



Not Particularly Surprised

Our lead headline in our July 2006 newsletter was OUCH! We were finishing up a quarter in which the inflation outlook proved bleak enough to drive the stock market into negative territory. Due to the inflation uncertainty, the stock market was rewarding safety—large cap, dividend producing, safe names while severely overreacting to companies that disappointed in some way and simply ignoring those companies in sectors such as technology which were viewed as less safe.

We are happy but not particularly surprised that we do not have to lead with a similarly negative headline. In the third quarter, the stock market acted as we have been predicting by finally displaying some strength. Companies were rewarded in the third quarter for how they were performing and not simply for the dividend they were paying. After three years of leading the indices by a fairly significant margin, Howe & Rusling's stocks lagged in the first two quarters of 2006 because we were much less grim in our inflation outlook than the overall market. As the environment turned closer to our outlook this past quarter, we are closing the performance gap.

Throughout much of the first half of 2006, the Federal Reserve inflation fight was the primary investment story. The Fed continued to increase rates and June marked the 17th consecutive short-term interest rate increase to 5.25%. The outlook for when the Fed would stop raising rates was far from clear as the economic growth numbers, rising oil prices and the economic inflation readings such as the consumer price index, seemed to indicate a need for continued increases making it unclear when the Federal Reserve would stop.

But interest rate increases have an economic impact after the fact and the trick for the Federal Reserve is to increase rates enough to reduce inflation without causing the economic hardship of a recession. As the impact of the interest rate increases is tough to measure before the fact, this balancing act is not simple. In fact, after the media piled on the "rampant inflation" bandwagon in the first two quarters, now the primary concern is whether or not the United States economy is headed for a soft landing or a recession.

On August 8th, when the Federal Reserve paused after the 17 rate increases, core inflation, a measure watched carefully was still above the 1% to 2% "comfort zone" of the Fed including Chairman Bernanke. In the 12 months through August, core inflation was 2.8%, up from 2.7% in the 12 months through July. The Fed is simply anticipating an impact in all the rate increases and a reduction in core inflation in the coming months. As the following statement from the Fed attests "... Readings on core inflation have been elevated and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand."

The Economy is Slowing Down

Recent economic data seems to validate the Fed's refusal to continue raising rates by pointing to an economic slowdown. Second quarter Gross Domestic Product grew at a much more reasonable annual rate of 2.9% after growing at an annual rate of 5.6% in the first quarter. Consumer spending climbed by just 2.5% in the second quarter after gaining 4.8% in the first quarter of 2006. However, the longed for increase in business investment, which is supposed to balance out the decline in consumer spending, also looked weak in the second quarter. Business investment gained just 2.7% after a huge 13.7% increase in the first quarter of 2006.

At the end of September, oil stood at approximately \$61/barrel which is down 22% from the high reached on July 14th which reduces inflationary pressure. The trend toward lower oil prices should continue at least in the short-term for several reasons. There are signs the global economy is slowing as Germany, Japan and China have reported slower growth. Combined with a slowing US economy this should lessen the pressure on oil prices. Also, increased prices affect behavior and demand. US consumers are trending toward more fuel efficient cars away from SUV's and trucks, Europeans are shifting to more efficient vehicles which burn diesel fuel and China has upgraded its

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AT A GLANCE

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3rd Quarter 2006
Bond Market Overview



We are not unrealistic in our cautious optimism. Economic conditions are not completely clear and there is still a chance that the Fed has overdone the rate changes and growth will slow more than intended. If the country slips into a recession or a worldwide event causes oil prices to spike causing renewed inflation fears, we stand ready to adjust the portfolio accordingly. However, we believe that history of the past two decades will repeat. It looks as if the stars are indeed so aligned.

transportation and utility systems to use less oil and more coal to generate electricity (not to say that China's demand for oil is going to fall, just that it shouldn't increase as fast as it did the past few years).

Commodities prices other than oil have dropped recently as well. The CRB Commodity Index has posted its biggest decline since 1974.

In mid-September financial markets were roiled for a few days by a monthly report from the Federal Reserve Bank of Philadelphia of the measure of manufacturing activity and the manufacturing sector's health in the Mid-Atlantic States. The expected figure was 15, but the index fell to a reading of -4 after being 18.5 in August. A negative reading denotes a contraction and it was the first time since April 2003 that the index had been negative. The negative reading was startling and caused recession jitters for several days.

The Conference Board issued a separate economic report that also signaled the economy is headed toward slower growth for the remainder of the year. It reported that its composite index of leading indicators—which attempts to forecast economic activity as much as six months into the future—fell .2% in August to a reading of 137.6.

Also, the bond market yield on the benchmark 10-year Treasury note fell to approximately 4.59% from 4.79% which is a sign of less investor inflation concern.

Finally, the housing market has been especially hard hit in 2006 playing a large role in the slowing economic growth. Housing starts dropped 6% in August from July and were down 19.8% from a year earlier. New home sales fell 4.3% in July. Also startling was the fact that existing house prices declined in August -0.9% from July and -1.8% from the previous year. If housing prices do not climb in October, they will be down -4.8% from the previous October. Amazingly, according to the economic research firm ISI, if housing prices simply remain unchanged through February, they will post the first annual decline on record. The outlook is not much better for 2007 as housing prices will climb just .43% in 2007 according to a survey of 48 economists performed by The Wall St. Journal.

Those same 48 economists surveyed now put the odds of a recession in 2007 at 26% which is up from 15% when they were surveyed in the spring. Instead of the intense debate about rampant inflation ruining the economy, the debate has developed into whether or not the US economy is headed for recession and economists and prognosticators are disagreeing on when the Fed will start reducing rates—some feel that the rate reduction will need to begin as early as March 2007.

Reasons for Optimism

We talked about strong company profits in the last quarterly newsletter and that continued in the third quarter as pretax corporate profits (adjusted for the value of inventories and depreciation) rose to a record 12.3% of GDP in the second quarter.

While global growth has been slowing, growth remains strong especially in emerging economies which continue to have a major impact on global growth and should keep growth healthy. In 2005, emerging economies accounted for more than half of total world GDP and now their share of world exports has grown to 43% from 20% in 1970.

Emerging economies have helped keep developed nations' inflation, interest rates and wages low and profits high. Since 2000, world GDP per head has grown by an average of 3.2% per year, thanks to the acceleration in emerging economies, which have averaged an annual growth rate of nearly 7% per year for the past five years. If this growth keeps up current growth will surpass the best global growth in modern history which was 2.9% per year from 1950 to 1973 as Japan and Germany rebuilt their economies in the aftermath of World War II.

Most importantly, the last two time periods similar to 2006 where there was midlevel slowdown were 1985 and 1995. In those two years there was a strong stock rally as bond yields declined.

Mid-Cycle Slowdown	Country	Decline in Bond Yields (bp)	Stock Market Rally
1967	U.S.	-70	25%
1885	U.S.	-300	40%
1995	U.S.	-250	40%
2004	U.K.	-100	35%
AVERAGE		-180	35%

Source: ISI GROUP, 2006

Are the Stars Aligned for Good Results?

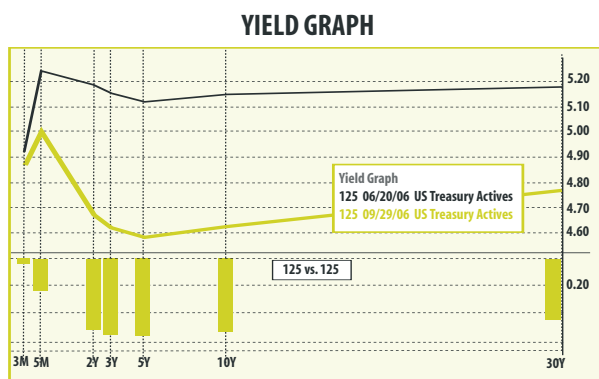
We are not unrealistic in our cautious optimism. Economic conditions are not completely clear and there is still a chance that the Fed has overdone the rate changes and growth will slow more than intended. If the country slips into a recession or a worldwide event causes oil prices to spike causing renewed inflation fears, we stand ready to adjust the portfolio accordingly. However, we believe that history of the past two decades will repeat. It looks as if the stars are indeed so aligned.

3rd Quarter 2006 Bond Market Overview

Bonds Rally on the Fed's Steady Monetary Policy

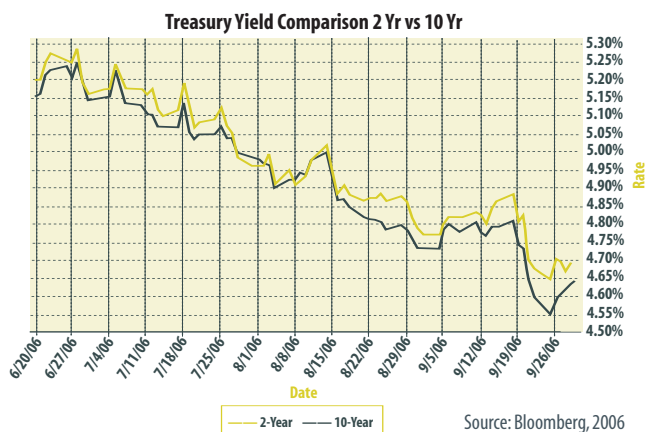
This past quarter's bond performance was the best the market has seen in four years. The reason for the positive results is directly attributable to the market's reaction to the Federal Reserve Bank's "pause" in increasing short-term interest rates and the implications of slower economic growth on future monetary policy.

Since our last writing, the general level of interest rates decreased approximately 0.5%. The graph below illustrates the decrease in yields for U.S. Treasury bonds of various maturities.



Source: Bloomberg, 2006

Virtually all sectors of the bond market were positively affected by increased prices associated with declining interest rates. Bonds with longer maturities outperformed bonds of shorter maturities. As the following illustration shows, the overall decline in rates (increase in prices) was fairly steady throughout the 3rd quarter.



Source: Bloomberg, 2006

The 10-year Treasury reached a high yield of 5.25% on June 28th, one day before the FOMC (Federal Open Market Committee) was to meet to decide about monetary policy. The FOMC did raise the Federal Funds rate in June to 5.25%. However, the official statement which accompanies every interest rate decision gave the market a signal that the FOMC might be changing their policy position from tightening to neutral. Of particular interest in the statement was:

"Recent indicators suggest that economic growth is moderating from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices."

While the statement also expressed the possibility of further rate increases and that the general level of inflation was currently higher than they would like, the market was focused on future inflation. The interpretation was that moderating growth will lead to moderating inflation in the future. As expected by the market, the next two meetings of the FOMC (August 8, and September 20) saw no change in short term rates. The Federal Reserve has been and continues to be "on hold" for the time being.

The Treasury yield curve once again inverted (short-term rates higher than long-term rates) in mid July and remained inverted for the rest of the quarter. Because of the inverse relationship between yields and prices — yields decrease, prices increase. The significant decrease in longer rates enhanced returns because of price appreciation. Once again, the market is reacting to expectations that slow economic growth will be more of a concern than inflation, thereby increasing the probability that the Federal Reserve Bank will not only remain neutral, but most likely will have to ease monetary policy in the near future to stimulate growth once again.

What's the likelihood of the Federal Reserve easing monetary policy in the near future? Statistically speaking, since 1980 the average time from the last rate hike to the first rate cut has been approximately 5 months. Based on that alone we are in the 3rd month from when the FOMC decided to leave interest

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At this time, with 10 year Treasury yields at 4.6% and short-term bond yields (Fed funds rate) at 5.25%, the bond market is anticipating a deflationary period ahead. Until we see further proof of a declining equity market, we believe that it will be difficult for long-term rates to decrease further in the 4th quarter.

rates unchanged. Therefore, if this economic cycle is similar to all others since 1980, then we would expect the Federal Reserve to begin easing monetary policy by year end and certainly no later than the 1st quarter of 2007. The big assumption with the above premise is that this cycle is similar to all others since 1980. That is a big assumption! Some of the notable differences between the end of this cycle and what we have seen historically are:

- Flat to inverted yield curve
- Credit spreads have not yet widened
- Equity markets have not sold off in anticipation of economic weakness

Historically the Treasury yield curve has tended to steepen shortly after the end of a tightening cycle. Perhaps the continued inversion of the yield curve may have more to do with technical factors than economic factors. There is far more demand from pension funds for longer term bonds than we have seen in the past. This is a result of proposed pension reform proposals that would require plan administrators to better “match” the duration of the plans’ assets and liabilities. To simplify, this merely means that pension plans must ensure that long-term liabilities (expected future payments to plan participants) are not entirely funded with short-term assets. Further demand for longer-term

bonds has also come from foreign investors (central banks primarily) seeking the safety of our capital markets and U.S. dollar denominated investments. These are some of the arguments that have been put forward by economists to help explain why long bond yields have not risen during the past tightening cycle.

Credit spreads (the difference in yield between corporate bonds and Treasury bonds) tend to widen shortly after the last rate hike. However, spreads are virtually unchanged over the last three months. The reason credit spreads widen after a monetary tightening cycle is simply because of the expectation that the economy will slow down and corporate profits will be negatively affected by decreased economic growth. This is also why equity markets tend to sell off. Yet we have not seen either of these happen this time.

There seem to be conflicting signals between the bond and equity markets. While equity markets can still have positive performance in anticipation of monetary easing to stimulate economic growth, they typically do not perform positively when the bond markets are signaling a recession. At this time, with 10 year Treasury yields at 4.6% and short-term bond yields (Fed funds rate) at 5.25%, the bond market is anticipating a deflationary period ahead. Until we see further proof of a declining equity market, we believe that it will be difficult for long-term rates to decrease further in the 4th quarter.

Recently, I wrote to our clients announcing some very exciting news that a small group of employees and local investors, led by me, has entered into an agreement to buy back the firm from our current owner, Third Security, LLC in Radford, Virginia. I have been with the firm for over six years and feel strongly that bringing the ownership back to Rochester is positive for the firm and especially our clients.

The acquisition is scheduled to close on October 31, 2006. We foresee no changes in the manner in which our clients’ portfolios will be managed subsequent to the transaction and believe the continuity of management and the ability to make all decisions locally will serve our clients well.

I hope you will not hesitate to call me or your portfolio manager with any questions (585-325-4140 or 1-800-325-4693).

Thank you for your continued support. Please know we remain committed to serving our clients at the highest level.

Craig D. Cairns, President

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.

Recent Changes in the Law: Are You Affected?

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Over the last several months there have been some significant changes in the law that may affect your gifting patterns, long term care plans, and even post-death planning. Some of these changes are highlighted in the following paragraphs.

I The Deficit Reduction Act of 2005:

This federal legislation ("DRA 2005") significantly impacts long term care planning. It is now much more difficult for people of moderate means to be able to transfer assets to their loved ones with the hope of trying to protect those assets from the ravages of long term care costs. Without going into great detail, transfers made within five years of applying for Medicaid benefits will result in a prospective penalty. This means that if an individual makes a gift and then applies for Medicaid benefits within five years, that gift will render them ineligible for Medicaid benefits for a certain period of time going forward from the date of application. As a result, individuals who may have been eligible for Medicaid benefits under prior law will now find themselves in the peculiar position of having no assets and also being ineligible for Medicaid benefits. One of the reasons for passing this new law, as trumpeted by Washington, was to keep "rich people" from transferring a large portion of their assets in order to qualify for Medicaid benefits in the future. Ironically, the result of the new legislation is that only rich people will be able to transfer a majority of their assets, retain enough to pay for five years of long term care costs, and then qualify for Medicaid.

As mentioned in a previous article in this newsletter, individuals who are in the habit of making gifts for unselfish reasons (college tuition for grandchildren, gift to charity, etc.) may find themselves ensnared by the provisions of this new law even though the gifts were made without any consideration of long term care planning.

DRA 2005 was signed by the President and became effective on February 8, 2006. However, many states require that their own Legislatures pass conforming laws in order for DRA 2005 to be applicable. For example, New York State just recently passed its own conforming

legislation effective, by and large, on August 1, 2006 (although some provisions do relate back to February 8th). If there is any concern about the applicability of DRA 2005 in your particular state of residence, and what the effective date of the new legislation may be, it would be advisable to check with your local advisor.

II The Pension Protection Act of 2006:

There are many provisions of this new law, but one of the more important provisions allows a "income tax free" distribution from an IRA to most public charities. Prior to this law, if an individual wanted to make a contribution to a charity from his or her IRA, the participant had to withdraw the funds from the IRA, report the withdrawal as taxable income, make a charitable contribution and then deduct the contribution on his or her personal income tax return. Because of the various limitations on charitable contributions, the deduction might not equal the amount of increased income and, as a result, the participant paid more income tax. However, the new law allows the distribution to be made directly from the IRA to most (not all, there are some limitations) public charities. There are other limitations as well. The maximum amount that can be transferred is \$100,000 per year, and the participant must have already reached the age of 70? (the age at which minimum distributions must begin). Since the distribution does not constitute taxable income to the participant, there is no offsetting charitable deduction to be taken on the personal income tax return. Also, this provision is only effective for 2006 and 2007.

There are other provisions of the Pension Protection Act of 2006 that may affect your own personal income tax plan and you should consult your accountant or other tax advisor to review these changes.

OCTOBER 2006

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Disposition of Remains:

New York State recently passed an amendment to its Public Health Law that now allows an individual to direct in writing who shall have the right to control the disposition (burial, cremation, etc.) of the individual's remains. Prior to this law, New York State (and many other states without specific legislation) provided that the surviving next of kin had the right to control the disposition of a decedent's remains. Normally, this did not cause any problems. However, in situations where there was a disagreement between the next of kin (for example, the children of the decedent) as to the disposition significant family fights could erupt. This was also a problem for individuals involved in non-traditional relationships where the intent was for the surviving partner to make and carry out the disposition

arrangements. The new legislation in New York allows individuals to avoid potential problems and specifically recognizes a "domestic partner" as someone who can be appointed for these purposes.

Again, this is a state specific issue and other states besides New York do have legislation in place addressing this. If this is of concern to you, you should consult with local counsel to see what arrangements, if any, can be made.

These are just a few of the highlights of some legislative changes that have taken place over the past several months. Again, if you have any questions about these changes, please contact your local counsel or tax advisor, or your Howe & Rusling portfolio manager.



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