

June 13, 2006



MASSEY QUICK
W E A L T H A D V O C A T E S

Market Mayhem

Worries Create Market Jitters. What Comes Next?



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Recent weeks have brought gut-wrenching declines and increased volatility to markets around the world. The change in sentiment seemed to come upon us quickly, like a fast moving violent thunderstorm. To place the recent mayhem in perspective, the following table reviews the performance of a number of major equity indices from May 1 through June 12.

Domestic

S&P 500	-5.42%
NASDAQ	-9.96%
Russell 2000 Growth	-12.74%
Russell 2000 Value	-8.27%

International

EAFE (Global Developed Markets)	-9.29%
FTSE (UK)	-5.50%
DAX (Germany)	-10.46%
MSCI Emerging Market Equities	-17.40%
MSCI Asia Ex Japan	-11.40%
<i>Through 6/13/06</i>	
Nikkei 225 (Japan)	-16.95%
Topix (Japan)	-16.10%

Years ago, one of my early mentors told me, “We are all long-term investors until markets become difficult. Figure out what’s working and what isn’t and stay the course. Don’t initiate change for the sake of change. Do your research and make educated decisions”. There are no two ways about it: May’s results were difficult to stomach. Sometimes it’s easier to understand when one manager underperforms. We can go in, analyze the portfolio, determine performance attribution, and review the stock selection process employed by the manager. We can then make a value judgment about whether or not to stay the course. When all markets drop simultaneously without an exogenous event (i.e. The Russian crisis, terrorist attacks, the Long Term Capital Management debacle), the task of understanding the decline becomes more difficult. We believe that there are three major forces in place that are creating concern and indecision regarding world markets. The first is that global central banks have been removing liquidity from the system causing speculators to sell stocks, bonds, and other financial assets. The other two concerns emanate from conflicting views regarding the impact of monetary policy. One camp is worried about inflation, the other about recession.

Global Central Banks are Removing Liquidity from the System

Interest rates were too low for too long. In late 2000 and throughout 2001, the U.S. Federal Reserve Bank, led by Alan Greenspan, was worried that the American economy was headed into a deflationary environment. Deflation, as opposed to inflation, is marked by a shrinking economy and the destruction of capital by falling asset prices. The Federal Funds Target Rate was reduced from 6 ½ % to 1% over two years. One of the tools the Fed uses to reduce rates is the “creation” of money in the banking system. To simplify the explanation, the Fed loans more money to banks all over the country at lower and lower rates. The banks then lend that money to individuals in the form of mortgages, home equity loans, or lines of credit. Corporations borrow for capital expenditures or acquisitions. Financial institutions borrow to leverage their balance sheets. All of these entities were willing to accept more risk because the absolute level of interest rates was so low. Money was “inexpensive” (low interest rates) and easy to borrow because there was excess capital in the system. In previous investment strategy pieces (please view them at www.masseyquick.com), we expressed concern that there was too much liquidity chasing too few opportunities. We believed some assets were overpriced. Our worry list included emerging markets, equity and debt, high yield corporate bonds, and speculative real estate. When money is so cheap for so long, it creates speculative bubbles in asset prices. This has been most evident in certain commodities, basic materials, and housing.

As policy makers were convinced the deflation scare was over, they began raising rates, removing some of the excess liquidity from the economy. This policy was not isolated to America. Japanese and European central banks also started draining liquidity from their banking systems. To complicate matters further, long-standing Fed Chairman Alan Greenspan did not pursue another term and economist Ben Bernanke was confirmed as the new Federal Reserve chairman. Market participants had grown comfortable with Alan Greenspan. His policy was fairly predictable. Bernanke, on the other hand, was an unknown quantity. He has not yet gained the confidence of investors. When it became clear that the new Fed Chairman was concerned about inflation, this gave a signal to market participants that interest rates might move even higher than they expected. The days of low interest rates and excess liquidity were coming to an end. Market participants began to unwind positions that were being financed with cheap money. The dramatic declines in May and early June were caused by what is now being labeled, “the risk reduction trade”. Everyone headed for the exits at the same time. Brian Westbury’s editorial in the June 7 edition of *The Wall Street Journal* summarized the situation well: “Monetary policy was overly accommodative for too long. Weaning investors, home builders, hedge funds, and proprietary trading desks from 50-year low interest rates is like forcing them to quit smoking: It’s good for the health of the economy, but it hurts and they are complaining loudly.” I urge you to read the entire piece.

Worry Camp #1: Inflation is Coming!

One component of the market is overly focused on the Federal Reserve. This camp is concerned that the Fed may have allowed interest rates to stay too low for too long. This usually results in an inflationary spiral. We have seen evidence of this in the housing markets, commodity prices, record low credit spreads, and other places for the “hot money” crowd. The Fed’s job is to create stability and balance for our economy through monetary policy. The worry is that if the Fed overshoot on the downside they may have created an inflationary environment that will take a long time to correct. Policy makers, especially a new Fed chairman, may feel compelled to raise rates beyond the point of equilibrium to quell inflationary pressures. Higher interest rates remove liquidity from the system, forcing asset prices lower. This camp decided to sell now in anticipation of lower prices in the future.

**Worry Camp #2: The Fed is Overreacting
and Will Force our Economy into Recession**

Another set of market participants doesn’t believe that inflation is a problem. This camp would argue that the 4% increase in the Fed Funds rate over the past two years has already started to put the brakes on the economy. There are signs that the American consumer is slowing down. Our savings rate is negative, job growth is decelerating, and energy prices and higher mortgage rates are working to reduce disposable income. There has been a dramatic decline in home equity loans, reducing another source of household liquidity. This camp is concerned that the Fed is overreacting and will raise interest rates too high, causing the economy to slow down too much and slip into a recession. Decelerating growth is not positive for financial assets.

“Don’t Bring Me Problems, Bring Me Solutions”

The above quote belongs to Margaret Thatcher, an outstanding leader. Part of our job *is* to bring you solutions. We do this by guiding you on asset allocation and choosing managers that will perform well under these asset allocation guidelines. Both of the above described concerns can’t be correct. While we do agree that the consumer will weaken, corporate America remains strong. Despite the 16 consecutive increases in the Fed Funds rate, corporate profits for the S&P 500 have experienced eleven consecutive quarters of double digit earnings growth. Companies continue to raise dividends. Merger activity remains robust. Business investment and productivity are still increasing. The consumer will become less vital to the growth of the economy; business investment will pick up the slack. We believe the appointment of Hank Paulson as Secretary of the Treasury will prove to be tremendously positive.

We recognize that each of our clients is different. Each family, endowment, or foundation has a unique set of goals for their capital. This is why we work to define investment policy and construct customized multi-manager portfolios. That being said, here are a few general themes that will guide our advice to you:

- Stable growth stocks will finally begin to reward investors.
- Dividends are important. The new tax bill extends the tax efficiency of dividends to individual investors. We continue to favor managers that focus on both absolute yield and dividend growth.
- Fixed income is becoming a more attractive place to be. We expect to see buying opportunities develop in the second half of the year as the perception swings to a slowing economic environment. Markets are not yet rewarding investors for credit risk. We would focus on AA rated or better municipal bonds. Tax-exempt investors and those subject to the Alternative Minimum Tax should own treasuries, not corporate bonds. We expect credit spreads to widen. Duration should start to be increased.
- We still believe developed international markets provide value. Despite the recent declines in Japan and Europe, we expect domestic demand to increase in these economies.
- We would stay away from emerging market equity and debt. Expect a high degree of volatility from these markets.
- We believe unleveraged long/short equity managers will perform well on a risk-adjusted basis. They have an important place in most portfolios.
- While correlations between managers and asset classes have been high recently, we expect this to normalize over the coming months.

As always, please call us if you would like to discuss our views, your portfolio, or specific managers.

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