYSE)	May: **$225.8B** (-2.0%)	May: $230.5B (-4.6%); *$278.5B in March 2000*	⇩

The Bond Market

The yield on the 10-Yr. T-Note fell 16 basis points in July closing at 4.98% – 70 basis points higher than on July 29, 2005. The returns on seven Lehman Bros. benchmark indices were as follows (July & **Y-T-D**): ***U.S. Treasury: Intermediate*** (1.05% & **0.85%**); ***GNMA*** (30-yr.) (1.42% & **0.86%**); ***Municipal Bond (22+)*** (1.52% & **2.14%**); ***U.S. Aggregate*** (1.35% & **0.62%**); ***U.S. Corporate High Yield*** (0.98% & **4.15%**); ***Global Aggregate*** (1.00% & **3.31%**); and ***Emerging Markets*** (3.13% & **3.82%**). Thanks to the dip in rates in July, not a single debt category was in negative territory with respect to price or total return. As mentioned above in the economic overview, we believe the economy to be healthier than your average analyst or pundit. We believe the Fed could take the fed funds rate to 6.0% without derailing the current expansion. By the way, the sector of the debt market that is poised to benefit from a 6% fed funds rate is senior loans, which are speculative-grade floating rate securities. One could use senior loans as a proxy for the economy. There were no defaults in July and the default rate on senior loans fell from 1.55% in June to a 10-month low of 1.36% in July, according to S&P LCD.

Key Rates as of July 31st

Rate	Value
Fed Funds	5.25%
2-Yr. T-Note	4.95%
10-Yr. T-Note	4.98%
30-Yr. Mortgage	6.62%
Bond Buyer 40	4.83%

Key Yield Spread

The spread between the Merrill Lynch High Yield Master II Index and the 10-Yr. T-Note was 361 basis points on July 31. The yield on the index was 8.59%. The spread was 362 basis points on July 29, 2005, when the yield was 7.90%.

2006 Debt Issuance through June
(Source: Thomson Financial)

Debt Category	$ Amount (Billions)	% change over '05
Corporate	$761.5	+16.1%
Convertible	$5.1	+45.1%
Asset-Backed	$892.3	+3.4%
Municipal	$177.3	-15.4%

The Investment Climate

Net cash outflows from equity funds totaled $8.4 billion in June, compared to the $3.2 billion of cash inflows in May, according to the Investment Company Institute. Bond funds had outflows totaling $345 million, compared to outflows totaling $2.5 billion in May. Money funds reported inflows totaling $20.1 billion, vs. inflows totaling $50.8 billion in May. Y-T-D through June, net cash flows into equity funds totaled $113.8 billion, vs. $20.2 billion for bond funds.