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TALKING POINTS

A Recap of September 2006

The Economy

It seems everywhere we turn, we hear analysts debating whether the US economy is headed for a soft or hard landing. The analysts go back and forth, with one side suggesting that an ugly recession is just around the corner and the other side countering that the economy will be sluggish, and that a full blown recession will probably be averted. Contrary to the assumptions built into this question, we do not believe that there will be any landing at all. Certainly, the economy has slowed; but with the head winds of 17 consecutive Fed rate hikes and a sharp pull-back in housing, this was to be expected. Fed Chairman Bernanke believes that the slowdown in housing could cut GDP growth by around a percentage point in the second half of 2006. These kind of short-term "pauses" happen in every expansion. For example, in the go-go 90's, between 1996 and 1999, there were three quarters of real GDP growth below 3%. More recently, in Q4 2004, real GDP fell to 2.6%. In such a large and dynamic economy, it is often difficult to explain the quarter-to-quarter fluctuations in economic activity. In these situations we advise investors to focus on the underlying fundamental drivers of economic growth: productivity and supply-side investment. Non-financial corporate productivity has increased an annualized 4.9% in the past six quarters, the fastest 6-quarter growth in thirty years. Over the same time period, business investment has increased at a 6.7% annualized rate – well above the post WW-II average of 4.6%. Both of these indicators suggest that the economy should accelerate in the quarters ahead. The air traffic controller can go to lunch; there will be no landing.

Indicator	Latest	Prior	Direction
ISM Index	**52.9** (Sep)	54.5 (Aug)	⇩
Durable Goods (M/M)	**0.0%** (Aug)	-2.8% (Jul)	⇧
Retail Sales (Ex Autos)	**0.2%** (Aug)	0.6% (Jul)	⇩
Chicago PMI	**62.1** (Sep)	57.1 (Aug)	⇧
Initial Claims (Weekly Avg.)	**313,000** (Sep)	317,000 (Aug)	⇩

The Stock Market

The three major indices were up in September with the DJIA, S&P 500 and Nasdaq Composite returning +2.7%, +2.6% and +3.5%, respectively. Small-cap stocks, as measured by the Russell 2000 Index, gained 0.8%. Some of the top performing S&P 500 groups in September were as follows: Home Furnishings (+13.4%); General Merchandise (+13.3%); Computer & Electronics Retail (+12.2%); Investment Banking & Brokerage (+10.5%); and Application Software (+10.2%). In September, the dividend-payers (384) in the S&P 500 (equal weight) posted a total return of 2.56%, vs. 2.76% for the non-payers (116). Y-T-D through September, the payers gained 9.18%, vs. 5.84% for the non-payers. For the 12-month period ended September 2006, payers gained 12.69%, vs. 6.83% for the non-payers. The number of dividend increases (S&P 500) year-to-date totaled 222, slightly lagging the 232 registered over the same period in 2005, but still above the 201 increases registered in 2004. The dividend yield on the S&P 500 was 1.86% at the end of September. It has not been above 3.00% consistently since 1991. With respect to performance, the three best months for the S&P 500 since 1950 are November (+1.7%), December (+1.7%) and January (+1.4%), according to the Stock Trader's Almanac. Since 1926, the average annual total return for the index is 10.4%, which means that 46% of the index's annual return has historically been generated over these three months.

Indicator	Latest	Prior	Direction
U.S. Dollar (U.S. Trade- Weighted Basket)	**0.87%** (Sep)	-0.40% (Aug)	⇧
AAII Sentiment Index	**51.3% Bullish** (9/30)	39.4% Bullish (8/31)	⇧
Short Interest (NYSE)	Sep: **9.74B** (+1.0%)	Aug: 9.64B (+3.7%)	⇧
Margin Debt (NYSE)	Aug: **$226.5B** (-2.2%)	Jul: $231.5B (+2.5%); *$278.5B in March 2000*	⇩

The Bond Market

The yield on the 10-Yr. T-Note fell 10 basis points in September closing at 4.63% – 30 basis points higher than on September 30, 2005. The returns on seven Lehman Bros. benchmark indices were as follows (September & **Y-T-D**): ***U.S. Treasury: Intermediate*** (0.73% & **2.72%**); ***GNMA*** (30-yr.) (0.59% & **3.03%**); ***Municipal Bond (22+)*** (0.83% & **4.92%**); ***U.S. Aggregate*** (0.88% & **3.06%**); ***U.S. Corporate High Yield*** (1.42% & **7.34%**); ***Global Aggregate*** (-0.01% & **4.49%**); and ***Emerging Markets*** (0.24% & **6.53%**). The combination of robust leveraged buyout activity and strong demand for bank debt is expected to boost the supply of senior loans over the next six months, according Standard & Poor's. S&P is anticipating $80 billion in new loans, the most since it began tracking such lending back in 1998. The expanded deal flow should be well received since strong demand has driven spreads down to record low levels. The default rate on senior loans remained at an 11-month low of 1.36% in August, according to Standard & Poor's LCD. The Standard & Poor's LCD default forecasting model predicts the default rate will climb to 2.48% by August 2007, still well below the historical average of 3.44%.

Key Rates as of September 29th

Fed Funds	5.25%
2-Yr. T-Note	4.69%
10-Yr. T-Note	4.63%
30-Yr. Mortgage	6.19%
Bond Buyer 40	4.68%

Key Yield Spread

The spread between the Merrill Lynch High Yield Master II Index and the 10-Yr. T-Note was 369 basis points on Sept. 29. The yield on the index was 8.32%. The spread was 380 basis points on Sept. 30, 2005, when the yield was 8.13%.

2006 Debt Issuance through August
(Source: Thomson Financial)

Debt Category	$ Amount (Billions)	% change over '05
Corporate	$940.8	+11.4%
Convertible	$7.6	+116.3%
Asset-Backed	$1.1 (Trillion)	-4.6%
Municipal	$235.3	-15.2%

The Investment Climate

Net cash inflows to equity funds totaled $4.8 billion in August, up from $738 million in July, according to the Investment Company Institute. Bond funds reported inflows totaling $6.7 billion, up from $3.2 billion in July. Money funds reported inflows totaling $42.7 billion, vs. inflows totaling $25.8 billion in July. Y-T-D through August, net cash flows into equity funds totaled $118.6 billion, vs. $30.5 billion for bond funds.