

**ECONOMIC AND FINANCIAL MARKET OUTLOOK
APRIL 15, 2006**

Following through on the strong year-end rally, the stock market put in its best first quarter performance since 1999. In terms of price appreciation alone, the S&P 500 rose more in the first three months of this year than it did for all of 2005. On a total return basis, which includes both dividends and appreciation, the market was up 4.28% through March 31st. Bonds did not fair as well as two Federal Reserve interest rate hikes during the quarter had most bond indices in negative territory.

Investor optimism was burnished by record high profit margins, acclimation to higher but stable commodity prices, and the belief that the Federal Reserve is nearing the end of its tightening cycle. Employment remains strong, with only 4.7% of jobseekers out of work. Domestic economic growth continues to be steady, although the rate of growth is slowing as higher rates start to take hold. Fortunately, this slowing of the growth trend in the U.S. is being more than offset by robust growth overseas, especially in Japan where consumers are on a U.S. style spending spree. After years of being the engine of growth for the world, we are finally seeing other countries contribute to the effort.

As the world economy booms and becomes more integrated, prosperity is spreading both here and abroad. Inflation remains subdued as companies offset higher commodity prices with lower labor inputs, either by improving productivity or by moving factories to lower wage locations. Corporate earnings remain strong and company balance sheets are even stronger, with cash balances at record highs and debt levels falling. From a purely economic perspective, things look quite positive.

However, we can't help thinking of a favorite Jack Nicholson line: "What if one day we realize that this is as good as it gets?" The double digit jump in corporate profits has been driven by record high margins, despite rising commodity prices and a lack of pricing power in most industries; it did not come from surging sales. These record margins are being generated from a combination of cost cutting measures that include outsourcing, moving production offshore, and increasing production and supply chain efficiency.

Unfortunately, peaks in operating margins are rarely sustainable. Worker salaries cannot be cut to zero and products are made out of materials that cost something. This is not to say that margins are set to collapse, but rather that productivity gains are harder to come by. Further profit growth will have to come from other sources, namely higher sales. As interest rates and energy costs rise, it is hard to envision an upward explosion in demand. We also note that with our low unemployment rate, most consumers have had steady jobs and have been spending right

along. In fact, in terms of economic expansions, the current cycle has already lasted longer than average. There is little pent up demand waiting to be released.

In this environment, further stock market gains will be closely linked to earnings and economic growth. As we have noted before, this is in sharp contrast to the 1982-2000 bull market where expanding valuation multiples were responsible for roughly half of the market's gain. During that eighteen year span, markets rallied when growth slowed because it signaled that the Fed would soon stop tightening and might even cut rates. For most of that time frame, interest rates were kept high to slow inflation and any sign of lower rates was warmly embraced. A potential longer term risk here is that we may see a mirror image of the '80's and '90's. If interest rates are at the start of a protracted upswing in response to surging commodity prices and robust global growth, valuation multiples could stay flat or even contract from current levels.

Put another way, we suggest that there is now an asymmetric relationship between interest rates and the market. Continued low interest rates may not be enough to initiate the strong rally that some now predict and there is not enough room to lower rates to a point where the cuts can have a stimulative impact on either the economy or the markets. Lower rates would also be a response to slower economic growth, implying that corporate profits would be slowing too. Conversely, faster economic growth will almost certainly stoke inflationary fears. This in turn will prompt higher interest rates as Central Bankers around the world continue their tighter monetary policies, slowing any significant rally. With this in mind, we repeat our observation from January: energy prices will be important, but interest rates will be the critical factor to watch in the months ahead.

Investment Strategy

If you have not gathered, we expect economic growth to slacken a bit by the second half of the year as higher interest rates start to take hold. However, the market has momentum and should continue its upward trend in the short run. Furthermore, the pressure causing higher rates comes from robust global growth and higher commodity prices, factors that bode well for several investment themes.

Certainly, multinational companies should do well in this environment. Proctor and Gamble and Colgate-Palmolive, for example, derive nearly 55% and 78% of their respective revenue from outside of North America, much of it from emerging markets. They are also attractive since consumer staples manufacturers have a better ability, as we saw in the '70's and '80's, to pass along price increases to consumers. International stocks should also continue to do well and we are maintaining our exposure to this asset class for clients with that mandate.

Other companies that are selling into global growth include capital goods manufacturers, enterprise technology companies, and resource related firms. Consumer staples, banking, insurance, and certain consumer discretionary names should also do well as investors add defensive names to their portfolios.

We are avoiding companies directly dependent on borrowing, such as home builders and automotive firms, and those that sell to highly leveraged customers, such as select consumer discretionary businesses. We also look to avoid highly leveraged firms that may need to refinance their debt in a rising rate environment, if they can refinance at all.

Our biggest change in outlook is in our fixed income strategy. We now believe that interest rates will stay locked in a trading range, but that the boundaries of this range have risen since our last writing. This outlook has had us holding bond money in cash for several months. We are starting to put this cash to work in recent weeks as rates have hit attractive levels. This buying complements the shorter duration bonds that we owned for clients going into this rate cycle. We continue to believe that defensive bonds, such as securities trading at high premiums, will reward investors.

As always, we welcome your questions and comments.

John T. Boland, CFA
Chief Investment Officer

Gerald C. Milkowski
Senior Vice President

Ramsey A. Ahmed
Principal

Timothy C. Escott, CFA
Vice President