The Oarsman Outlook

First Quarter 2006

Stubbornly high energy prices and rising interest rates proved no obstacle to global stock markets in the first quarter, as gains were both ample and abundant. Larger-company U.S. stocks nearly equaled in just three months their performance for all of 2005, while small-company stocks, non-U.S. stocks and real estate securities all posted double-digit three-month returns. Accelerating global economic growth, coupled with renewed worries over rising prices, pushed bond yields to their highest in two years, however, resulting in lackluster returns from all but the shortest-maturity fixed-income investments.

Within the U.S. stock market, the strongest sectors were Communication Services, Capital Goods, Energy and Basic Materials; lagging the averages were issues in the Utilities, Financial Services, Consumer Staples and Health Care sectors. Non-U.S. stock performance was paced by Hong Kong-listed Chinese stocks, which gained more than 20%.

Benchmark Performance – Equities

	First Quarter 2006	Last Twelve Months
S&P 500 Index	+4.2%	+11.7%
Dow Jones Industrial Avg.	+4.2%	+8.3%
NASDAQ Composite	+6.4%	+17.2%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+3.9%	+11.6%
Small-Cap Stocks (Russell 2000)	+13.9%	+25.9%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+9.4%	+27.7%

Benchmark Performance – Fixed Income

	First Quarter 2006	Last Twelve Months
Lehman Aggregate Bond Index (taxable)	-0.6%	+2.3%
Lehman Municipal Bond Index (tax-exempt)	+0.2%	+3.8%

Review

Investors expended considerable mental energy during the first quarter attempting to divine the near-term course of U.S. monetary policy. Federal Reserve policymakers surprised no one by raising overnight interest rates 25 basis points at each of their two first-quarter meetings (one-half percentage point, in total). More important, the Fed indicated that, after being essentially "on autopilot" for much of the past two years as it raised rates from abnormally low levels, it had returned to a more normal mode in which future policy actions would be dependent on the tone of incoming economic data.

Notwithstanding a weak but backward-looking report of fourth-quarter 2005 gross domestic product growth (+1.7%), recent data depict a U.S. economy seemingly shrugging off high energy prices, rising interest rates and a cooling real estate market, and growing at a healthy clip of 4% or more in the first quarter. Although most indicators suggest inflation remains subdued, investors nevertheless have concluded the Fed is likely to keep raising rates in the months ahead, and pushed the benchmark 10-year Treasury yield from 4.39% at yearend to 4.85%, a level not seen since mid-2004.

Meanwhile, American businesses continued to fire on all cylinders. According to Standard & Poor's, aggregate corporate profits grew by 14% in the fourth quarter of 2005 (compared to a year earlier), marking the tenth consecutive double-digit gain. Moreover, relatively few companies have "pre-announced" disappointing figures for the first quarter of 2006, which is expected to show another 11% rise. American companies also stepped up their return of cash to shareholders. Among the companies that make up the S&P 500 Index, dividend payments increased more than 14% in 2005, while stock buybacks surged to $349 billion, a 77% increase over the 2004 figure.

Outlook

The economic and market outlook seems murkier today than for much of the past two years. The U.S. economy appears, in the short run, highly dependent on the fate of the housing market, specifically how the unfolding slow-down will impact consumers. We continue to expect ample gains in business spending, as U.S. companies enjoy high returns on capital and global competition places a premium on increasing efficiency. Likewise, we expect accelerating demand from abroad (see below) to fuel growth in the export sector. But these sources account for less than 30% of the U.S. economy, compared with nearly 70% for consumer spending. Recent data suggest that, as long as the job market remains firm and prices of other asset (e.g., stocks) hold up, a modest slow-down in real estate may do little to dent consumer confidence and spending. A more pronounced housing downturn, however, would be almost certain to cause consumers to retrench, and poses the biggest risk to the economic outlook.

Similarly, the near-term trajectory of U.S. financial markets may be more-than-usually dependent on what appear to be the less-than-usually-predictable actions of the Federal Reserve. Investors seem to be anticipating one or two more quarter-point rate increases in coming months, at which point the Fed would go "on hold" for a time, before eventually beginning to reduce rates. Barring evidence – as yet absent – of a sustained rise in inflation, robust growth statistics like those tallied in recent weeks should not cause the Fed to raise rates much further. But worrisome inflation data would likely prompt a more aggressive response from the Fed, and cause increasing concern among investors about a substantial economic slowdown, or even recession, in 2007.

We believe inflation is well contained: oil and other commodities are less important cost factors today than in the past; commodity prices have already soared for two years without any appreciable "pass through" into general inflation; globalization and technology remain powerful deflationary forces; and yield spreads between inflation-indexed and regular Treasury bonds suggest longer-term inflation expectations peaked a year or more ago. We also think Fed policymakers share our view regarding the importance of the housing sector, and are acutely aware of how sensitive this sector is to rising interest rates. Accordingly, we judge they will prefer risking slightly higher inflation (which they know how to combat) rather than possibly inflicting major economic damage via a real estate implosion with disturbing *deflationary* implications (where their credentials are unproven).

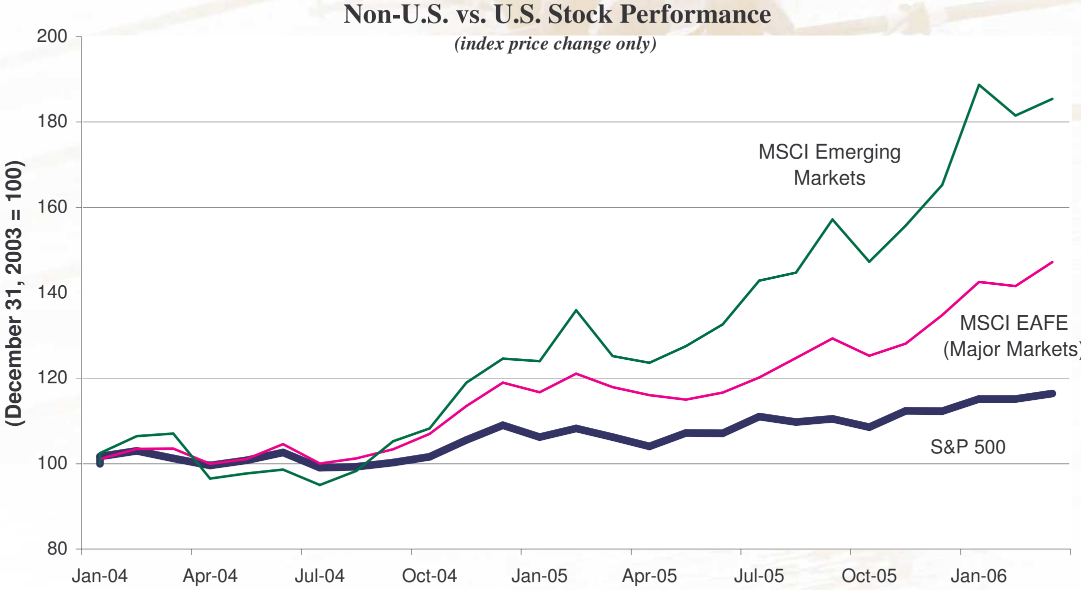
Outside the U.S.

The situation abroad seems more clear-cut: growth is accelerating across an expanding front. China's economy continues to grow at an eye-popping annual rate north of 9% and, importantly, appears to be entering a more balanced phase, less dependent on potentially volatile capital spending. In Europe, a closely-watched measure of German business sentiment has reached its highest level since the reunification-induced euphoria of 1991, suggesting growth in that region's largest economy is set to tick up. Finally, the emergence of the Japanese economy – the world's second largest – from its 15-year deflationary malaise seems likely to be an important impetus to global growth. While vexing impediments to sustained growth remain, the Japanese economy has been expanding steadily in recent quarters and both business and consumer confidence are clearly on the mend.

The strong performance of non-U.S. stock markets over the past two years (see chart below) already largely discounts improving economic prospects. Moreover, foreign central banks are beginning to raise interest rates, while the U.S. Fed appears set to go on hold, reversing the favorable relative-monetary-policy environment that benefited non-U.S. markets in 2004 and 2005. While these factors may augur a pause in the out-performance of non-U.S. stocks, we believe these investments remain attractive. In the near term, both relative-growth and monetary-policy trends could lead to renewed depreciation of the U.S. currency, which would boost returns to dollar-based investors. Longer-term, we believe non-U.S. stocks will continue to add value as portfolio diversifiers and as hedges against structural imbalances that loom over the U.S. economy.

Non-U.S. vs. U.S. Stock Performance

(index price change only)



Pulling it All Together

If the Fed soon stops raising short-term rates, the U.S. housing market will cool rather than collapse, while corporate profits will keep expanding, albeit at a slower rate than over the past three years. Employment growth should remain reasonably healthy, allowing consumer spending to slow only modestly, in turn yielding only slightly-below-average aggregate (GDP) growth of between 2% and 3% for the remainder of the year. A shift in global economic growth away from the U.S., perhaps coupled with a weaker dollar, will boost exports (and the earnings of U.S.-based multinationals) and begin to shrink the trade deficit. Finally, absent a monetary-policy headwind for the first time in two years, valuations of financial investments – both stocks and bonds – could be expected to rise.