



## FOCUS POINTS

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### Markets this Quarter

During the second quarter, a virtually flat Treasury yield curve drifted up about 30 basis points for all maturities two years and longer, as new economic data confirmed our predictions that both inflation and growth in early 2006 were above the consensus. Through mid-May stocks continued their first quarter advance, but then turned sharply lower in two selling waves that took 100 points off the S&P 500 by mid-June. By month end, the index had retraced about half of its sell-off, but was still down for the quarter. Weak foreign markets undoubtedly caused stress and increased volatility in our markets.

The media focus is an effort to determine when the Fed will stop raising rates and what that will mean for the economy. Obviously, “when” is pure speculation while it is clearly pointless to guess the impact until the Fed does stop.

### Outlook for Growth

Some combination of waning real demand and less accommodative money is slowing projected economic growth for the next twelve months, but an above-average rate still looks likely. Government spending is still expansionary, exacerbated by a free-wheeling Congress trying to buy votes for re-election. Consumers are griping about energy prices but employment conditions are favorable, so spending for non-durables and services should expand. A continued moderation in the demand for houses and durables is in keeping with an aging cyclical recovery and should not lead to an economic crisis or downturn. As we have commented previously, business spending, aside from stock repurchases, has been cautious until very recently, when acquisition activity turned up. If that suggests growing confidence, then capacity expansion is likely to follow.

### Fed's Predicament

Expanding or contracting the money supply has a direct impact on the nominal or reported level of economic activity – a languid economy can be stimulated by pumping excessive amounts of money into the system and a vibrant economy will falter if it is starved for money. However, what portion of that change in nominal growth is **real** and what portion is a change in the rate of **inflation** is not solely determined by the Fed. This is part of what makes the Fed's job so difficult.

As interest rates moved above 5% some economists started to express concern that monetary policy was too tight. While it was comforting to hear the Fed acknowledge that possibility, it was very unsettling to read in the Fed's minutes: “Although the moderation in the growth of aggregate demand should help to limit inflation pressures over time...” **Regardless of the level of real growth in the economy, there still can be too much money in the system for that level and that excess money creates inflation.** So, if the Fed stops raising rates because nominal growth is slowing, but there is still too much money in the system, the result will be “stagflation.”

### Still too early to make THE call

Last quarter we foreshadowed the need to shift strategy and to *make a call* on whether the Fed has found a non-inflationary interest rate level when it stops raising rates. As long-term rates moved above 5% we moved to an **average duration in bond portfolios**, while maintaining a **positive approach to equities**. The time for *the call* is closer, but not yet here. Additional strategy changes may occur this quarter.