



HOWE & RUSLING

INVESTMENT STRATEGY NEWS

JULY 2006

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

AT A GLANCE

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OUCH!!

What ails the securities markets? A simple answer: "Interest Rates." The U.S. Central Bank (a.k.a. "The Fed") has been raising rates for two years, and now the central banks of other countries are following suit. The cause of these increases: fear of inflation rising to much higher levels. If inflation rises to a higher plane, it is normally coincident with higher interest rates. Higher interest rates mean that bond prices fall. Higher rates also influence price-earnings multiples of stocks, bringing them down.

This is precisely what has been happening in the U.S. and the world markets in the past quarter. In our U.S. stock market, corporate earnings continue to surprise on the upside, but stocks have been dropping in price.

The Fed is working hard to manage inflationary expectations. This is a challenge of the first order. If the Fed raises interest rates enough, then the high cost of money can choke off economic growth sufficiently to throw us into a recession. The balancing act here is a precarious one, with no outcome fully predictable.

Investment Results

The second quarter, as mentioned above, has been disappointing for stocks and bonds. We have given back a bit more than we had gained in the first quarter, and are, at the time of the writing of this letter, slightly behind for the year. However, please allow us to provide the perspective of the prior three years, when returns were excellent. In this quarter, our stocks have given back only a tiny fraction of what was made in those three years.

As will be discussed later in this article, based on the strength of corporate and consumer balance sheets, strong positive corporate cash flow, growing earnings which continue to surprise on the upside, and reasonable company valuations in the market, we believe it is correct to anticipate a stronger stock market within the framework of the balance of this year and next. This stock market is currently preoccupied with expectations of higher inflation which might stifle future corporate earnings growth or even cause earnings to diminish in the near term. We don't think this will happen.

Global Inflation Fears

The big story in the second quarter was the air coming out of the global markets as Central Banks from the United States to Japan to China to the European Union have expressed a determination to fight inflation by raising interest rates.

There has been some fear that this was a replay of 1980-1981 when there was a similar coordinated effort to stem inflation by raising global rates. The current period is much different, however. Inflation was double digits in the late 1970's and early 1980's, Paul Volcker was appointed Fed chairman and there was a coordinated effort to stem global growth which resulted in a recession, but significantly reduced inflation.

Inflation is much more modest now and the attempt is being made to cool global growth slightly in order to insure against the threat of rising inflation. A good example that we used in our client letter is that the Chinese Central Bank is attempting to reduce the rate of growth from 18% to 16%.

Much of the reason for the current downturn in global markets including in the United States is the reversing of the trend of easy money at very low rates worldwide. Interest rates have been low globally which has allowed a period of easy money for speculators, which has driven up the price of assets from copper to gold to emerging market stocks to homes. Now with the threat of global inflation the central banks have decided to reduce the supply of money and raise the price that speculators have to pay for it.

Speculators have unwound leveraged positions and investors have moved out of the hottest markets, many of which have suffered the biggest corrections. For example, Gold peaked in May at \$732 with talk that it might hit \$1,000 an ounce, but closed in mid-June at \$613 an ounce, a drop of 16%. So much for the claims of many financial advisors that gold is a safe haven!

Some of the most speculative markets were especially hard hit. See list on page 2



Whereas we do perceive the rate of economic growth slowing, with some of the steam being taken out of certain markets such as housing and materials, we are convinced that consumers' and corporations' liquidity and financial strength augur well for a more robust economy than the media anticipate.

What is central to the concerns of investors around the world is that central banks will overdo the current round of interest rate increases. History has shown us that central banks have made this error several times in the past. If indeed this is what happens, then economic growth will be slowed more than what might be required to limit inflationary expectations.

Whereas we do perceive the rate of economic growth slowing, with some of the steam being taken out of certain markets such as housing and materials, we are convinced that consumers' and corporations' liquidity and financial strength augur well for a more robust economy than the media anticipate.

The Fed chief said the "US economy was clearly flagging but that inflation had risen to unwelcome levels that would require vigilance." He said that "the US economy is entering a period of transition towards lower growth, but at the same time, because of high energy prices, core inflation rates are on the rise." Core consumer inflation, excluding energy and food prices, rose 3.2% over the past three months. "These are unwelcome developments," Bernanke said, stressing that Fed policymakers would be "vigilant to ensure that the recent pattern of elevated monthly core inflation readings is not sustained."

The Fed has to maintain a tough balance between keeping inflation in check and not causing a recession when the economy slows by too much. Because there is a lag in the time it takes interest rates to take effect, investors are worried that the Fed seems willing to sacrifice growth on the altar of inflation prevention. We have some concern that slower growth in the second half of the year will pose a danger to stock prices. If inflation and interest rates are moving up, stocks need higher earnings in order to keep even because higher inflation and interest rates cut the multiples that investors are willing to pay for earnings which in turn serve to drive stocks down.

There are many reasons to be concerned. However, we believe the market is overdoing it. First of all, as we stated in our recent letter to clients, company valuations are approximately the historical average and are much conservative than they were prior to the market peaking in 2000.

Additionally, companies and consumers are in their best financial shape in years. Household spending has helped keep the

economy growing even in the face of rising gasoline prices and interest rates. According to data from the Federal Reserve, household net worth increased by \$4.9 trillion to a record \$53.8 trillion over the past year. Gains in financial assets contributed most of the increase.

Some of the most speculative markets were especially hard hit:

Country	% Change
Dubai	-58.5%
Saudi Arabia	-43.3%
Egypt	-30.8%
India	-26.3%
Jordan	-26.1%
Turkey	-26.0%
Russia	-22.2%
Cyprus	-21.8%
Czech Republic	-21.1%
Latvia	-20.7%
Pakistan	-20.3%
Indonesia	-20.1%
Morocco	-20.0%
Hungary	-19.9%
Greece	-19.5%
Austria	-19.0%
Romania	-18.4%
Argentina	-17.4%
Germany	-17.3%
Sweden	-17.1%

Source: John Mauldin, 2006

Consumer liquidity remains strong as well. In the first quarter, households held \$6.3 trillion in various readily accessible deposits, including checking and savings accounts. As a percentage of after-tax income, this is the highest percentage in more than 13 years. These solid household balance sheets combined with low unemployment should keep consumer spending healthy.

Corporate balance sheets are very strong as well. Corporate net worth for non-financial corporations is up \$1.3 trillion over the course of the past year to a record \$12.6 trillion. Even more impressive is the \$170 billion rise in cash flow. This gain was more than double the increase in capital spending, which will help fuel future spending for operations and growth.

There you have it: our case for optimism for future stock market valuations. Our economy indeed has strong headwinds with which to deal, namely high energy costs, higher interest rates, and inflationary fears. Yet, we have already significantly unwound much of the speculative excess in materials prices, and it appears that some of the froth in housing prices is dissipating. We never know how far this unwinding might take the markets, but what we do know is the strength of our economy, despite the headwinds which have been digested well. Short of a financial crisis, which is difficult to anticipate (e.g., an unwinding of Hedge Funds), financial fundamentals are in good shape.

Pessimism Breeds Opportunity

And a final note: According to "Investors Intelligence," pessimism about the near term direction of the U. S. stock market rose to the highest level last week since October 2002, which coincided with the lowest level the Standard & Poor's stock index hit so far in this century. Reason given for this acute level of bearishness: "... lingering concern higher interest rates will detail economic growth." (Bloomberg News, 6/28/06). In October 2002 the Standard & Poor's 500 Index dropped to a five year low, which formed the base for a new bull market within which stocks rose 60%.

2nd Quarter 2006 Bond Market Overview

Waiting on the Fed

As you read this newsletter it may already be "old news" that on June 29th the Federal Reserve Open Market Committee (FOMC) raised short-term interest rates another 0.25% to 5.25%, making it the 17th increase in the last 24 months. This past quarter the Federal Reserve unanimously voted for 0.25% increase in May, but it's not only short-term rates that are increasing. Longer term yields have increased also, as the illustration below indicates.

Notwithstanding the slide in the stock market, the 10-Year Treasury yield is once again approaching the highest yield of the quarter (5.20% on May 12th).

The Federal Reserve is responsible for (among other central bank functions) maintaining monetary policy so as to promote economic stability and "full employment." However, it also has a mandate to accomplish the above while maintaining inflation in "check." It is becoming increasingly apparent to the bond market that controlling inflation supercedes all other explicit or implicit goals of the Fed. This is not just an opinion, but is backed by several statements made by the Fed Chairman himself, as well as other members of the committee:

JUNE 5, 2006 Speaking at the American Bankers Association conference, Chairman Bernanke said; "increases in measures of inflation are unwelcome." The U.S. Economy "is entering a period of transition and the anticipated moderation of economic growth seems now to be under way." He went on to say that the Fed "will be vigilant to ensure that the

recent pattern of elevated monthly core inflation readings is not sustained."

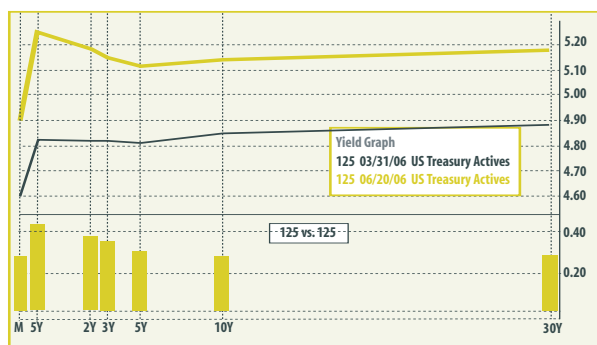
JUNE 7, 2006 Federal Reserve Bank of Atlanta President, Jack Guynn said recent inflation figures are "bothersome" and policy makers must be open to rethinking the level of interest rates. He later said that the Fed will do its "dead-level best" to control inflation.

JUNE 8, 2006 Federal Reserve Governor, Donald Kohn, addressing the Senate Banking Committee at a hearing on his nomination as Fed Vice-Chairman; "I have found the recent inflation data somewhat troubling" and raises a warning flag for the U.S. central bank even as the economy slows.

JUNE 12, 2006 Federal Reserve Bank of Cleveland President, Sandra Pianalto, said recent inflation readings exceed her "comfort level," while long-term indicators of the public's expectation of price pressures are "contained."

JUNE 14, 2006 Federal Reserve Governor, Susan Bies, speaking at the Mortgage Bankers Association

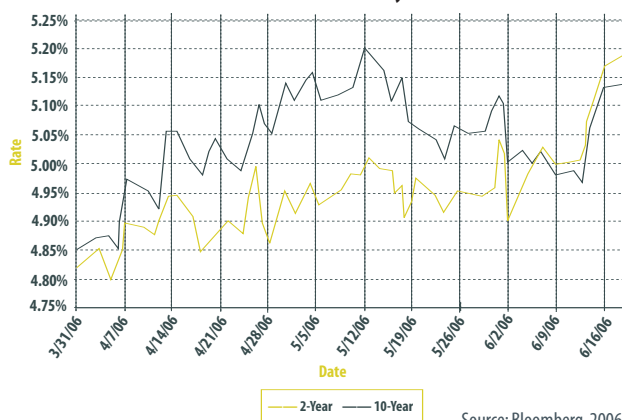
YIELD GRAPH



Source: Bloomberg, 2006

While interest rates have increased approximately 35 to 40 Basis points (0.35 to 0.40%), it has not been a steady progression upward. Shortly after the last FOMC meeting (May 10th), there was a growing expectation that the economy would be slowing down and that the Federal Reserve would most likely stop the tightening cycle. As a result, (and as discussed in the first part of this newsletter) there was a significant sell-off in the stock markets that saw a reallocation into the relative safety of bonds.

2-Year & 10-Year Treasury Bond Yields



Source: Bloomberg, 2006

We have focused on bonds having short average maturities in recent years, so our clients have been protected against the rather significant price drops experienced by holders of longer term bonds.

conference said in response to a reporter's question said: "Both today's core CPI (Consumer Price Index) and the trend over the last six to nine months, as well as the core PCE (Personal Consumption Expenditures) price index in the last nine months, have been running in the high 2 percent range. Personally, core inflation in that period of time in the high 2 percent range is above my comfort level. I want to see core inflation lower than where it has been running in the past nine months."

JUNE 14, 2006 Federal Reserve Bank of Dallas President, Richard Fisher, said that one measure used by the bank shows that inflation is running at a "corrosive" pace and that he must be "relentlessly bird-dogging inflation."

Source: Bloomberg, 2006

So, there should be no ambiguity about what is foremost on the Federal Reserve's collective mind—inflation. Having said that, they still believe that inflation is well contained. While this sounds like a contradiction, it actually is a fair statement, because many of developed nations' central banks are being proactive in tightening monetary policy so that inflation does not get out of control.

This does not alleviate the uncertainty facing the bond market, where we have seen the Treasury yield curve start out "flat" (2 to 10 year rates about the same), become positive sloping, only to once again invert (2 year yields higher than 10 year yields). As we have written in the past, an inverted yield curve is thought by some to be an indication that the Federal Reserve may raise short-term rates too much, which would further decelerate a slowing economy. At the extreme, it could produce a recessionary period which could compel the Federal Reserve to lower short-term interest rates in an attempt to stimulate the economy. The keyword is extreme. An economy that grew at an annualized 5.3% GDP (Gross domestic product) in the first quarter of 2006 is not very likely to go into a recession in the near future. A slowdown is likely because 5.3% is not realistically sustainable for long periods of time in a well developed economy such as ours. So, don't be surprised if you hear the word stagflation resurfacing in the news. For those of you who remember the 1970's well, you'll recall a period in the mid 70's where real economic growth was stagnant—high unemployment with high prices. This is not the 70's and in today's global economy, there is much more flexibility in adjusting prices to affect supply and demand. We don't believe that the expectations for the inevitable "slowdown" in the economy will lead anything worse than that. However, if I can

borrow the quote by Federal Reserve Chairman, Ben Bernanke, (cited above),

"The U.S. Economy" is entering a period of transition and the anticipated moderation of economic growth seems now to be under way." As such, we remain cautious in our fixed income discipline.

Should Anyone Be Happy about Owning Bonds?

Why do we hold bonds in most of our clients' portfolios? Simple answer: provide increased price stability, increased income, and act as a buffer against the relatively higher volatility of the stock market. Interest income from your bonds has proceeded without interruption.

Index	Return for Period
1 - 3 Yr Gov	0.85%
Municipal tax-exempt 1-10 Yr Blend (1-12)	0.15%
U.S. Agency Intermediate (2-10 years)	0.08%
U.S. Treasury: Intermediate (2-10 years)	-0.55%
Intermediate Corporate (2-10 years)	-0.94%
U.S. Agency Long	-4.75%
U.S. Treasury: Long	-5.46%
Long U.S. Corporate	-5.83%

Source: Bloomberg, 2006

The chart shown (above) depicts the results displayed on a TOTAL RATE OF RETURN basis for different sectors of the bond market on a year to date basis as of June 22. It might be scary to contemplate the large negative return of longer term bonds in this short time period. However, these negative returns do NOT mean that bond holders didn't receive their interest payments. This is purely a reflection of bond price adjustments responding to the higher interest rate environment.

Why Can I Feel Comfortable With My Bonds?

Rest easy: The bonds that we at Howe & Rusling have selected for your portfolio have little if any risk of default (not paying interest and principal obligations). Furthermore, we have focused on bonds having short average maturities in recent years, so our clients have been protected against the rather significant price drops experienced by holders of longer term bonds. No doubt: the total rate of return in recent quarters has been disappointing, but the recent increases in interest rates mean that future returns from bonds must be at a higher, more satisfying level. The bond market goes through cycles, with the recent part producing less than satisfactory returns.

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.



“THINKING ABOUT PAYING YOUR GRANDCHILD’S COLLEGE TUITION? BETTER THINK AGAIN.”

Philip L. Burke, Esq.

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JULY 2006

Gifts to family members are beneficial for a lot of reasons —potential estate tax benefits, the joy of helping someone who needs assistance, transferring income producing assets to someone in a lower tax bracket, etc.

Up until recently, a gift of this nature could be made without worrying about any long term negative effects on the individual making the gift. However, that is no longer the case due to the passage of the Deficit Reduction Act of 2005 (“DRA”) which was signed by the President on February 8, 2006.

A portion of the DRA deals with Medicaid eligibility and Long Term Care Planning, and primarily affects senior citizens. Under prior law, senior citizens facing long term care expenses in a nursing home or other similar facility had various options available to them which would, in most cases, allow them to pay for a portion of their long term care but, at the same time benefit their family by making gifts of some of their assets. Generally speaking (and subject to the nuances of the law of the State where the person resides), prior law provided that if an individual made a gift of assets to children or grandchildren, the individual would be ineligible for Medicaid benefits for a period of time, beginning on the first day of the month following the month in which the gift was made. For example, if an individual made a gift on February 15, 2005, they would be ineligible for Medicaid for a certain period of time beginning on March 1, 2005. The length of this ineligibility period was a function of the amount of the gift made and the assumed cost of nursing home care (a number promulgated by the Department of Social Services). For example, if DSS assumed the monthly nursing home cost in a particular area was \$7,000, and a \$70,000 gift was made on February 15, 2005, the individual making the gift would be ineligible for Medicaid for 10 months, beginning on March 1, 2005 ($\$70,000 \div \text{the } \$7,000 \text{ per month rate equals } 10 \text{ months}$). Consequently, under

prior law it was possible to give away some of the assets, retain enough to pay nursing home bills through the course of the penalty period and then apply for Medicaid benefits once the individual ran out of funds. This is an over simplified example, and there are several other factors that need to be considered, but all of this has changed as a result of the DRA.

The DRA now provides that the penalty imposed as a result of a gift begins not the month after the gift is made, but at some point in the future when an individual applies for Medicaid benefits. Also, the DRA provides that the Department of Social Services can “look back” through a person’s financial records for five years to see if a gift was made. Consequently, if an individual helped with a grandchild’s college tuition within five years of applying for Medicaid benefits, those tuition payments would render the individual ineligible for Medicaid going forward from the point he or she applies for Medicaid, not from the point at which the gift was made. For example, if on February 15, 2007, an individual gives \$30,000 to a grandchild to help pay tuition, and makes a similar gift on February 1, 2008, a total of \$60,000 has been transferred. Using the new five year look back rule, the 2007 gift would be subject to consideration if the individual applied for Medicaid before February 1, 2012 and the 2008 gift would be under consideration for a Medicaid application filed before February 1, 2013. If, in this example, the individual applied for Medicaid in 2010, the \$60,000 of tuition gifts would render them ineligible for Medicaid for a period of months going forward from the date of application. As a result, the individual who is then in a nursing home with no funds (hence the need to apply for Medicaid) will not be eligible for Medicaid benefits for several months due to what was, at the time, a fairly innocent gift of college tuition made out of the kindness of the individual’s heart.

Because of the new five year look back requirement, and the new “prospective” penalty period calculation, individuals have to be more careful in transferring substantial wealth to family members since the effect of the gift on the donor’s long term care options now needs to be taken into consideration, along with the other considerations normally reviewed in deciding to gift assets. Some commentators have also opined that a substantial gift to charity (which is made with no consideration whatsoever for long term care planning purposes) would be caught up in the five year look back “net.”

In summary, the new law pretty much requires individuals who wish to make substantial gifts to stay healthy for at least five years (or retain enough assets to pay for nursing home costs over a five year period) or to purchase long term care insurance in an amount calculated to cover these costs. Since, depending on where you live, a nursing home could cost \$100,000 a year or more, it is easy to see that an individual’s nest egg could be substantially or completely depleted as a result of a long term nursing home stay. Please contact your Howe & Rusling portfolio manager if you have any questions.

***Author’s note:** Since Medicaid laws are very often a function of state law, readers should check with their local advisors to see how the new law affects Medicaid eligibility and long term care planning in their particular jurisdiction. For example, in some states the federal changes are automatically incorporated into state law and effective immediately. However, some states require their legislatures to pass “conforming legislation” in order for the federal law to be applicable.*



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