



Report Card

At the time of this writing, which is more than a week before the end of June, it appears that our clients will be observing soundly positive results for the second quarter in both their common stock investments as well as in bonds.

A later article in this newsletter addresses in more detail the outcome of changes in interest rates, and a deepening of Federal Reserve Chairman Greenspan's "conundrum" in the seemingly quixotical movement downward of longer term interest rates.

Nevertheless, it is heartening to experience these positive returns in the second quarter. This article will finish with our observation on what the U.S. economy may be presenting later this year, which we believe will provide a recipe for a healthy stock market, much to the chagrin of our domestic media.

Headwinds: Forward Progress Impeded

Sailors know how much quicker forward progress can be when you have favorable winds. Such progress is not necessarily doomed by headwinds, but the rate is decidedly slowed. In the past year, huge increases in the price of energy and the cost of borrowed money have provided economic headwinds which are just now beginning to manifest themselves in the world's developed economies. The lesser developed countries are smarting under the same influences, but the larger economies are the focus of the major "engines" which drive our global economic picture.

What immediately follows is a tongue-in-cheek look at our economy and securities markets from a weatherman's perspective.

Securities Markets Weather Report

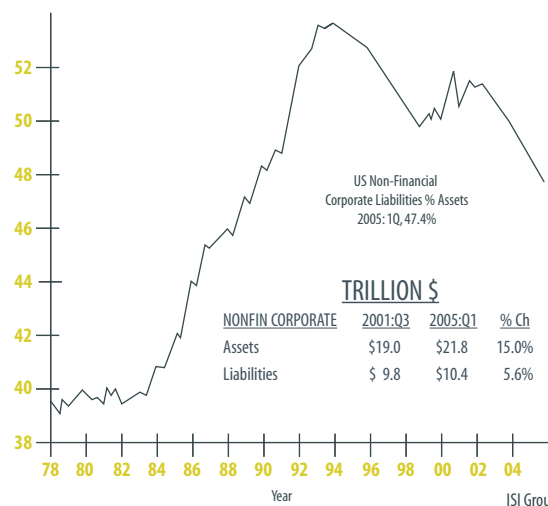
Expect unsettled conditions due to higher short-term interest rates moving in from many directions and higher oil prices emanating from the east. Anticipate less economic sunshine as these headwinds have their way with business and consumer spending plans, here and around the world.

Is a Storm on the Horizon ?

Do these unsettled conditions mean we're approaching the end of economic growth in this cycle and that a recession is on the way? No! We are confident that, short of an unexpected crisis we cannot anticipate at this time, our economy is strong, not overheated, and will continue to produce growth in business activity, job creation, and profits.

We draw your attention to the following chart, courtesy of the ISI Group, which points out the very large improvement in non-financial corporate balance sheets since the low level reached in the 2001 recession. From the third quarter of 2001 to the first quarter of 2005 (3.5 years' elapsed time), assets increased 15.0% while liabilities increased only 5.6%. Paraphrasing this observation: There has been a "solid" gain in corporate assets vs. a very "restrained" growth in corporate liabilities.

HEALTHIER CORPORATE BALANCE SHEETS



Therefore, short of an unexpected financial crisis from source(s) unknown, we do NOT anticipate a financial storm.

Providing professional investment management to individuals, retirement plans, and charitable organizations since 1930.

AT A GLANCE

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So, Where's the Stock Market Going ?

QUESTION: With the economy still doing quite well, why hasn't the stock market continued to escalate in 2005, after having turned in a magnificent gain in 2003 and a near average gain (close to 11% for the S&P 500) in 2004?

ANSWER: History tells us that the stock and bond markets have big trouble making headway when the Federal Reserve keeps raising interest rates, even though economic conditions which are normally conducive to good stock market performance may be in place. In addition to the headwind of the Fed raising short-term interest rates, there is a high correlation of escalating energy prices causing a lagged decrease in economic activity (growth in GDP), the time lag being about one year. This is our second major headwind.

Economic Conditions Here and Abroad

In the U.S. the evidence is clear that both of these headwind factors are causing a moderate slowing in the growth of economic activity. Please note that we are saying "slowing," not a cessation, of growth.

One of Wall Street's clearest thinkers (in our opinion) is Ed Yardeni, who has offered us his insights as to why the economy has continued to do so well. He refers to pay per worker, which he defines as total wages and salaries divided by payroll employment, which came in \$700 stronger than the original estimates, totaling \$42,494 this past March. The very next month, the number gained \$224 to a record \$42,718. With gasoline prices 22 cents per gallon higher than a year ago, Ed quips, "... these numbers help to explain why higher gasoline prices haven't stopped consumers from getting into their SUVs, filling up the tank, and going shopping."

Yet, when we look outside our borders, there is even more evidence of slowing economies, some even experiencing moderate recession. According to ISI research, one of the foremost authorities on international strategy and investing, there are currently twelve foreign central banks which are contemplating lowering their short-term interest rates, with the intended effect of once again stimulating their local economies. Such reduction in local interest rates also serves to weaken their currency relative to trading partners, with the net result of effectively lowering the prices of the goods

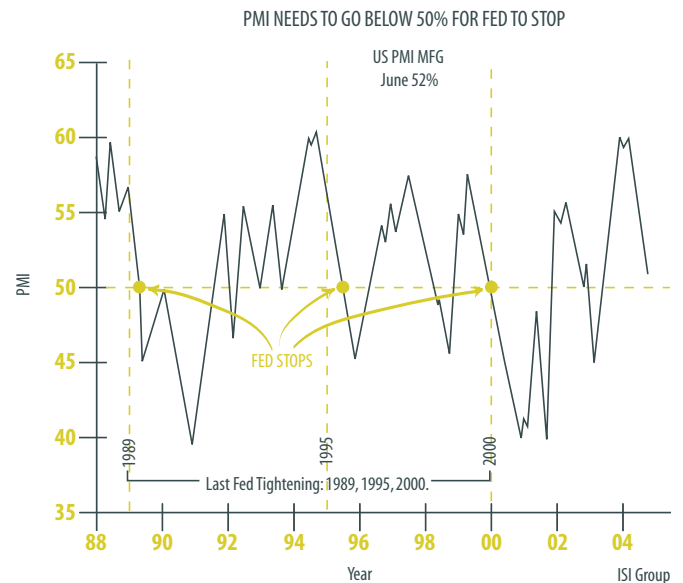
and services they export, affording them a competitive advantage on the international market.

Sunshine in the Forecast

Given a weakening of foreign economies, and also understanding that the U.S. economy is no longer as insulated as used to be the case, we're now anticipating that our Federal Reserve Board may be getting close to the end of this escalating interest rate cycle. We must be clear that we do believe there will be more increases of moderate size, but it now looks like a matter of a few months remaining.

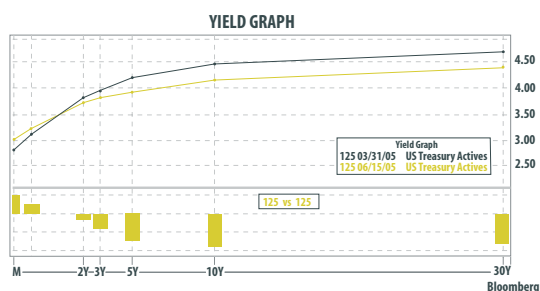
It is interesting to observe that the Fed, in the past three tightening cycles (1989, 1995 and 2000) stopped raising short-term interest rates when the Purchasing Managers Index dropped below 50%. The ISI Group expects this index to "slip below 50% at least by October."

Once the Fed ceases raising our domestic short-term rates, it is our sense that there will be clearer sailing for higher stock prices. Then, we expect we'll have the pleasure of reporting even more satisfying performance reviews for our clients.



Bond Market Overview

With every quarterly newsletter, we give our clients an update on trends in interest rates. As of our last writing, we noted that there had been an increase in interest rates across the board. The entire yield curve had shifted up. At that time, we questioned whether this increase was the precursor to the widely anticipated rise in long-term interest rates due to the Federal Reserve Board's monetary policy. Well, the following graph answers that question.



On the very short end of the curve, there was a slight increase. The longer maturities decreased substantially. This is good news for our fixed income portfolios, since lower yields mean higher prices and positive performance.

Yield Table

125 US Treasury Actives 3/31/05		125 US Treasury Actives 6/15/05		Spread	
Term	Description	Yield	Description		
3 Mos.	B 0 6/30/05	2.7767 BBT	B 0 9/15/05	2.9929 BBT	0.2162
6 Mos.	B 0 9/29/05	3.1248 BBT	B 0 12/15/05	3.2192 BBT	0.0944
2 Yrs.	T 3 ³ / ₄ 3/31/07	3.7848 BBT	T 3 ¹ / ₂ 5/31/07	3.7124 BBT	-0.0724
3 Yrs.	T 3 ³ / ₈ 2/15/08	3.9277 BBT	T 3 ³ / ₄ 5/15/08	3.7705 BBT	-0.1572
5 Yrs.	T 4 3/15/10	4.1679 BBT	T 3 ⁵ / ₈ 6/15/10	3.8818 BBT	-0.2861
10 Yrs.	T 4 2/15/15	4.4835 BBT	T 4 ¹ / ₈ 5/15/15	4.1053 BBT	-0.3782
30 Yrs.	T 5 ³ / ₈ 2/15/31	4.7567 BBT	T 5 ³ / ₈ 2/15/31	4.4029 BBT	-0.3538

What occurred during the period that affected the yield curve? Short-term rates increased due to another Federal Funds increase of 25 basis points (0.25%) on May 3. There was a 25 basis point increase on March 22 as well.

With the last increase, the Federal Reserve has moved the short-term benchmark rate higher eight times, from 1% to the current 3%. However, as we have been writing in our newsletters for some time now, the trend in the yield curve continues to “flatten.” Short rates go up while long rates come down. A number of economic factors affected long-term interest rates.

Last quarter, investors were concerned that inflation was accelerating and that the Federal Reserve would have to increase the pace of monetary tightening (increasing the Federal Funds rate more rapidly). This quarter, those concerns are diminishing due to data that indicates a “softening” of economic growth. Some of these factors are:

- Lower-than-expected CPI (Consumer Price Index) readings for the last two months.
- Lower-than-expected GDP (Gross Domestic Product) readings for the last three months.
- Lower-than-expected Non-Farm payrolls (measure of new job creation) in two of the last three months.

These are not the only measurements of economic activity that affect economic growth. However, the bond market does pay very close attention to these, and others, to formulate expectations of inflation and longer term rates. One fact remains very clear; the volatility in the bond market will continue until investors are more certain the Federal Reserve may be nearing an end to increasing short-term rates. When will we know? We can't ever know for certain. Nevertheless, the market does provide insight into future expectations through the futures markets. Currently, the December Fed Funds futures contract is trading with an implied yield of approximately, 3.80%. It hit a recent high of 4.06% on March 28. Clearly, expectations for further Fed tightening still do exist. Given the current economic information available to the market, investors' expectations are for at least three more 25 basis point increases in short-term rates, to a 3.75% Federal Funds Rate.

If the market is correct in its expectations, this gives additional support to those who believe that longer term rates should not increase much more in the near future unless inflationary pressures begin to accelerate.

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Nobody Likes Paying Taxes, but Everyone Must Deal with Them

We wanted to take a short amount of space to walk through a sensitive topic—taxes. Nobody likes paying taxes, but everyone must deal with them. Taxes should not drive investment decisions; however, at Howe & Rusling we are sensitive to situations where clients have large unrealized capital gains, and we evaluate the tax impact of our decisions for all of our clients.

One of the many advantages of Howe & Rusling management, especially for taxable clients, is the care we take in managing for taxes on realized gains. In fact, for our taxable clients, prior to making a stock sale we consider whether a stock has been held for more than one year and whether that sale will generate long-term or short-term capital gains. When the decision is made to sell a stock, if it has been held for more than one year and there are not unusual circumstances (such as extra large position sizes or unusually large capital gains), the decision is relatively simple. We sell. If the stock has not been held for more than one year and we are not uncomfortable with the downside risk, we may continue to hold the stock until one year is up before we sell. If there are any realized short-term losses, the sale may be straightforward as well.

In many instances, though, we may decide to move immediately on a stock sale, especially if we believe a stock has run up quickly on speculation and believe the downside risk outweighs the potential tax savings of waiting, or we might accept short-term capital gains if we believe there is a much better opportunity in a different stock.

We have many clients who have inherited stocks or have owned positions for many years and have unusually large unrealized capital gains. We are sensitive to these situations. We have two concerns in this instance: the first is allowing the portfolio to become undiversified because of a resistance to ever pay capital gains taxes; the second is keeping a stock when we believe better opportunities are found elsewhere. As shown in the examples below, it may not take much of a decrease in stock price to eat up the benefit of holding a stock for tax reasons.

For example, say a client has owned 1,000 shares of stock XYZ longer than one year. XYZ is currently trading at a price of \$50 with a cost basis of \$30, showing a nice gain of \$20,000. Long-term capital gains tax rates vary with a client's tax bracket, but most clients are in the 15% bracket. In this example, if the stock is sold, the capital gains tax paid is 15% of \$20,000 or \$3,000, and the \$47,000 proceeds will be invested in what is anticipated to be a better long-term opportunity.

If the decision is made to hold the stock and the stock price falls more than \$3 per share, or 6%, the value of the portfolio is less than the \$57,000 realized after taxes from the sale of the stock at \$50 in the previous example. There are many reasons a stock can fall 6%—a bad quarterly earnings report, a downgrade by a sell-side analyst, a stumble by a competitor causing investors to worry about the industry, etc.

Even in the most extreme case, it does not take too much of a drop in stock price to overwhelm tax savings from a decision to hold a stock. For example, let's assume the 1,000 shares of XYZ have been held more than one year and are trading at a price of \$50 with a cost basis of \$0. If XYZ is sold, the capital gains tax paid is 15% of \$50,000 or \$7,500, and \$42,500 is left to invest in a better opportunity. In this example, if the stock falls more than \$7.50 per share (or 15%) to below \$42.50, then the client is better off selling the stock.

We know that clients are different. Different clients have different tolerances for capital gains taxes and have a different willingness to accept the risk of sitting on large positions. Many other investment managers do not take the care to treat clients individually. We are reasonably flexible in terms of how we deal with capital gains. In some instances, we might work large position sizes down over three years or more instead of one. In other cases, we may recommend the use of large positions as a source for charitable giving.

We will also look to take advantage of unrealized losses in stocks to offset gains. Please remember that we provide an update on your realized gains several times during the tax year, and we are happy to provide the report to your tax professional upon request as you do your planning. Of course, we welcome discussion of this information at any time. As always, if you have any questions regarding your portfolio, please contact your portfolio manager.

If you are interested in learning more about our affiliate, Cook Mayer Taylor, and their small-cap portfolio management, please contact your portfolio manager or Craig Cairns, President of Howe & Rusling.