



# 1<sup>ST</sup> QTR 2006

It appears that bond market investors recently woke up and surmised the U.S. economy is stronger than they thought. We have seen healthy employment increases and solid economic growth. Even though I was optimistic the Federal Reserve was almost done raising rates it looks like we have a further steady grind to higher rates during the second quarter.

The Treasury market had its worst annual start since 1999. Government debt including all maturities lost an average of -1.2%. So when you review the last page of your report titled "Total Return" this explains your paltry number. "Total Return" reports that on March 31<sup>st</sup>, if you liquidated your entire portfolio at the stated market price, what your rate of return would have been for the first quarter of 2006.

Coupon interest and dividends kept pace but as we know, when rates rise *all* bond prices decline. And it is that erosion which reduced your total return. You can see that when you notice "Unrealized Gains" is a negative number. That simply means you have small paper losses. Most accounts had price declines which pretty much equaled the interest and dividends earned...a pretty blah quarter no question.

Even with; the flat yield curve, bad inflationary news and commodity prices rocketing to twenty year highs, your portfolio maintained itself.

As I prematurely wrote in our fourth quarter 2005 Investment Outlook, these higher interest rates will snake through the economy and eventually slow it down. Take the California housing market for example. The inventory of unsold homes has doubled from a year ago. Homes on the market represented a 6.7 month supply in February up from 3.2 months a year ago. So even our

red-hot California housing market is taking a breather.

While so many market pundits are waiting for another shoe to drop, by virtue of their worrywart messages, economic growth continues to move along quite well. With fifteen interest rate hikes during the past twenty-one months, oil over \$65 a barrel, gold around \$600 an ounce, commodity prices at twenty year highs etc., etc. Don't you think it's amazing rates are this tame?? Well I do, I've never been through a bond market cycle when economic data and commodity prices could "nuke" the bond market but haven't.

Our economic expansion is growing old by historical measures. Our normal expansion runs around five years. Sure, there have been exceptions but that's the average. And while Standard & Poors 500 non-financial profit margins are at a high; cash balances are leveling off. Must be all the money spent on increasing shareholder value and takeovers.

Municipal bond investors have also mildly suffered as rates have increased but there's been no event risk, credit quality risk, or merger and acquisitions. Munis trade off into a world of their own invariably shaken by higher rates rather than the event risk that presently plagues corporates.

So even though your account and every investment grade corporate and municipal fund produced rather colorless, flat total returns, this certainly will end soon. The Federal Reserve is at the tail end of its tightening cycle. I can hardly wait for this bear market in bonds to be over.

As always, we appreciate your business.

Marilyn