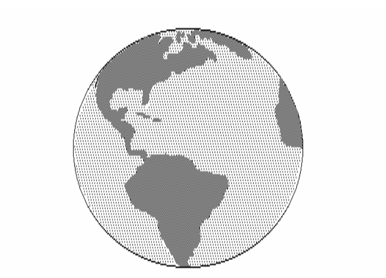
# Market Watch

Q2 2006

**Summary**

- Quarterly returns were generally negative this quarter, one which started out as a continuation of recent past good results and tumbled in mid-May over interest rate concerns.
- Domestic stocks fell almost 2.5% for the quarter. Small stocks fell more than larger stocks, on average. Value continued to out-perform growth, at all company sizes.
- Non-U.S. stocks were also generally negative although not as much as U.S. averages, with emerging markets and Japan leading the way. European stock averages were up slightly.
- Real Estate stocks were minimally negative.
- Bond results were mixed for the quarter, but all close to breaking even.



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After a pleasantly robust market rise in the first quarter, investors found themselves on a roller coaster ride in the second quarter. Rising interest rates, inflation fears and uncertainty regarding the sustainability of corporate profits all contributed to a market sell-off in May and most of June.

This market reaction was paralleled throughout most of the world. Low interest rates have allowed economies around the world to expand rapidly the last few years (and the global economy and corporate profits still continue to grow at a healthy rate). However, concerned that such economic growth might re-ignite inflation, the U.S. Federal Reserve, the Bank of Japan, and the European Central Bank all moved to increase short term interest rates. This move — intended to slow economic expansion — ignited investor fears instead and contributed to the global decline in the markets.

During the quarter, there were few places for investors to hide. Not only were U.S. markets down, most foreign markets declined, the Lehman Brothers Aggregate Bond Index declined by more than 1%, and the Dow Jones-AIG Commodity Index fell more than 10% from its peak in May to it's level on June 30.

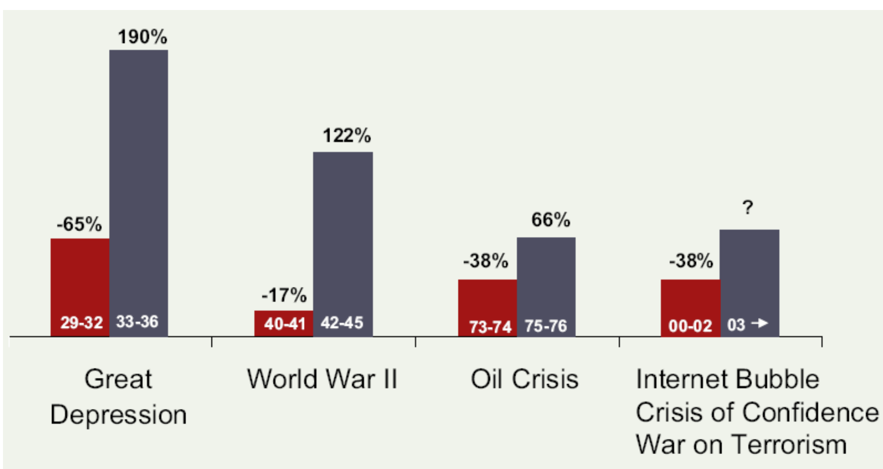
## *Key Factors*

**Economy and Profits:** Over the long term, economic growth and corporate profits are the key drivers of stock performance. At this writing, the U.S. economy is fundamentally healthy — unemployment is low, interest rates are still relatively low, and corporate profits are forecast to show a 12th straight quarter of double digit percentage gains. Nonetheless, there are signs that the economic fundamentals may have peaked. It is certainly reasonable to expect that the pace of earnings growth will slow from the very high rates we've seen over the last few years.

**Inflation:** In an effort to moderate economic growth and keep inflation in check, the Federal Reserve has increased short term interest rates aggressively over the last year and a half. While fighting inflation will continue to be a Fed priority, it appears that the Fed may be ready to slow or halt further interest rate increases (to avoid choking off economic growth). Inflationary pressures are also being dampened by the continued globalization of production and by the high rates of productivity achieved through expanding use of technology. The slow-down in the housing market and its impact on consumer spending is also likely to lessen inflationary pressures.

**Interest Rates:** Interest rates are an important component of stock valuations (they provide a basis for the discount rate used to measure the present value of future earnings). Over the longer term, it is realistic to expect that rates will rise at least somewhat higher given the large U.S. budget and current-account deficits. Should rates go up without a corresponding increase in corporate earnings growth and wages, this would be a negative for stocks.

**Market Returns After Consecutive Down Years**




Source: JPMorgan Asset Management, Standard & Poor's

**Strength/Weakness of the U.S. Dollar:** With the exception of a rally in 2005, the dollar has been in decline for the better part of four and a half years. This has the effect of making U.S. exports less expensive to foreign buyers and as such, tends to be positive for corporate earnings. U.S. investors also enjoy the relative rise in value of non-U.S. investments. However, a weakening currency can negatively impact the financial markets in that it reduces the return foreign investors receive on their U.S. based investments. If this leads foreign investors to pull money out of the U.S. markets, a decline in U.S. stock prices and higher domestic interest rates are both distinct possibilities. This scenario has not yet materialized, but a crash in the U.S. dollar is a risk (given our very high current-account deficit). This would not only hurt the markets in the short-term, but could also have a much bigger and longer-lasting impact by tilting the U.S.—and by extension its major trading partners—into recession.

**Other Factors.** The troubling wars in Afghanistan and Iraq, the regular news reports on terrorism, uncertainty about the November elections, and concerns over global warming have all added to investor cautiousness. Investors appear less willing to take on risk than they were just a few months ago.

### *U.S. Stocks*

U.S. stock markets ended the second quarter with mixed, but generally negative results. Larger, value-oriented stocks weathered the swoon the best. The large-cap indexes held up the best during the May-June weakness, with the mid-cap and small-cap indexes bringing up the rear.

On May 10, the Dow Jones Industrial Average was up more than 8% for the year and came within 100 points of its all-time record. Ben Bernanke, the new Federal Reserve Chairman, let it be known that the Fed was seeing signs of inflationary pressures which would likely continue to push interest rates higher. Then the ride got rough — with 100-point daily declines and advances becoming almost the norm. By the end of the quarter, roughly half of the year-to-date gains achieved through early May had been given up. For the quarter, the Dow rose 0.4% and was up about 4% for the year to date, ending the quarter at 11,150.22, less than 600 points short of its January, 2000 record of 11,722.98.

In contrast to the Dow's small gain, the S&P 500, a broader indicator of the large stock U.S. market, was down 1.9% for the quarter and the NASDAQ composite average (typically smaller and growth stocks) was down 7.2%. These were the first quarterly losses for these indexes since the first quarter of 2005.

Small U.S. stocks were hit harder than U.S. large stocks during the quarter. The Russell 2000 small stock index (which had more than doubled since its 2002 low point) was trading at a record level in May — up 16% for the year-to-date. Despite a late-June rebound, the index fell 7.3% from its May high. For the full quarter, the Russell 2000 Index was down 5.3% — but still up 7.6% for the first six months of 2006.

Many observers feel that the Spring decline was simply a market correction and not the beginning of negative market trend. Over the past four years, the markets have risen steadily, without even one 10% decline. Markets rarely rise so steadily. For many, this fall-back was a healthy pause in an otherwise rising market.

In late June, the Fed signaled a likely slowing or halt to further interest rate increases. This strengthened the markets, boosting them a few percentage points from their quarter lows.

## *Non-U.S. Stocks*

Outside the U.S., the declines from recent high points were, in many cases, more dramatic. Japan's main stock index fell 12% from its recent high. India's benchmark index was down 16%, Columbia's declined by 33% and Turkey by 26%.

Despite the significant declines noted, for the full quarter, the news was more moderate. Across all international categories, the average decline during the quarter was a bit over 2% (but international funds as a group are still up 33.9% for the twelve month period ending June 30).

**Surprisingly, U.S. stocks are "cheaper" now than they were at the market low point, in P/E terms.**


Source: Standard & Poor's, First Call, FactSet, JPMorgan

Not surprisingly, results varied by region. European funds gained nearly 1/2% during the quarter and are up 28% over the last twelve months. Japanese funds were down 6.8% for the quarter, but have gained nearly 34% over the last twelve months. The Emerging Markets category dropped 5% in the quarter but still have twelve month returns of 34%. Latin American stock funds were down 3.4% for the quarter, but continue to lead the international category with twelve month returns of nearly 55%.

## *Bonds*

Bond yields have remained stubbornly low for several years now. While this may disappoint bond investors, it has helped to support the economy by keeping borrowing costs low (the yield on the 10-year Treasury serves as an important benchmark for many mortgages and loans).

In 2006, bond yields of all maturities have been trending higher. This has begun to crimp economic growth, in areas like housing, consumer spending and corporate profits. The 10-year Treasury bond yield which was at 4.3% in January ended the second quarter at 5.15%.

During the quarter and over the last twelve months, intermediate term bond funds declined in value (by 0.17% and 0.86% respectively). Short term bond funds saw a modest increase of 0.50% and 1.38% over this same period. Inflation Protected Bonds (TIPS) gained 0.32% during the quarter but have declined by 1.94% over the last twelve months. High yield bonds, which more closely track the equity markets, lost an average 0.11% for the quarter but are up 4.76% over the last year. World bonds fared slightly better for the quarter (+1.59%) but are up only 0.42% over the last twelve months. Assuming interest rates begin to stabilize somewhat, it would be reasonable to expect improved returns from bonds in the future.

Like their taxable counterparts, municipal bonds experienced mixed results over the last quarter and year. National short-term muni bond funds gained 0.43% for the quarter and 1.4% over the last year. National intermediates however, fell 0.02% and gained only 0.14% over these same periods. California short / intermediate tax-frees gained 0.02% and 0.52% over the quarter and last twelve months respectively.

## *Other Asset Classes*

Like equities, commodity futures have also been on a wild ride — driven by the competing influences of rising commodity prices and fears of a possible Fed-induced recession. Even gold, at $613.50 a troy ounce, was down 15% from its May 11 high of $719.80. Futures prices are generally higher than spot prices currently. This may suggest potential pricing weakness going forward. Nonetheless, we continue to believe commodities are a valuable diversifier and have a place in a broadly diversified portfolio.

We thank you for your confidence and trust.

*Sources: Morningstar, Wall Street Journal, SF Chronicle, JP Morgan Quarterly Review, Advisors Intelligence*

**World Market Returns by Region Since 1995**

| 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | YTD 2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| S&P 500 37.6% | FTSE UK 28.8% | S&P 500 33.4% | MSCI Europe Ex-UK 33.9% | TOPIX Japan 76.0% | MSCI Europe Ex-UK -7.1% | MSCI EME -2.4% | MSCI EME -6.0% | MSCI EME 56.3% | MSCI EME 26.0% | MSCI EME 34.5% | MSCI Europe Ex-UK 14.2% |
| FTSE UK 23.7% | S&P 500 23.0% | MSCI Europe Ex-UK 25.0% | S&P 500 28.6% | MSCI EME 66.4% | S&P 500 -9.1% | MSCI Asia Ex-Japan -3.8% | MSCI Asia Ex-Japan -8.3% | MSCI Asia Ex-Japan 47.0% | MSCI Europe Ex-UK 22.4% | TOPIX Japan 28.7% | FTSE UK 14.0% |
| MSCI Europe Ex-UK 22.6% | MSCI Europe Ex-UK 18.7% | FTSE UK 18.8% | FTSE UK 16.8% | MSCI Asia Ex-Japan 64.7% | FTSE UK -15.0% | S&P 500 -11.9% | TOPIX Japan -8.9% | MSCI Europe Ex-UK 43.6% | FTSE UK 19.3% | MSCI Asia Ex-Japan 23.2% | MSCI Asia Ex-Japan 7.7% |
| MSCI Asia Ex-Japan 4.0% | MSCI Asia Ex-Japan 10.0% | MSCI EME -11.6% | TOPIX Japan 7.73% | S&P 500 21.0% | MSCI EME -30.6% | FTSE UK -16.3% | FTSE UK -13.9% | TOPIX Japan 38.6% | TOPIX Japan 18.1% | MSCI Europe Ex-UK 11.3% | MSCI EME 7.3% |
| TOPIX Japan -1.5% | MSCI EME 6.0% | TOPIX Japan -28.1% | MSCI Asia Ex-Japan -7.8% | MSCI Europe Ex-UK 17.8% | TOPIX Japan -32.7% | MSCI Europe Ex-UK -22.0% | MSCI Europe Ex-UK -19.9% | FTSE UK 31.1% | MSCI Asia Ex-Japan 17.7% | FTSE UK 8.0% | S&P 500 2.7% |
| MSCI EME -5.2% | TOPIX Japan -16.5% | MSCI Asia Ex-Japan -40.3% | MSCI EME -25.3% | FTSE UK 16.2% | MSCI Asia Ex-Japan -35.2% | TOPIX Japan -29.3% | S&P 500 -22.1% | S&P 500 28.7% | S&P 500 10.9% | S&P 500 4.9% | TOPIX Japan -0.1% |

Source: MSCI. FTSE. TOPIX. Standard & Poor's. FactSet. JPMorgan

(Note: MSCI EME = an index for Emerging Markets)