

Dear Client,

In the second quarter of 2006, the stock market sent a message to the Federal Reserve. The gist of the message was, ENOUGH ALREADY. Letting policy changes drag on forever and constantly overshooting the mark at the wrong time is getting old. We realize the folks running the Federal Reserve are government bureaucrats at heart and always have to be doing something to justify a bigger budget. However, investors also know that it's much easier for the Fed to kill an economic recovery than to start one.

Around the end of the quarter, new home sales were drying up, the number of unsold new homes was ballooning, and the housing market finally appeared to be crying uncle. Although we got another rate increase at the end of June, the Fed changed its language and implied that the string of 17 straight increases may finally be coming to an end. I suppose it's only fitting that a housing boom created when the Federal Reserve overshot the mark and dropped the Fed Funds rate to 1% should end with Fed excess in the other direction.

First quarter earnings came in ahead of expectations again and economic growth was strong in the first quarter. However, another spike in energy prices dampened future prospects for consumer spending while higher interest rates also appeared to be taking the steam out of housing. During the quarter, Congress also showed signs that the tax cuts that stimulated consumer spending and investment may be allowed to fade into the sunset. Overall, investors saw mostly bad news in the second quarter and reacted accordingly.

The second quarter of 2006 generally turned the first quarter on its head. What worked in the first quarter didn't in the second quarter and vice versa as the stock market gave up its first quarter gain. Investors didn't want to own anything with tech in the name or industry description, big companies outperformed smaller ones, value outperformed growth, and industries that aren't economically sensitive mostly outperformed the others. For

reference, here's the equity market segment scorecard for the second quarter of 2006:

	<u>Symbol</u>	<u>3/31/06</u>	<u>6/30/06</u>	<u>% Change</u>
Large Cap. Value	IVE	68.85	68.71	-0.20%
Large Cap.	IVV	130.13	127.55	-1.98%
REITs	VNQ	67.92	66.30	-2.39%
MidCap Value	IJJ	76.69	74.53	-2.82%
MidCap	IJH	79.23	76.40	-3.57%
Small Cap. Value	IJS	72.59	69.45	-4.33%
Large Cap. Growth	IVW	61.09	58.40	-4.40%
Small Cap.	IJR	65.00	62.10	-4.46%
MidCap Growth	IJK	80.49	76.72	-4.68%
Small Cap. Growth	IJT	128.70	122.60	-4.74%
Microcap	IWC	58.10	53.86	-7.30%

Source: Thomson One Financial

In addition, here's the stock market index and industry group scorecard for the same period:

	<u>Symbol</u>	<u>3/31/06</u>	<u>6/30/06</u>	<u>% Change</u>
Dow Industrials	.DJIA	11,109.32	11,150.22	0.37%
Nasdaq Composite	COMP	2,339.80	2,172.10	-7.17%
S&P 500 Index	SPX	1,294.83	1,270.20	-1.90%
Transportation	TRAN	2,625.20	2,779.30	5.87%
Utilities	IXU	312.44	327.23	4.73%
Energy	IXE	545.56	568.54	4.21%
Consumer Staples	IXR	236.18	241.73	2.35%
Health Care	DRG	329.31	330.35	0.32%
Capital Goods	IXI	338.73	338.61	-0.04%
Consumer Services	IXY	336.35	333.90	-0.73%
Financials	IXM	324.25	321.79	-0.76%
Basic Industries	IXB	333.65	330.44	-0.96%
Commercial Services	.SICSS	194.63	188.29	-3.26%
Biotech	BTK	712.97	663.91	-6.88%
Technology	IXT	222.96	203.84	-8.58%
Alternative Energy	ECO	227.14	201.25	-11.40%

Source: Thomson One Financial

We have trouble getting too worked up about the second quarter and view it as a correction in an otherwise healthy market. Although we're also aware that stock investors are generally on vacation during the summer, corporate profit growth is still in the midst of an extraordinary run (double digit growth since early 2003) and economic growth appears stubbornly strong. As a result, we wouldn't be surprised to see stock prices stabilize if second quarter earnings meet or beat expectations.

<u>Current Yield</u>	<u>3/31/06</u>	<u>6/30/06</u>	<u>% Change</u>
90 day Treasury Bills	4.63%	5.01%	+8.2%
5 Year Treasury Bonds	4.82%	5.10%	+5.8%
10 Year Treasury Bonds	4.86%	5.15%	+6.0%

Source: Bloomberg LP

In the fixed income market, yields rose across the board during the quarter, with the sharpest increase again occurring in the short end. The result is we now have a yield curve that only a government bureaucrat could love. One year bonds produce the highest yield and five year bonds produce the lowest yield. Yields rise from five to twenty years, then decline again to thirty years. The result so far this year is that bond portfolios in the short to intermediate range have produced modest positive returns while longer bonds have produced negative returns.



Source: Bloomberg LP

In addition to higher gas prices and slowing demand for housing, consumer credit card debt is high. At present, we expect the prime rate of 8.25% to add some additional pressure. With 2/3 of the U.S. economy still tied to consumer spending, some slowing in economic growth appears likely. Our strategy in fixed income so far has been to stay in the short to intermediate range and emphasize government Agency bonds unlikely to

be called. However, if the long awaited economic slowdown finally materializes, we think it may be time to consider lengthening maturities in our bond portfolios.

The second quarter correction in stock prices coupled with higher earnings reduced valuations to a level where stocks now appear cheap relative to interest rates. Although stocks may show the usual pattern of going sideways for the rest of the summer, we like the combination of an undervalued stock market coupled with rising earnings. Real estate is no longer much competition for stocks and it's an open secret that the years leading up to Presidential elections tend to reward investors with above-average returns. As a result, we'll be surprised if the stock market remains undervalued once the summer doldrums are over.

In the meantime, please feel free to contact us if you have any questions or if we can be of any service.

Best regards,

Paul

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