

INVESTMENT UPDATE

Executive Summary

- Economic growth was strong in the first half of the year at an estimated +4.5%. We expect economic growth to remain healthy but slow to a more normal level of +3% in the second half of the year.
- With the Fed Funds rate at 5.25%, the Federal Reserve is nearly finished raising short-term interest rates.
- Core inflation rate (excluding food and energy) may peak at +2.8% later in the year before declining back to the 10-year average rate of +2.3% in 2007.
- Strong growth in corporate profits this year is evidence of a healthy economy and will eventually support higher stock prices.
- The long-term bond market has become more attractively priced with the yield on the 10-year Treasury Note climbing to 5.14% at the end of the second quarter. We are extending bond durations but are still keeping them shorter than the benchmark duration of 5.1 years.

Federal Reserve

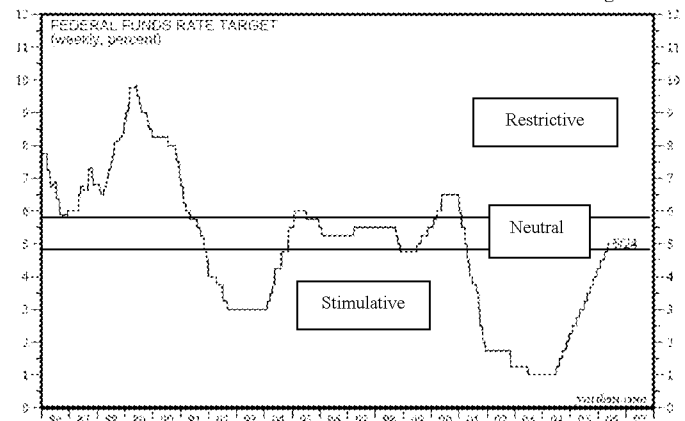
Federal Reserve Chairmen Ben Bernanke took over for Alan Greenspan at a very tenuous time for the markets. The Fed had been extremely stimulative to economic growth from 2001 until the middle of 2005. The excess liquidity has resulted in strong economic growth, a weak dollar, higher inflation, lower interest rates, and rising speculation in commodities and emerging stock markets. The excess liquidity helped re-ignite economic growth and remove deflationary pressures. However, too much stimulus can result in a boom-bust type scenario with rising inflation forcing the Fed to raise interest rates too high, which ultimately chokes off economic growth. The Fed understands this and has raised rates 17 times since July 2004 from 1% to 5.25% in an attempt to remove the excess liquidity fast enough to prevent inflation from getting out of control but slow enough not to cause a recession (see Chart 1).

Growing concerns regarding the Fed's ability to engineer a soft landing developed earlier in the year when Bernanke and the Fed hinted that a pause in interest rate hikes was imminent. The Fed would have been erring too much on the side of stimulus, resulting in much higher inflation and closer to a boom/bust scenario. The markets agreed as gold, commodities, and emerging markets all soared. Bernanke quickly changed his tune and started emphasizing the need to err on the side of restraint and fighting inflation. Gold, commodities, and emerging markets quickly erased most previous gains indicating

some renewed confidence that the Fed is not going to let inflation get out of control.

Historically, the Fed has not been extremely adept at engineering a soft landing as it has occasionally overshoot its target, increasing interest rates until there was a financial crisis or a recession. Therefore, in a matter of days, investors have switched from worrying about excessive stimulus to worrying about the Fed raising rates too high and causing a recession. We believe the Fed has been only modestly behind the curve in raising rates and will be able to manage a successful soft landing. Bernanke has more aggressively responded to forward-looking indicators (such as gold, commodities, and the inflation expectations) than his predecessor, which adds to our confidence in the Fed. We believe the Fed will increase the Fed Funds rate one more time to 5.50% and then pause. However, until it is clear that the Fed has accomplished a soft landing we expect continued high levels of volatility in the markets.

Chart 1: The Fed is Back to Neutral and Close to Pausing



Economy

The economy remains healthy and is not showing signs of a significant slowdown. In fact, economic growth accelerated in the first quarter to a +5.6% annualized real growth rate, the fastest quarterly growth in 10 quarters. Economic growth for the rest of the year appears to be slowing to a more normal +3% growth rate. Economic growth is becoming more balanced with many sectors contributing to the growth. Consumer spending and a strong housing market have been the drivers of the economy during the past few years. Looking forward, economic growth appears to be more balanced with areas of strength coming from corporate spending (+8.9% in the first quarter), commercial construction (+5.1%), and exports (+8.1%) along with continued growth in consumer spending (+3.9%) offsetting

