Talking Points: Summer 2006 Update

The Economy -- Second Quarter Slowdown

1. **Second quarter real GDP growth slowed to a 3.0% rate from 5.6% in the prior quarter and is likely to remain in a 2.5% to 3.0% range in the second half of the year.**

   The most prominent weakness is evident in housing which benefited earlier from historically low interest rates and speculative demand stimulated by rapidly rising prices for residential property.

   - **US home construction averaged an annual rate of 1.931 million units in the second quarter, the lowest since the three months ended November 2004. Home building decreased at an annual rate of 6.3% during the period, the most in six years. Building permits, a sign of future construction, fell 2.1% according to the Commerce Department.**

   - **The National Association of Realtors reported a 1.3% decline in home resales in June to an annual rate of 6.62 million, the slowest in four months. Meanwhile, the supply of homes for sale rose to the highest level since July 1997 increasing about 6% to 3.725 million, bringing inventories up to 6.8 months worth at the end of June. Historically, a supply of 5½ to 6 months is considered normal.**

The Economy -- Second Quarter Slowdown (continued)

- **Confidence among US homebuilders dropped to an eleven year low in May with the NAHB/Wells Fargo index declining to 42, the lowest level since 1995. A reading below 50 signals pessimists outnumber optimists. Several national homebuilders have recently slashed earnings estimates due cancellations and to slower than expected sales.**

- **While housing continues to weaken, the economy is benefiting from increased commercial construction which rose 2.7% in June, up 22% from the same month last year.**

2. **Other data confirm the slowdown as consumers pull back due to higher interest rates, high gasoline prices, and a reversal of the "wealth effect":**

    - **Consumer spending rose 0.4% in June, the smallest monthly gain this year.**

    - **Retail sales, which account for almost half of consumer spending, and about 70% of the economy, declined 0.1% in June -- the first drop since February. Autos, electronics, and building materials were weak.**

    - **The Conference Board's index of leading economic indicators increased 0.1% in June after falling 0.6% in May, the most in nine months, signaling the robust pace of growth earlier this year will give way to a slower expansion. Our firm's proprietary Economic Model confirms this trend. (See page 12)**

    - **US vehicle sales dropped 11% in June -- the fifth straight monthly decline -- as rising energy prices, acting as a tax on consumers, have blunted demand for trucks which account for a majority of sales at the three US based automakers.**

    - **Personal Consumption expenditures increased only 0.4% in June, the smallest gain this year.**

The Economy -- No Recession But Slower Growth Will Persist Through Year End

1. **Despite signs of slowing in housing and consumer spending, growth continued, albeit at a more moderate pace, since midyear.**

   - **July retail sales rebounded 1.0% (ex autos) exceeding expectations lending credibility to the view consumers will continue to spend despite the headwinds of high energy prices and the deteriorating housing market.**

   - **Projecting slower but continued expansion, the Institute of Supply Management's (ISM) index of non-manufacturing businesses including banks, builders, and retailers, fell to 54.8 in July from 57 in June. Readings above 50 indicate growth in the index, which includes industries that account for almost 90% of the economy.**

   - **Also portending continued expansion, the ISM's factory index unexpectedly upticked to 54.7 in July from 53.8 the previous month.**

   - **Durable goods orders remain strong, increasing 3.1% in June suggesting factories should continue to operate at close to full capacity.**

   - **The Conference Boards' index of consumer confidence unexpectedly increased in July to 106.5 the highest in three months bolstered by gains in employment and income helping to mitigate the effect of rising gasoline prices and interest rates.**

   - **Industrial production increased in the second quarter at an annual rate of 6.6% -- the fastest since the final three months of 1997 -- a sign corporate investment is sustaining growth as consumer spending slows. The ongoing efforts to compete in today's global economy are going to keep businesses -- operating at 82.4% of capacity -- investing.**

The Economy -- No Recession But Slower Growth Will Persist Through Year End (contd.)

- May US trade figures show the deficit may be leveling off as faster economic growth in Europe and Asia spurs exports at the same time a slowdown in the US keeps a lid on US imports. The dollar's 4% decline in the last year is making US goods cheaper abroad.

2. But, signs of the slowdown abound.

- July payroll growth remained slow at 113,000 and the unemployment rate climbed to 4.8% after a sharp reduction in the number of new jobs created in the second quarter.

- Consumer spending is currently growing at a 2+% rate -- down from about 5% earlier this year.

- Housing will remain weak for a considerable period. The Mortgage Bankers Association's index of applications to purchase or refinance a loan fell 30% year-over-year in the last week of July, the lowest reading in over four years.

- S&P profits, which have increased at double-digit rates for 14 consecutive quarters, probably grew at over 14% in the second quarter. 8-10% growth is forecast for the next two quarters.

The Fed Has Paused But Investors Remain Skeptical It's Through

1. Should the Fed raise rates further?

- The economy is clearly slowing limiting job growth.

- But, the Personal Consumption Index inflation rate is above the Fed's "acceptable" 1-2% range and inflation, a lagging indicator, is likely to remain elevated for several months.

The Fed Has Paused But Investors Remain Skeptical It’s Through (continued)

- **Market based inflation indicators such as commodity prices, including gold, and the inflation rate implied by TIPS (Inflation Protected US Treasury Bonds) remain mixed.**

- **Despite high energy costs, thus far there has been little translation of this pressure into “core” consumer inflation rates.**

- **Further rate increases would act as a brake on growth.**

2. **Is it only a matter of time before slower growth tamps down inflation pressures?**

Fixed Income Strategy -- Beginning to Buy Bonds

1. **Rates have remained historically low for good reasons.**

- **There is a widespread belief the Fed has the commitment and capacity to do what is necessary to control inflation.**

- **We continue to experience massive demand for dollar-denominated fixed income assets as a result of surplus global savings and our own Current Account deficit.**

- **There is a global hunger for yield.**

- **The issuance of new corporate bonds has been meager.**

- **The US economy is entering a period of slower growth due, in part, to weaker housing and consumer spending. This softening will reduce labor cost pressures and diminish the ability of corporations to raise prices eventually muting inflation.**

Fixed Income Strategy -- Beginning to Buy Bonds (continued)

- **Higher short term rates and reduced liquidity, as central banks work to control inflation, are dampening economic strength through a number of avenues including weaker stock prices, deteriorating housing prices and activity, and wider credit spreads in the emerging market sector. A consequence of these developments is a reversal of the wealth effect and consumers' willingness to spend.**

2. **Until recently, bond investors were not being adequately compensated for inflation and market risks.**

3. **Given the likelihood bond rates are near their peaks for this cycle we began to increase portfolio durations as rates on 5-year US Treasury bonds rose to 5% late this spring.**

4. **Expecting the eventual widening of credit spreads as the economic cycle matures, we have limited purchases to US Treasury notes in taxable portfolios.**

Equity Investment Strategy

1. **We are witnessing a re-run of 1994-95. Stocks went nowhere until it was clear to investors the Fed was done raising rates -- not yet a sure thing.**

2. **Stock prices have lagged corporate profit growth by a wide margin. (See page 10)**

3. **Large cap stocks absolute and relative valuations have been declining steadily for almost seven years (See page 11). As a result, today's relative valuations are at 20 year lows. While the catalyst for a conclusive reversal in this trend remains elusive, the recent tightening of global liquidity and prospects of slower earnings growth may do the trick.**

Equity Investment Strategy (continued)

4. During the most recent market correction, the most volatile asset classes have had sharp corrections while large cap stocks, as measured by the S&P 500, have been resilient.

Index	Four Months Performance
Nasdaq Composite	(10.8)%
Russell 2000	(10.6)%
DJ Transportation	(10.1)%
S&P Small Cap 600 Index	(9.9)%
S&P Mid Cap Index	(9.3)%
MSCI Emerging Markets Index	(8.7)%
Russell 3000 Index	(4.1)%
MSCI EAFE Index	(3.2)%
S&P 500 Index	(2.9)%

5. While not immune from random geopolitical shocks, US large cap equities remain extremely attractive from a valuation standpoint.

	S&P 500	Russell 2000
Estimated P/E Ratio	15x	23x
Dividend Yield	1.92%	1.24%

6. The Fed Valuation Model (see page 9) shows stocks to be 28% undervalued when compared with bonds.

Equity Investment Strategy (continued)

7. The metrics of equity portfolios under our management remain compelling.

	2007 P/E	Estimated Future Growth Rate	Dividend Yield	ROE	P/E to Future Growth Rate
FBA Average Growth Stock	16x	14%	1.2%	30%	1.4
FBA Average Value Stock	11x	11%	2.5%	22%	1.2
FBA Total Portfolio	14x	12%	1.8%	27%	1.3
S&P 500	14x	7%	1.9%	20%	1.9

8. Many "growth" stocks are now priced as "value" stocks. Our portfolio is, therefore, more closely balanced between "growth and value" than at year-end 2005.

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Fed Valuation Model

The Fed stock market valuation model, which incorporates the yield on 10 year US Treasury Notes and estimated S&P 500 profits, shows stocks remain undervalued.

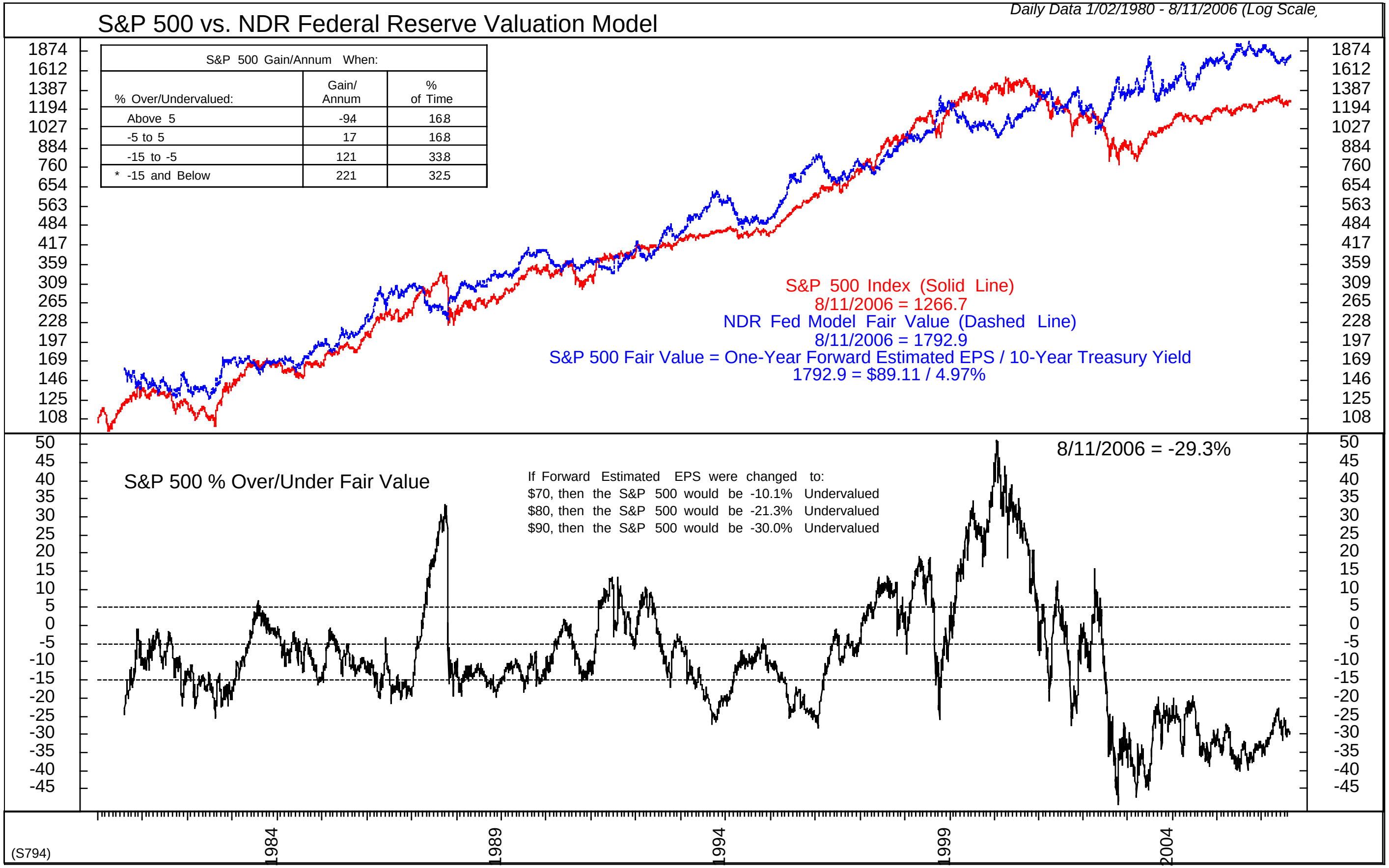
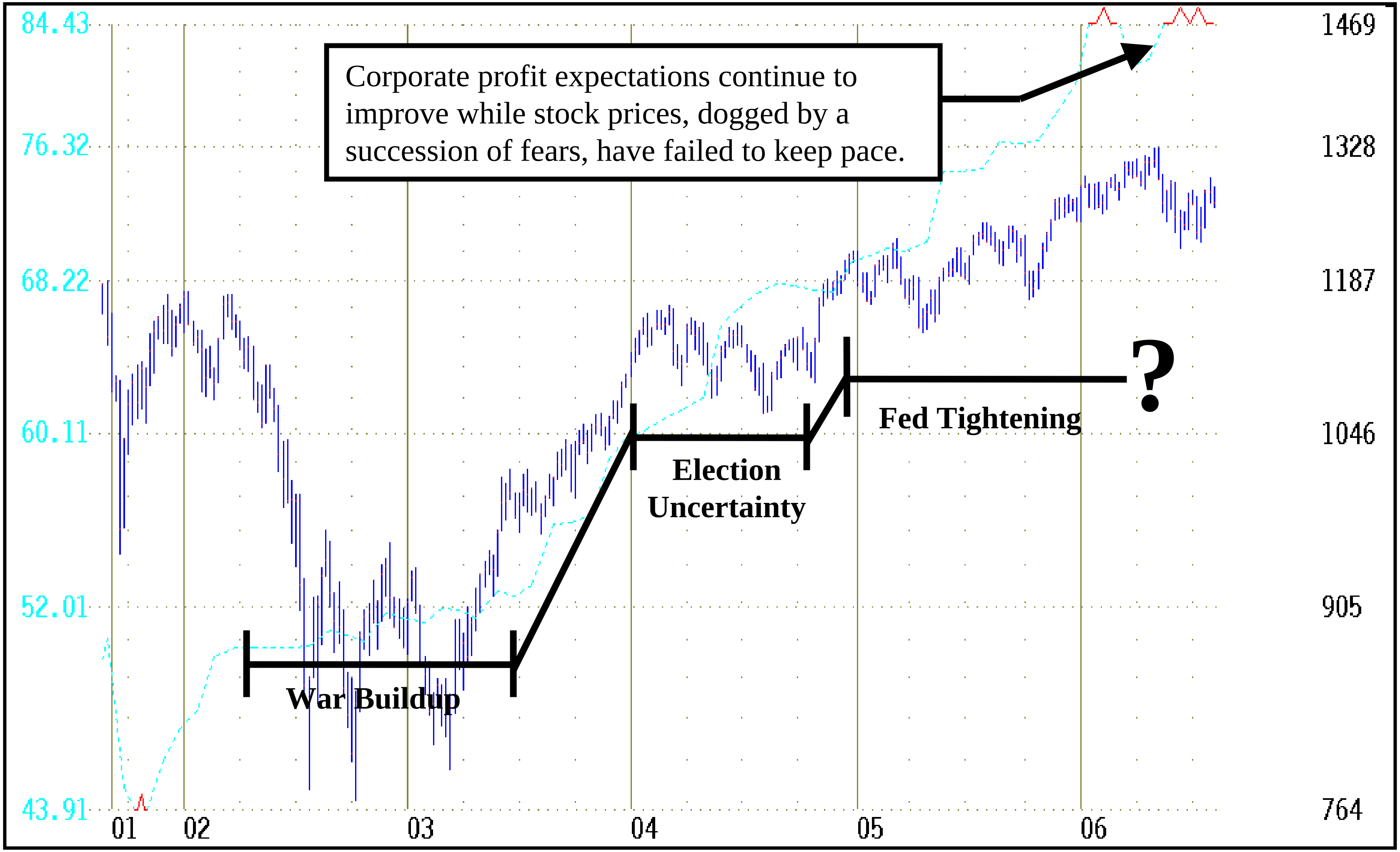
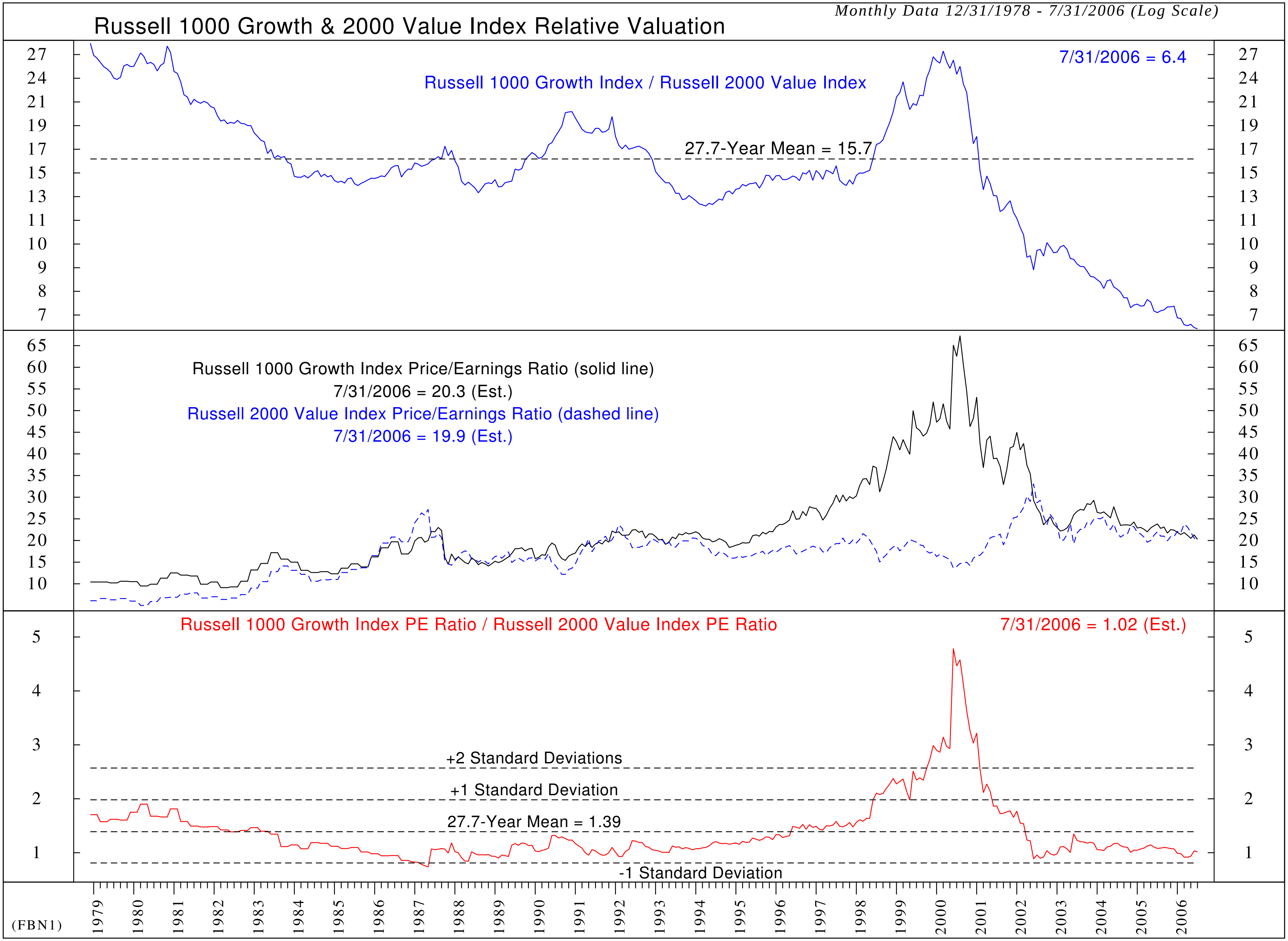


Chart Courtesy of Ned Davis Research

S&P 500 vs. Consensus Earnings Estimate for the S&P 500




Monthly Data 12/31/1978 - 7/31/2006 (Log Scale)
Russell 1000 Growth & 2000 Value Index Relative Valuation
7/31/2006 = 6.4
Russell 1000 Growth Index / Russell 2000 Value Index
27.7-Year Mean = 15.7
Russell 1000 Growth Index Price/Earnings Ratio (solid line)
7/31/2006 = 20.3 (Est.)
Russell 2000 Value Index Price/Earnings Ratio (dashed line)
7/31/2006 = 19.9 (Est.)
Russell 1000 Growth Index PE Ratio / Russell 2000 Value Index PE Ratio
7/31/2006 = 1.02 (Est.)
+2 Standard Deviations
+1 Standard Deviation
27.7-Year Mean = 1.39
-1 Standard Deviation
(FBN1)
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Front Barnett Associates Economic Model