July, 2007

2007 Second Quarter Update

Review: Stocks had a strong quarter, rising 6.3%. The first half increase was 7.0%. Bonds fell by 0.1%, but gained 1.5% for the half.

	2Q07	***1Q07***	***4Q06***	***3Q06***	***2Q06***
S&P 500 Index	***6.3%***	0.6%*	6.6%	5.7%	-1.4%
Merrill Lynch Intermediate Bond Index	***-0.1%***	1.6%	1.0%	3.2%	0.2%

* corrected

The Economy: There were increased cross currents in the second-quarter economic data. The key positive was the employment picture. The job market remained strong, fueled by hiring in education, healthcare and government. However, cyclically sensitive industries, such as retail, shed jobs.

Housing and energy prices were the clear negatives. The housing market continued to slide. Tightening credit standards in the mortgage market hurt housing sales. Energy prices remained high due to strong global demand.

Other data were mixed. Retail sales have been good at upscale stores, but retailers such as Wal-Mart have seen slower sales. Capital spending, which had been expected to boost the economy, has slowed to a tepid pace.

Our outlook for the economy is slightly more cautious than last quarter. We expect consumer spending to grow at 2.0-2.5%, this year, down from the 3.2% rate recorded in 2006. With slower consumer growth and lackluster capital spending growth, real GDP growth will also likely slow, from 3.4% in 2006 to 2.5% this year. In summary, we look for below trend economic growth for the US.

In contrast to the US, global growth continues to be robust. A recent International Monetary Fund forecast calls for 4.9% growth for the world. Emerging Asia is projected to grow even faster, at more than 8%. Export demand to meet the infrastructure needs of the emerging economies has boosted many US companies' order books.

In the past, emerging economies have suffered disproportionately when the developed economies, such as the US, have slowed. Now, however, large currency reserves and the emergence of a middle class will help insulate these economies from weakness in the developed economies. Therefore, strong growth can continue in developing economies.

Stock Market: As first quarter corporate earnings were announced, it became clear that the economy was still doing reasonably well and stocks responded with a strong gain. However, investors' appetite for risk decreased, and high-quality stocks outperformed riskier stocks- a rare occurrence in recent years.

Bond market: For the bond market, the second quarter was almost a mirror image of the first quarter. Early in the second quarter bond investors believed that the Fed would cut interest rates in the second half of the year. As the strength of corporate earnings became evident, rates increased because investors became convinced that the Fed would not cut rates until at least early next year. With the yield on the five-year Treasury note up sharply to near 5%, bonds are becoming more attractive. We expect the Fed to keep rates unchanged through 2007.

With the turmoil in the sub-prime mortgage market and the veritable explosion of supply of low-quality bond offerings to fund corporate buyouts, bond investors became more concerned about risk. We expect spreads between high quality and low quality bonds to widen.

Strategy: As we look forward to the second half of the year, we expect the US consumer economy to remain soft due to weakness in housing and high energy prices, while global growth will be strong. Over the past quarter we have moved our equity portfolios to a more conservative posture by cutting back economically sensitive and high multiple stocks. Our purchases have been stocks such as AT&T, Verizon, Walgreen and Northern Trust that will do well even in a time of economic softness. We maintain a significant exposure to high quality stocks that will benefit from robust international growth, such as General Electric, Procter & Gamble, and Exxon.

Our valuation work indicates that stocks still have more potential over the next year than bonds, but the margin has narrowed. We will consider increasing the ratio of bonds in our balanced portfolios, and extending the average maturity to lock in higher yields for a longer period if bond yields continue to increase.