

The focus of the capital markets during the second quarter was almost exclusively on deciphering Federal Reserve Chairman Bernanke's direction on future monetary policy. The result was a heightened level of volatility in the capital markets and another quarter of dismal performance for financial assets. The quickening pace of inflation, coupled with the expected slowdown in domestic growth, have provided the expected fuel for the debate on when the Fed will stop raising short term interest rates. The Fed raised interest rates 25 basis points at the end of June kicking off a powerful rally in the stock market. After 17 consecutive increases in rates over the past two years, the Fed indicated after this last move that further increases were not certain, but depended on the outlook for economic growth and inflation. We believe the Fed is not done raising rates.

2006 2nd Quarter Economic Review

The U.S. domestic growth rate slowed during the second quarter from a rate of 5.6% in the first quarter to an expected rate of 3.2% in the second quarter. The first quarter GDP growth rate was the single best quarterly rate of growth our economy has experienced in the past six years. Remarkably, the economy has remained resilient over the past year in the face of rising interest rates, higher oil prices and a heightened level of financial market risk. Rising interest rates are helping to slow the housing market which in turn is helping to curb the consumer sector. Retail sales during the second quarter were down -0.1% and auto sales have declined through the year. The pressure on consumers is starting to increase. Until recently, higher oil prices were offset by wealth gains from equities as well as from housing and other stimulative effects of lower interest rates; however, housing has clearly peaked, and equity market gains were depleted during the second quarter. This has affected consumers' willingness to spend beyond the pace of income growth. The dramatic decline in the personal saving rate, along with higher debt servicing costs, are providing stiff headwinds for the consumer sector.

We believe that given the healthy state of the corporate sector an increase in business spending will provide some necessary offset to the weakening consumer sector. Corporate profitability continued strong and M&A activity remained robust. Normally, this would bode well for equities, however, this has not necessarily been the case so far in 2006. Wage gains are running near 3.9% on an annualized basis and job growth continued to be steady. With the unemployment rate running close to 4.6% and capacity utilization inching toward 82%, there are not a lot of slack resources in the economy. With respect to the trade balance, we expect import demand to weaken in the second half of the year. The weaker dollar and demand for U.S. goods overseas is boosting exports, which in turn will ease pressure on the trade gap.

The transparency of Greenspan's measured rate hikes provided an almost comforting stability for the financial markets over the past two years. The result was that the economy probably remained too strong for too long. However, now the U.S. seems headed for several quarters of below-trend growth at the same time that inflation is starting to accelerate. We believe the Fed is

nearing the end of its tightening cycle, but is not finished. Inflation measured by the May Core CPI increased at an annual rate of 3.8%. Unless inflation surprises on the high side, we expect the Fed to increase rates in September.

By definition, a tight monetary policy results in some level of financial pain. Yet, aside from higher gas prices and increased mortgage payments for those with ARMs, there has not been a significant level of pain felt by consumers. The risk of a policy overshoot has increased. An environment of stagflation, where the economy experiences below trend growth combined with higher inflation, is of greater concern but still a relatively low probability.

Capital Market Outlook

A higher level of volatility in global financial markets marked the second quarter of 2006. A mild "melt down" in emerging market equities and most currencies this past quarter helped to punctuate the heightened level of risk in the capital markets.

Similar to the first quarter of 2006, interest rates ended the second quarter higher than where they started. The yield on the benchmark 10-year Treasury rose 29 bps to end the quarter at a 5.14%. Similarly, the yield on the 2-year Treasury note rose 33 bps to end the quarter at a 5.15%. The Fed funds rate of 5.25% is somewhat higher than the rest of the yield curve. This has only happened four times and each time the economy has slowed afterwards. While we believe the Fed is nearing the end of its tightening cycle, it is not done. We are cautious on interest rates and our target portfolio duration remains short their benchmarks reflecting a continued defensive bias.

We have been slower to reduce our overweight to the corporate sector than originally planned but still are intent on doing so. The credit market landscape is less certain given the increase in equity volatility. The corporate market, measured by the Lehman Brothers Credit index, underperformed widening by six basis points during the quarter. While corporate earnings continued strong, relative value in both investment grade and high yield credit is still out of line with market risks. Throughout the year, shareholder friendly activity continued to haunt bondholders. This past quarter, Tribune widened by 80 bps after the board voted to split up the company. Also, earlier in the quarter, Kinder Morgan Inc. announced their intent to take the company private and bonds widened 140 basis points on the expected downgrade from mid-BBB to high yield.

The auto sector finished strong for the quarter led by GM/GMAC bonds. The company announced that a larger number of employees had accepted the company's buyout package, which should help reduce its cost structure and help its competitive position over the long-term. Residential Capital Corporation remains as one of our larger portfolio holdings. We still believe GM will either sell or spin it off to shareholders as part of its restructuring. In either event, it would be a positive for the credit and would likely be upgraded upon separation from GM.

Looking ahead, on a fundamental basis we have concern with the Homebuilders, Property & Casualty insurance, Telecom, and Media/Cable sectors.

In the face of rising interest rates and increased market volatility, the MBS sector underperformed during the second quarter. GNMA 30 years significantly underperformed conventionals, and durations extended almost a full year over the first half of 2006. We have selectively added to the structured securities portion of the portfolio, preferring CMO's with tight windows over MBS pools.

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