



# Investment Commentary

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Stocks were generally up last week, with the Dow Jones Industrial Average gaining 1.4% to close at 10,568, the S&P 500® Index up 1.1% to 1,228 and the Nasdaq® Composite advancing 1.6% to finish the week at 2,151. With last week's gains, September was a positive month for equities, the first positive September in seven years. For third quarter 2005, stocks were up slightly and bonds were down slightly, following the "muddle through" theme we have been discussing all year. Year to date, the S&P is up a little more than 1% and the Dow and Nasdaq are both down slightly more than 1%. On the international front, where stocks generally have been outperforming their U.S. counterparts, Japanese equities reached a new four-year high last week based on both strong exports and improving domestic demand.

We continue to believe that the U.S. economy will experience a slowdown. Higher short-term interest rates, higher energy prices, a savings rate that is close to zero and declining consumer confidence are all taking a toll on the consumer sector of the economy. We believe that these drags will offset the gains attributable to the housing market, which is itself showing signs of slowing. Government spending in response to Hurricanes Katrina and Rita should provide some stimulus, however, and should help prevent the economy from sliding into a recession. In our view, the biggest risk to the economy is the possibility of the Federal Reserve overreacting to inflation and increasing interest rates more than is necessary. The Fed has raised rates 11 times since the middle of last year, and has continued to advance the same message: It remains more concerned about inflation than about slowing economic growth. We believe we will see at least one more 25 basis point increase in the federal funds rate this year (the rate currently stands at 3.75%). When the Fed does finally stop raising rates, we think that will be a catalyst for some sort of improvement in equity prices.

Regarding energy prices, demand remains reasonably robust and continues to grow, especially in Asia. Supply remains constrained, and there is a shortage of refining capacity, which obviously has resulted in higher gasoline prices. We believe that some drop in demand (or at least a slower rate of increase) in the face of higher prices is possible. Our view is that, for now, oil prices will likely remain in a broad trading range of between \$50 and \$70 per barrel.

In our opinion, investors appear overly complacent in the face of higher energy prices and rising short-term interest rates, and we question the prevailing assumption that U.S. consumers will be able to maintain their high spending levels. Additionally, we believe that expectations for corporate earnings are overly optimistic, and we expect to see earnings disappointments for the next couple of quarters. In this sort of environment, we continue to recommend that investors follow a conservative investment strategy. Stocks and bonds have both produced lackluster returns this year, and it is difficult to make a case for major changes in this trend over the next six to 12 months. While we do not expect a significant drop in equity prices, we would encourage investors to wait for a less risky time before adopting a more aggressive investment stance. Equity investors should look for buying opportunities, which could be signaled by signs that the Fed is pausing, by lower stock prices as a result of disappointing earnings or by lower energy prices.