FIRST AMERICAN
WEALTH MANAGEMENT GROUP

Quarterly Commentary
Second Quarter 2006

This was a quarter when neither securities markets nor the economy seemed able to make up their minds. Both the Standard and Poor's 500 and the Nasdaq Composite indices lost ground, while the Dow Jones Industrial Average posted a marginal gain. Bond yields increased, and investors increasingly preferred Treasury securities to riskier emerging market and high-yield "junk" issues. Energy prices continued to climb, exerting inflationary pressure and easing any concerns the Federal Reserve may have had about continuing its long march to higher interest rates. The quarter's two quarter-point additions to the Fed funds target rate are the latest of 17 straight rate hikes. Meanwhile, though consumers remained relatively confident about the direction of the economy, their purchasing slowed, particularly in the housing market. Still, despite considerable economic hemming and hawing, restated figures for the first quarter show the gross domestic product expanding at a determined 5.6% pace.

The Stock Market

The S&P 500 and the Nasdaq ended the quarter in negative territory, dropping 1.9% and 7.2%, respectively, while the Dow inched ahead by 0.4%.

Large capitalization stocks held up better than their smaller company counterparts. The Russell 1000, a proxy for large cap performance, ended the quarter down 1.66%, compared with a 5.02% loss for the small-cap Russell 2000. The Russell 1000 Value Index actually eked out a gain of 0.59% for the quarter, while the Russell large-cap growth benchmark slid by 3.90%. The small caps fared worse, with the Russell 2000 Growth Index spiraling down by 7.25% while small-cap value lost 2.70%.

As crude prices rose and mergers and acquisitions increased, "other energy" and integrated oils prospered, while health care and technology lagged. Of the 10 S&P sector indices, three ended the quarter in positive territory. The winners were utilities, energy, and consumer staples, posting returns of 4.73%, 3.85%, and 2.31%, respectively.

Beyond U.S. shores, many investors lost their nerve, overall the MSCI EAFE Index faded by 4.02% when measured in local currencies, though it was up 0.94% by the yardstick of U.S. dollars, which dropped against other currencies. That was the silver lining for U.S. investors. Though the dollar's decline meant they had to pay more for imports, their profits on international investments gained value when they brought them home, exchanging yen or euros for dollars.

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If you have questions about this information, or about other investment topics, contact First American Wealth Management Group.

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The Bond Market

The Federal Open Market Committee bumped up the federal funds target rate by a quarter percentage point at each of two meetings during the quarter. The target rate, for overnight loans among banks, ended June at 5.25%, and that increased the cost of borrowing, particularly for consumers and businesses holding variable rate loans. But in the face of renewed signs of economic growth—and accompanying inflationary pressures—new Fed chief Ben Bernanke had little choice to continue the string of rate hikes started by his predecessor, Alan Greenspan.

The bond market fared better this quarter than during the horrendous first, the worst since 1994. Still, Treasury yields rose along with the Fed rates, pushing down bond prices. In June, yields on 10-year notes suffered their worst slump since 1974, yet ended the quarter at 5.14%. Meanwhile, the Lehman Brothers Aggregate Bond Index dipped 0.08%. And with investors flocking to the highest quality issues, only corporate high-yield bonds outperformed Treasuries on a duration-adjusted basis.

Total returns on mortgage-backed securities were flat, slipping 0.01%, while "junk" rated corporate bonds rose 0.25. And the junkier the issue, the bigger the gain, with CCC-rated bonds rising 2.09% compared with a 0.22% loss for BB-rated bonds.

And the big picture? Much may depend on Ben Bernanke's assessment of the economy and his plan for additional interest rate hikes. Further tightening could hurt the economy, reduce disposable income, and heighten the risk of personal bankruptcies. But keeping rates where they are could translate into higher inflation and a decline in growth and productivity. Because it can take as long as six months for monetary policy to make itself felt, the ultimate outcome of Bernanke's next move may not be known for some time.