



INVESTMENT COMMENTARY

Market Review – As anticipated in our last Investment Commentary, the equity markets began a correction in May, breaking a string of three consecutive positive quarters. Most equity indices fell in value, with the steepest declines occurring in the more risky small-cap, emerging markets, and growth sectors of the stock market.

Fixed income market returns once again were essentially flat as the negative impact of rising interest rates was offset by coupon interest payments¹. The Federal Reserve Board continued its two year effort to cool the economy by adding another ½% to short-term interest rates. The US Treasury yield curve remained flat through the second quarter as yields on the benchmark 10-year US Treasury Note rose from 4.8% to 5.1%. Although the municipal and corporate bond yield curves offered slightly more positive slope, we remained generally cautious in our bond purchases, experiencing very little yield penalty by holding money market cash.

Comparative Performance Indices		Quarter		3-Year Average
Total Return for periods ending June 30, 2006 ²			Year	Annual Return
U.S. Stocks	Russell 3000 Index	-2.0%	+9.6%	+12.6%
Foreign Stocks	MSCI EAFE Index	-0.3%	+23.4%	+21.1%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	-0.1%	-0.8%	+2.1%
Municipal Bonds	Lehman Brothers Municipal Bond Index	+0.0%	+0.9%	+3.2%

The indices above are representative of investment asset classes. The Lehman Brothers Aggregate Bond Index is composed of U.S. Treasury, U.S. government agency, corporate bond, and mortgage-backed securities. The Lehman Brothers Municipal Bond Index is composed of general obligation (GO) and industrial revenue bonds issued by state and local governments. The Russell 3000 Index is composed of the 3000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market. The Morgan Stanley Capital International Europe, Australia and the Far East (MSCI EAFE) Index is a widely followed group of stocks from 20 countries, excluding the U.S. It is not possible to invest directly in an index.

Economic data³ continue to demonstrate the strength and resilience of the US economy. Despite high and rising oil prices, higher interest rates, an apparent housing slowdown, hurricanes, protectionist sentiments, geopolitical concerns, etc., first quarter nominal GDP growth was revised upward to 8.9%, an unsustainable rate in our view. Corporate profits grew at an extraordinary 28.5%, making 16 consecutive quarters of double-digit growth in profits.

With many of our financial services stocks, and indeed much of the economy, dependent upon the residential housing market, it appears that the “soft landing” scenario that we have been expecting is now occurring. Although certain local markets are experiencing severe price declines, excessive inventory, and mortgage foreclosures, the national statistics indicate a more moderate picture. Existing home sales (a lagging indicator) in May slowed to an annualized rate of 6.7 million homes, down from 7.1 million homes a year ago. Year-over-year change in median resale prices declined to +6.4% from +11.7% a year ago. New home sales (a leading indicator) in May slowed to 1.2 million homes, down from 1.3 million homes a year ago. Inventory of existing homes for sale has increased to 6.3 months supply from 4.3 months a year ago⁴. Though the housing and construction markets are clearly slowing, signs of a crash are not evident (yet).

¹ Since we hold bonds to maturity, fluctuations in market value are less meaningful for long-term portfolio returns.

² Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, July 5, 2006.

³ Bureau of Economic Analysis, U.S. Department of Commerce

⁴ Housing market statistics from Bear Stearns



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Market Outlook – The markets seem to be anticipating a cessation of interest rate increases by the Federal Reserve Board. However, we do not believe that the Federal Reserve Board is as close to ending their two year campaign of interest rate increases as many market commentators have suggested. Signs of rising inflation abound, suggesting that the Fed's efforts to slow the economy and dampen inflationary expectations have not been totally effective yet. In addition to rising oil, metal, and other commodity prices, the growing US economy is bumping up against capacity constraints – creating inflationary pricing pressures. The US unemployment rate is at 4.6%, well below the 5% level considered full employment by most economists. Total capacity utilization has passed 82%, above the long-term average of 80%. Moreover, the Fed's preferred indicator of inflation, the Personal Consumption Expenditures (PCE) Deflator has been growing at 2.1% for April and May, significantly above the Fed's desired range of 1-2%⁵. All of these indicators suggest the need for further monetary restraint by the Fed, i.e. more interest rate hikes, perhaps more than the markets expect.

Therefore, we expect the next few months to remain choppy at best for the equity markets. Potential *near-term* risks to the equity markets include:

- Based on data supporting the inflationary pressures described above, the Federal Reserve Board is likely, in our view, to increase short-term rates by at least another quarter point and probably more; disappointing the markets. Long-term interest rates will rise with inflationary expectations. With such a delayed response to rising inflationary expectations, the Fed may well be forced to “overshoot”, thereby contributing to an economic slowdown later this year.
- July and August will see most corporations reporting their second quarter earnings. Based on the past four years of double-digit earnings gains, expectations are high. Any shortfall will disappoint, leading to negative market reactions.
- Geopolitical threats from Korea, Iran, and terrorism show no signs of abating soon. Events are always possible; markets will react.

Beyond the next few months, however, our market outlook becomes considerably more favorable and consistent with the “low return” environment that we have been expecting for the last few years. We believe that the Fed will succeed (one way or the other) in restraining inflationary expectations. And that success will allow interest rates to moderate. Corporations and private equity investors are flush with cash, suggesting a continuation of dividend increases, stock buybacks, and acquisitions. Earnings yield remains the most reliable predictor of *real* (after inflation) equity market returns⁶. With the earnings yield of the S&P 500 Index beginning the third quarter at 6.6%⁷, stocks should be able to resume their upper single digit *nominal* (including inflation) annual returns, barring an unexpected collapse in corporate earnings or a significant monetary crisis. Under these conditions and given our outlook, we remain vigilant for buying opportunities in pursuit of long-term gains.

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⁵ Economic data from Bear Stearns

⁶ Jeremy J. Siegel, *Stocks for the Long Run*

⁷ Standard & Poors