

INVESTMENT UPDATE

At this point in the economic cycle, we'd expect inflation to be rearing its ugly head. After all, the US is completing its fifth year of economic growth since we hit rock bottom in late 2001. "Real" US GDP growth has averaged more than 3.5% since then, and the US unemployment rate has fallen from 6.3% to 5.0%. Typically, a strong economy with growing consumer demand and a low unemployment rate conspire to push up the cost of doing business, costs which are in turn passed on to consumers.

Earlier this year, it looked like we were in the early stages of repeating this historical pattern. Between August of 2004 and March 2005, core inflation (CPI-excluding food and energy) rose from 1.7% year-over-year to 2.4%. By March, the three-month annualized rate of core inflation was 3.3%. The unemployment rate was falling and unit labor costs were rising. Adding to the overall inflationary stew was a weakening dollar, which was both spurring sales of US-produced goods in overseas markets (boosting US industrial production) and simultaneously making the myriad of imported consumer goods more expensive. All-in-all, we were bracing for a cyclical resumption of the familiar inflation spiral.

But something funny happened on the road to higher consumer prices. Core inflation measures stalled, and then started dropping. Especially after the disruption to the energy and transportation infrastructure from this year's hurricanes, the drop in non-food and energy inflation (currently hovering between 2.0% and 2.1% YOY) is one of the most surprising stories of 2005.

So, what happened? First, let's take a closer look at the CPI. The Consumer Price Index measures the price of a market basket of commonly-purchased goods and services. Typically, economists and capital markets analysts prefer to work with core CPI, eliminating the volatile food and energy components which can often give false readings. Deconstructing the CPI should be straightforward, but the Bureau of Labor Statistics doesn't provide all the sub-components of CPI that would allow for a full analysis.

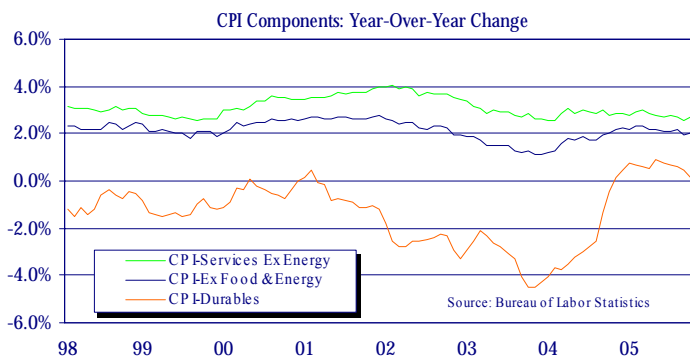
Nevertheless, we can identify a few important components that show the main driving elements of core inflation.

As the chart on this page shows, the overall core CPI has been relatively stable over the past few years, hovering between 1.1% and 2.5% since 1998. During this same period, non-energy service prices paid by consumers have been equally stable, albeit at higher levels than the overall Index. Offsetting the rising price of services have been the much less inflationary consumer goods (here represented as "durables," as the BLS doesn't report on "total goods," much less "core goods"), which have been through periods of outright deflation over the past few years. This is not surprising, since so much manufacturing is now being done overseas, where resources (including labor) are plentiful and cheap.

Looking closer at the chart, we see that the prices of durable goods have not only been falling (i.e., below zero, year-over-year) for most of the recent past, but they have been far more volatile. In fact, the rise in core CPI since early 2004 appears wholly attributable to the re-inflation of durables' prices, and was the primary reason why so many economists upped their inflation forecasts earlier this year. But the upward push on manufactured goods prices has

turned down, and is now dropping back into negative territory.

This has massive implications for bond investors. If the Fed is convinced that core inflation will remain in their unofficial 1%-2% target range, they can ease off the monetary brake pedal and stop raising short-term rates sooner rather than later. In the past few weeks, despite the fear of increased home heating costs this winter, long-term inflation expectations have been falling, supporting long bond prices and limiting the upward push on longer interest rates. As a result, the yield curve is at its "flattest" slope in years, with a measly 30 basis points separating two- and thirty-year maturity Treasury yields. Even though we've been warned by Fed Chairman Alan Greenspan that things



could be different this time, a flat yield curve is the traditional sign that the interest rate cycle is nearing its peak.

Meanwhile, the economy appears to be settling into a gentler glide path. Consumer spending, the main driver of our economy since the last recession, appears to be moderating as higher interest rates finally are skimming the froth off of the US housing market. Until now, consumers have used the inflation of their personal real estate portfolios to boost their spending, both directly and indirectly.

Homeowners benefited directly from refinancing their mortgages at lower rates, which, especially when combined with popular “cash out” options, put disposable funds into consumers’ wallets. Higher rates have all but removed the economic incentive to refinance (as well as the income boost to homeowners), yet the housing market has continued to provide *indirect* stimulus to consumer spending during a period of mostly rising rates. While much more difficult to quantify, there is a psychological boost that homeowners experience when seeing their neighbors’ houses selling for record prices. Greenspan has spoken about how the inflation of home prices—a form of “unrealized gains”—have significantly supported consumer spending during the current economic expansion.

We’ve believed for some time that the US housing market would eventually plateau, and that now appears to be underway. While we’re not necessarily looking for a housing “bust,” it’s reasonable to assume that the housing market, after the price inflation of the past few years and with interest rates at higher levels, is due for price correction. As the chart on this page shows, the affordability of the average US home is at its lowest level in nearly 15 years.

With the possibility of a slowdown in personal spending, the US economy will need some help from the industrial

side of the equation. There is reasonably good news here, as capital expenditures continue to grow at a decent enough pace. As the bottom chart on this page shows, non-defense capital goods shipments are maintaining growth rates in the high single digits, down slightly from the early days of this economic recovery (when the yearly comparisons were easier). For the sake of long-term economic growth, we’d like to see more capital investment in “brick and mortar” structures, since so much of current US CAPEX has been going towards

computer equipment and software (now 46% of total nonresidential fixed expenditures, up from just 25% ten years ago).

We’re anticipating a resumption in more traditional capital investment in 2006, as corporate treasurers have done all they needed to do to repair their overburdened balance sheets caused by the excesses of the 1990’s. After husbanding their cash reserves for five years, there is a need for necessary investment that has been put off in the interest of fiscal prudence. And the time is right for many of these industries, as cash flows are strong and demand prospects look favorable. In particular, we are looking for hefty gains in CAPEX in the communications, oil and gas, and electric utilities industries.

All in all, we’re looking at a fairly favorable environment for bond investors—interest rates are high enough to provide respectable yields, inflation appears to be well contained, economic growth is solid, and prices for most bonds seem to fairly reflect their underlying values. Of course risks are present, and we will be watching two, in particular: The risk of a severe deflation of housing values and the possibility of a sudden liquidation of US bonds by foreign investors. We assign a small, but not insignificant possibility to each of these.

