Skepticism continues in the markets

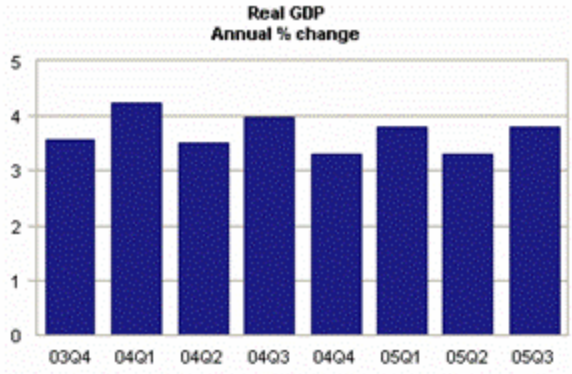
U.S. stocks lose ground in October

The impact of higher interest rates and fears over rising inflation dampened investors' appetite for stocks in October and failed to offset a number of positive developments, including strong quarterly earnings gains for U.S. stocks and a marked decline in energy costs that drove the price of oil to a three-month low of $59.76/barrel at month-end. As a result, all three of the major market indices* lost ground.

The Dow Jones Industrial Average lost 1.09 percent to close the month at 10,440.07, while the tech-laden Nasdaq Composite Index declined 1.46 percent to close at 2,120.30. In the broader market, the S&P 500 Index fell 1.67 percent to finish the month at 1,207.01.

On a relative basis, large-cap stocks (as measured by the Russell 1000 Index) outperformed small-caps, realizing a loss of 1.75 percent, versus a 3.11-percent decline in the Russell 2000 Index. Within the large-cap arena, growth outdistanced value: the Russell 1000 Growth Index lost 0.97 percent, while the Russell 1000 Value Index dropped 2.5 percent. In the small-cap arena, the opposite held true, with the Russell 2000 Growth Index off 3.7 percent, versus a 2.5-percent decline in the Russell 2000 Value Index.

U.S. economy continues to surprise to the upside



Investors and economists were positively surprised, however, by the most recent quarterly report on gross domestic product (GDP), which indicated that the economy expanded at a stronger-than-expected 3.8-percent annualized clip in the third quarter. This number was well ahead of consensus estimates and the 3.3-percent pace logged in the previous quarter.

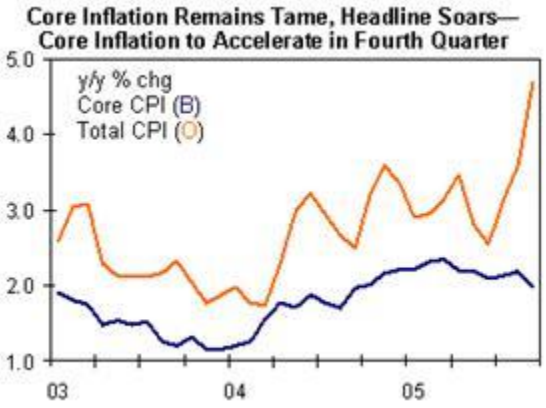
GDP, which measures the total output of goods and services produced in the domestic economy, is often regarded as the broadest measure of economic health. While the recent report—which leaves GDP ahead 3.6 percent for the year—surprised many, it also elevated fears that the Federal Reserve (the Fed) will be forced once again to lift interest rates in an effort to cool demand and keep inflation in check.

Source: Commerce Department

Consumer spending, the largest component of GDP, was fueled this past quarter by a number of factors, including a string of pricing incentives from U.S. auto manufacturers. Looking forward, however, expect GDP growth to slow, as the impact of hurricanes Katrina, Rita and Wilma—not fully represented in the most recent report—combined with higher interest rates and inflation, weigh on consumer confidence and spending in the months ahead.

Inflation fears have impact on bond markets

As noted in last month's newsletter, inflationary pressures—while still contained—are on the rise, and the Fed has openly communicated its intent to further lift rates, if necessary, to keep demand and price increases in check. Although the Fed has lifted rates 12 times since June 2004, the increases have done little to dampen consumers' appetite for everything from cars to homes.



Source: Bureau of Economic Advisors

Strong consumer demand, combined with a sharp run-up in energy costs at the end of summer, helped push core inflation up to 2 percent for the year—a number that bumps against the upper limits of the Fed's acceptable range.

As the chart illustrates, the increase in core inflation masks the extent to which food and energy prices, in particular, have risen this year (Total CPI) and further supports the view that the Fed will continue to nudge rates higher for the balance of the year and into early 2006.

The prospect of higher interest rates and inflation took its toll on the bond markets in October. The yield on the benchmark 10-year Treasury (which moves inversely to price) climbed from 4.33 percent to 4.6 percent. The increase marked a six-month high in the benchmark that serves as a reference in setting mortgage and corporate borrowing costs. Longer-term bonds, as measured by the 30-year Treasury, also lost ground, rising to 4.77 percent from 4.57 percent at the end of September.

The bond markets were further unsettled in advance of President Bush's late-October decision to nominate Ben Bernanke to replace Alan Greenspan as head of the Federal Reserve when Greenspan retires at the end of January. Wall Street reacted favorably to the news, however, as Bernanke is believed to share the views and opinions of the current Fed chairman with regard to both economic and monetary policy. Bernanke spent most of his career as an economist at Princeton University before joining the Federal Reserve Board in 2002, where he has since been promoted to chairman of the Council of Economic Advisors in Washington.

The strong similarities between Bernanke and Greenspan imply little, if any, change in Fed monetary policy under his guidance, which takes effect February 1, 2006. But the Fed continues to be in a difficult position. At the same time the energy shock from back-to-back hurricanes lowers output, growth and consumption, it increases the potential for higher inflation. The concurrent conditions of massive fiscal stimulus, a peaking of the housing market boom, and fears that energy prices could feed through into core inflation make it unlikely that the Fed will deviate from the course it has set. It will likely take signs of a dramatically slowing economy to cause the Fed to alter its plans.

Investment implications
Stocks will likely remain volatile as investors sort out the risks of the Fed tightening rates too much, slowing the economy or crimping currently high profit margins. As a leading indicator stocks have been anticipating a slowdown for some time, for price gains in stocks have not kept pace with earnings gains: Since early 2004, operating earnings have increased more than 26%, while the S&P 500 is up just 5%. So, relative to most other investment alternatives, there continue to be opportunities in equities, especially among larger, high-quality U.S. companies and those of a number of other developed countries.

Many places in the southeastern region of this country have weathered the statistically improbable event of three major hurricanes within a one month period. If you are rebuilding your home in this region, would you want your architectural plan to target the 93% probability that no major storm of the same magnitude would hit again within 50 years, or would you build with the improbable in mind? Investment portfolios need to be constructed with this analogy in mind.

Whether one is considering the strength of a home or a portfolio's ability to withstand volatility, it is important to consider more than just the most likely outcomes. Allocations also need rebalancing occasionally, in response to significant changes in asset valuations and economic conditions. Maintaining sufficient portfolio diversification can thus play a useful role in managing the financial impact of improbable events, and we may then not be as compelled to adjust allocations at inopportune times.

Please feel free to contact my offices with any comments or questions. Thank you.

Very truly yours,

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Please remember that past performance is not indicative of future results. Securities are subject to market volatility. Investors should also note that diversification does not assure against market loss and there is no guarantee that a diversified portfolio will outperform a non-diversified one.

* All indices are unmanaged and investors cannot actually invest directly into an index. Past performance is not indicative of future results. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 1000 Growth Index measures the performance of Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Value Index measures the performance of Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Sources: Mellon Financial Corporation, *Investment Update*, 10/2005; Commonwealth Financial Network, *Monthly Market Recap*, 10/2005; Norian Capital Management, *Portfolio Review*, 11/2005.