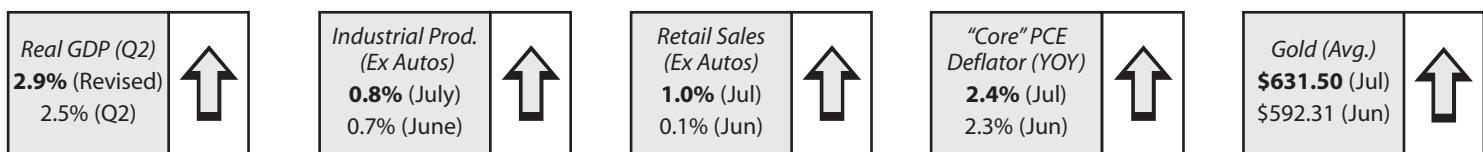


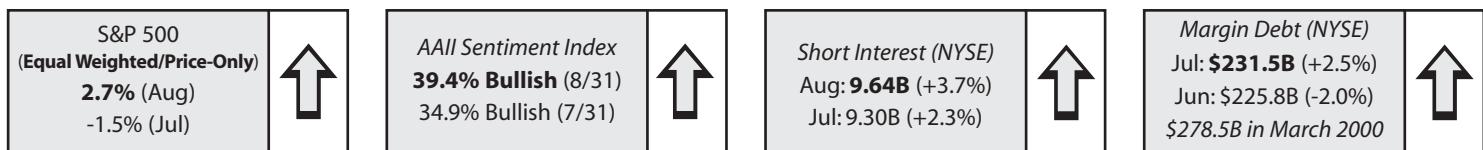
### The Economy

After 17 consecutive rate hikes by the Fed, which began in June 2004, the Fed finally decided to pause at its last FOMC meeting (August 8). The Fed paused because it believes that "economic growth has moderated," which in turn will cause inflation to "moderate over time." Part of the impetus behind the Fed's forecast of slower growth is based on a significant slowdown in the housing market. This has caused a major debate about whether the economy faces a soft or hard landing. But the data are not cooperating. In July, retail sales, excluding autos, increased 1.0% (9.2% in the past year), new orders for non-defense non-aircraft capital goods (a harbinger for business investment) increased 1.6% (12.8% in the past year) and industrial production, excluding autos, rose 0.8% (5.3% in the past year). With numbers like these it is very hard to imagine that the economy is coming in for any landing at all. We do not agree that weaker than expected second quarter real GDP growth (2.9% versus a 5.6% first quarter) signals any significant slowdown. If Babe Ruth hit a home run in his first at-bat and a triple in his second would a sportswriter suggest that the second at-bat means the Bambino was losing power and struggling? But, even if the economy slowed a bit, there is no historical correlation between growth and inflation. In the late 1990s, the economy boomed and inflation remained low. In the 1970s, the economy faltered, yet inflation rose to double-digit levels anyway. As a result, it is our belief that the two major assumptions by the Fed's staff – that the economy is slowing and that this slowdown will tame inflation – are wrong. Our forecast calls for 3.5% real GDP growth in the second half of this year and the "core" CPI to climb above 3%.



### The Stock Market

The three major indices were up in August with the DJIA, S&P 500 and Nasdaq Composite returning +2.1%, +2.4% and +4.5%, respectively. Small-cap stocks, as measured by the Russell 2000 Index, gained 3.0%. Some of the top performing S&P 500 groups in August were as follows: Construction Materials (+17.4%); Computer Storage & Peripherals (+15.2%); Internet Retail (+14.7%); Communications Equipment (+13.5%); and Electronic Equipment Manufacturers (+11.2%). In August, the dividend-payers (385) in the S&P 500 (equal weight) posted a total return of 2.07%, vs. 6.46% for the non-payers (115). Y-T-D through August, the payers gained 6.45%, vs. 2.99% for the non-payers. For the 12-month period ended August 2006, payers gained 10.70%, vs. 4.95% for the non-payers. The number of dividend increases (S&P 500) year-to-date totaled 214, nearly matching the 217 registered over the same period in 2005, but still well above the 185 increases registered in 2004. The dividend yield on the S&P 500 was 1.90% at the end of August. Stock buybacks involving the companies in the S&P 500 surged 43% year-over-year in the second quarter and were 175% higher than in the second quarter of 2004, according to Standard & Poor's. Companies spent a record \$116 billion on buybacks in the second quarter - eclipsing the previous high of \$104.3 billion spent in the fourth quarter of 2005. The total spent on buybacks over the last seven quarters was \$630 billion. Over 40% of companies reduced their share count in Q2.



### The Bond Market

The yield on the 10-Yr. T-Note fell 25 basis points in August closing at 4.73% – 71 basis points higher than on August 31, 2005. The returns on seven Lehman Bros. benchmark indices were as follows (August & Y-T-D): **U.S. Treasury: Intermediate** (1.12% & **1.98%**); **GNMA** (30-yr.) (1.56% & **2.43%**); **Municipal Bond (22+)** (1.87% & **4.05%**); **U.S. Aggregate** (1.53% & **2.16%**); **U.S. Corporate High Yield** (1.62% & **5.84%**); **Global Aggregate** (1.16% & **4.50%**); and **Emerging Markets** (2.37% & **6.28%**). Emerging markets debt has performed well in recent years thanks to an improved credit quality climate. For the 12-month period ended August 31, the Lehman Brothers Global Emerging Markets Index returned 10.3%, over four percentage points higher than the next best debt group – high yield corporates. The U.S. dollar is down 5.53% in 2006 against a basket of major currencies. Standard & Poor's has registered 61 upgrades this year through August 25, vs. 19 downgrades, according to S&P. The 24% downgrade ratio is up from 14% in 2005, but is still a huge improvement over the 83%, 66%, and 47% ratios posted in 2000, 2001, and 2002.

| Key Rates as of August 31 <sup>st</sup> |                   | Key Yield Spread   |                   | 2006 Debt Issuance through July<br>(Source: Thomson Financial) |                      |                   |
|---|-------------------|--|-------------------|--|----------------------|-------------------|
| Debt Category                           | % change over '05 | Debt Category  | % change over '05 | Debt Category  | \$ Amount (Billions) | % change over '05 |
| Fed Funds                               | 5.25%             | The spread between the Merrill Lynch High Yield Master II Index and the 10-Yr. T-Note was 374 basis points on August 31. The yield on the index was 8.47%. The spread was 396 basis points on August 31, 2005, when the yield was 7.98%. |                   | Corporate  | \$844.6              | +13.1%            |
| 2-Yr. T-Note                            | 4.78%             |  |                   | Convertible  | \$6.3                | +79.7%            |
| 10-Yr. T-Note                           | 4.73%             |  |                   | Asset-Backed   | \$961.6              | -2.5%             |
| 30-Yr. Mortgage                         | 6.38%             |  |                   | Municipal  | \$204.7              | -16.0%            |
| Bond Buyer 40                           | 4.73%             |  |                   |  |                      |                   |

### The Investment Climate

Net cash inflows from equity funds totaled \$585 million in July, compared to \$8.6 billion of cash outflows in June, according to the Investment Company Institute. Bond funds had inflows totaling \$3.2 billion, compared to outflows totaling \$362 million in June. Money funds reported inflows totaling \$26.8 billion, vs. inflows totaling \$19.8 billion in June. Y-T-D through July, net cash flows into equity funds totaled \$114.2 billion, vs. \$23.9 billion for bond funds.