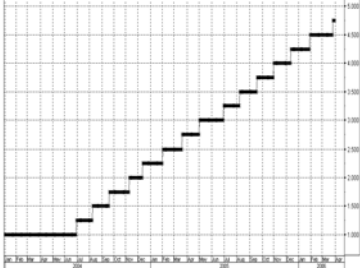




Fed Funds Target Rate 12/31/03-03/31/06



With 5, 10 and even 30 year Treasury issues selling at the same yield and the Federal Reserve likely to stop raising rates this year, our next strategy decision is to *make a call* on whether the Fed has it right or not.

Economic impact:

Monetary policy affects the economy with a lag. This makes the next six to nine months a very difficult period for the Fed. Since June of 2004 it has been raising short-term interest rates to reduce the amount of additional inflation it injects into the system.

If the Fed raises short-term rates too high, the economy will be starved for money and that will probably induce a recession nine to twelve months later. At the other extreme, if the Fed stops raising short-term rates at too low a level, real growth will be strong but inflation will further intensify.

Ideally, the Fed would like to stop raising rates at “the level” that creates enough new money to sustain real economic growth at about 3%, but with a somewhat lower inflation rate. This would extend the economic expansion, perhaps for years. The obvious problem is choosing “the level” when the most current economic data only reflects the level of interest rates months ago.

Clearly, the Fed must act based upon the intuition of its board members, *because there is no other choice.*

Market impact:

When the Fed stops raising rates, the economy will look good for the following six months regardless of whether or not it chose “the level” correctly. We think this will cause bond and stock prices to rise, perhaps for a few months. After that initial reaction, future returns will depend upon how good the board members’ intuition was.

If short-term rates were, in fact, already too high when the Fed acted, the opportunity to lengthen the duration of bond portfolios at attractive prices will diminish very rapidly and stocks

could enter a bear market phase that would foreshadow a recession. In theory the Fed could reverse course, but with reported inflation still climbing, that seems like an unlikely prospect and might not calm the markets anyway given the lagged effect.

If short-term rates were still too low to stop a further acceleration of inflation, owning long-term bonds will become a major disappointment a few months later. As inflation climbs, investors will start to fear even higher inflation and long-term rates are likely to move back up, probably well above current levels. Then the Fed would be forced to start raising short-term rates again, in an effort to catch-up with the rising level of fear in the marketplace. That fear would likely constrain or even depress stock prices.

Personalities matter:

With recent changes, including Greenspan’s departure, there is only one Washington Fed board member remaining with any practical experience in setting a new monetary policy. And Bernanke, the new Chairman, needs to assert his leadership of the board, a challenge that may lead him to take unnecessary risk. Both of these factors reduce the already low odds that the Fed will get it right.

The world is watching:

There was a time, not too long ago, when Fed policy could be geared to just our money supply and its affect on our domestic economy. We now have unparalleled levels of financial leverage in the world with trillions of dollars sloshing around the globe. This changes the dynamics of the Fed’s control, and very unstable markets could result that would challenge the Fed’s resolve to maintain its new policy.

Our strategy:

For the time being, we are maintaining a *below average duration in bond portfolios* and a *positive approach to stocks*, but sense a change in both our strategies could be near and wanted to signal it.