

Beware the Ides of... May

*Rough winds do shake
the darling buds of May,*

*And summer's lease
hath all too short a date.*

- William Shakespeare, Sonnet XVIII

As months go, May doesn't usually stand out in the financial markets. It seems to lack the panache of many of the other months. Sure, there's the whole "sell in May and go away" thing, but by and large most of the really big stuff tends to occur in flashier months. Take October. Now that's a biggie. And then there's January, which gets some action every now and then. But May? Hardly ever.

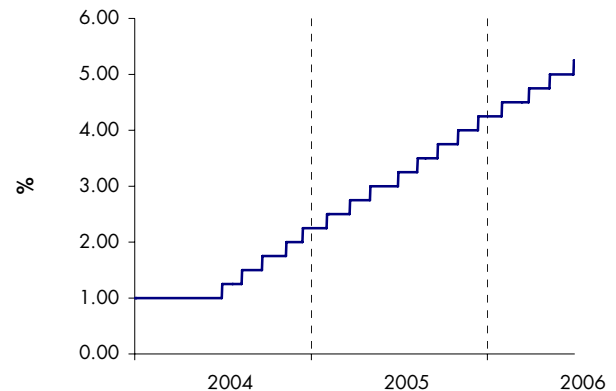
That certainly wasn't the case with the 2006 version. This was one for the ages. At first glance, it all seemed to start with the ridiculous Bernanke – Bartiromo affair. Setting that bonehead move aside for now, it's obvious that the markets were having trouble getting a handle what exactly the Fed Chairman and his cohorts at the FOMC have been trying to get across. What isn't so obvious is whether this has been an encoding or a decoding problem. No doubt there's always something for everyone in most Fed communications; ample ammo for both bulls and bears. And its hardly surprising after two years worth of 25 bp hikes in the Fed funds rate at every meeting, that market participants might get a little schizo with the prospect of having that faux-certainty taken away. But you have to admit that the ham-handedness of May 2006 is not likely to be prominently mentioned in the next edition of "How To Run a Central Bank." Way too much has already been written about the confusion emanating from the Fed in the second quarter, so let's just chalk it up to a rather inauspicious start for Ben, and leave it at that.

It all seemed to come to a head in and around the middle of May, when the Fed tightened as expected for the 16th consecutive time, bringing the funds rate to 5.00%. (See Figures 1 and 2) What was apparently not expected was the language used in the statement released after the meeting. As usual, it was minutely parsed every which way, but this time it caused all hell to break loose. Volatility exploded, and the price of risk was marked up in chunks. Looking back at the charts of a wide variety of global markets – from equities to commodities to currencies to bonds – one thing stands out; clear and near-universal inflection points made during the middle of the month.

(cont. on page 2)

Figure 1. Intended Federal Funds Rates

December 31, 2003 to June 30, 2006



Source: U.S Treasury

Figure 2. Intended Federal Funds Rates

June 30, 2004 to June 30, 2006

Date	Increase (Basis Points)	Level (%)
2006		
June 29	25	5.25
May 10	25	5.00
March 28	25	4.75
January 31	25	4.50
2005		
December 13	25	4.25
November 1	25	4.00
September 20	25	3.75
August 9	25	3.50
June 30	25	3.25
May 3	25	3.00
March 22	25	2.75
February 2	25	2.50
2004		
December 14	25	2.25
November 10	25	2.00
September 21	25	1.75
August 10	25	1.50
June 30	25	1.25

Source: U.S Treasury

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So what is it about the Fed's statement that would make disparate markets like the Russell 2000, silver, the Japanese Yen, and 10-year notes from just about anywhere in the world all turn on a dime and drastically change direction? (See Figures 3, 4 and 5) Sure, there's the whole notion that the Fed is so concerned about inflation that it will end up tightening monetary conditions too much and force the economy into a recession. Such concerns are understandable because, historically, this is the type of thing that has kicked off recessions. But should these fears really make normally very different markets trade in unison? Perhaps so, but maybe we should expand our search for an explanation a bit further.

Remember that in the last edition of our quarterly commentary we wrote about the Bank of Japan (BoJ) announcing in March the end of its successful Quantitative Easing campaign. We explained that it might be a bit premature to think that Japan had successfully navigated its way clear of the 15-year deflationary fog that had enveloped the nation. It turns out that the BoJ did in fact get ahead of itself by removing reserves far too quickly from their banking system. The BoJ began to clue into this – you guessed it – around the middle of May, as rising short-term rates, a rapidly appreciating currency, and a collapsing stock market warned that they were indeed moving too fast.

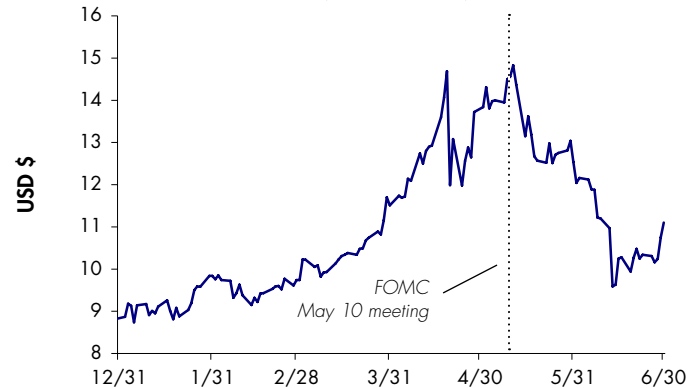
What makes this so important is that the removal of liquidity in Japan was beginning to impact the cost of that liquidity at the same time that many other central banks – the Fed included – were already in a tightening mode. This speaks volumes as to the importance of low Japanese interest rates and the degree to which they were used to fund purchases of higher risk assets, such as emerging markets stocks, commodities and higher yielding currencies – the so-called yen carry trade.

So maybe all of the blame shouldn't be heaped on Bernanke and the FOMC. Maybe central bankers around the globe need to take a long, hard look at how risk gets re-priced when the torrent of liquidity that was used as a backstop for the purchase of risky assets gets withdrawn. Although no self-respecting central banker would admit it, asset prices – at least in this environment – must be considered in the setting of monetary policy. Balancing the re-pricing of risk - the psychological ebb and flow between risk-taking (greed) and risk-avoidance (fear) - in a highly levered world may turn out to be as important to the current global situation as balancing growth and inflation. Otherwise, it could be the margin clerks that end up calling the shots.

To put a finer point on it, uncertainty about the Fed is occurring at the same time that the markets are struggling to comprehend the impact of liquidity being drained from the global financial system. Serial bubbles – created by massive, levered pools of capital utilizing what amounts to momentum strategies and energized by cheap borrowing costs – are being deflated as the riskiest (and increasingly highly-correlated) assets are sold in a flurry of de-leveraging. Whether couched as concerns about Fed credibility, or inflation, or economic growth, or global imbalances, or even geopolitics, the result is the same. Asset

Figure 3. Price of Silver

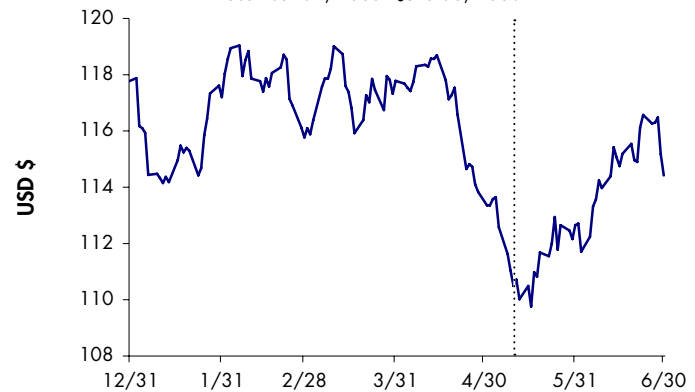
December 31, 2005 - June 30, 2006



Source: Bloomberg

Figure 4. Price of Japanese Yen

December 31, 2005 - June 30, 2006



Source: Bloomberg

Figure 5. Russell 2000 Index

December 31, 2005 - June 30, 2006



Source: Bloomberg

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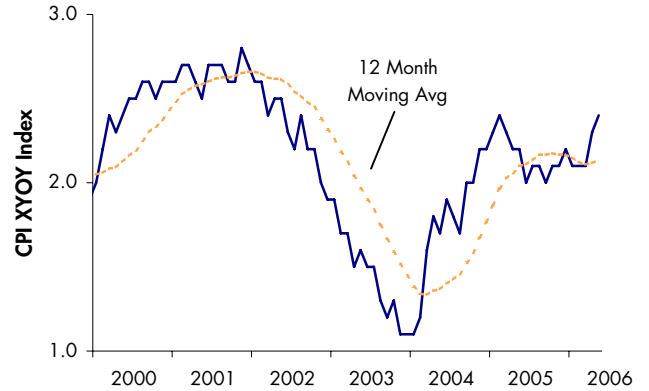
prices matter, regardless of whether or not central bankers want to admit it. These are financial markets - and this is a global economy - with a jones for carry, and cold turkey just won't cut it these days.

As the second quarter comes to an end, the markets are trying to stabilize after a very tough six weeks. Despite the turbulence, however, Seneca Capital Management's outlook for the domestic economy remains intact. We believe that the current anxiety about inflation is way overdone and will prove to be transitory. Much of it has to do with the Fed appearing to be alarmed that lagging inflation indicators - such as core CPI - had rebounded, and that its credibility was being attacked. (See Figure 6) Butchering its communication process didn't help much either. Nevertheless, as we've written often, we continue to believe that inflation - and its all-important counterpart, inflation expectations - will be contained by powerful longer-term disinflationary forces. Sizable productivity gains in the developing countries, corporate restructuring in the developed economies, and globalization are the structural keys to the continuation of the current low inflation backdrop. One of our secular investment themes has been that these forces will swamp the various cyclical inflationary factors currently garnering so much attention. As such, we expect inflation, as measured by the Fed's favored core PCE deflator, to remain within the 1.5% - 2.25% Fed target zone for the rest of the year.

The Fed's tough talk will likely be vindicated by the data over the next few months and Bernanke should get a promotion, earning his inflation-fighting stripes. He won't be promoted to full Volcker-ship, mind you, or even full Greenspan-hood, but the market should promote him nonetheless.

We continue to expect the U.S. economy to slow down a bit, with a couple of quarters of sub-3% GDP growth on tap for the second half of the year. Housing has been the significant driver of the economy over the last few years, but there is little doubt that the best news on housing is behind us. We continue to expect the end point of the Fed tightening cycle to be less aggressive consumer spending and a re-opening of the output gap. In fact, it appears

Figure 6. Consumer Price Index (ex Food/Energy)
US CPI Urban Consumers (Less Food and Energy Year over Year NSA)
December 31, 1999 - May 31*, 2006



Source: Bloomberg
* Latest data available as of publication date

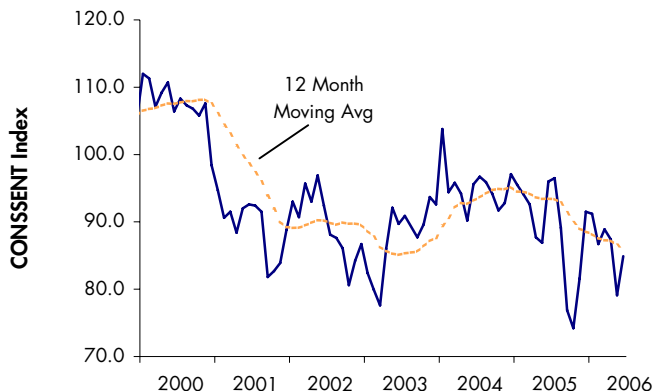
that a housing-led consumer slowdown has already begun, although we expect it to be tempered by a decent employment outlook, a fairly healthy corporate sector, and an improving global economy. We believe that only a cooling of the housing sector is in the cards, as opposed to the collapse predicted by some. The combination of higher borrowing and energy costs, along with moderating wealth gains thanks to the slowdown in home price appreciation and the recent setback in equity prices, is already having an impact. Consumer and business confidence is turning down. (See Figures 7 and 8)

The Fed raised the funds rate to 5.25% on June 29, and the market is currently placing better than even odds of another hike at the August 8 meeting. Our key takeaways from the statement released after the June meeting included the Fed patting itself on the back that its forecasts for economic growth and inflation were confirmed, attempting to correct its own miscommunications regarding forward-looking vs. backward-looking data, continued posturing to earn its inflation-fighting stripes, and giving itself

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Figure 7. Consumer Confidence

University of Michigan Survey of Consumer Confidence Present Sentiment
December 31, 1999 - June 30*, 2006

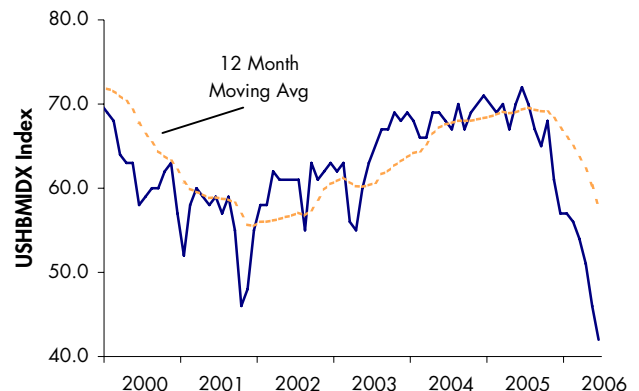


Source: Bloomberg
*June 30, 2006 data is preliminary

Base Year 1966=100

Figure 8. Home Builders Confidence

National Association of Home Builders Index - Seasonally Adjusted
December 31, 1999 - June 30, 2006



Source: Bloomberg

Equity Portfolios

The second quarter of 2006 was certainly not a quarter for the faint of heart. Following a strong start to the year, equity portfolio managers longed for sustainability. We didn't get it. In fact, many equity indices posted losses in the quarter with some of the more dramatic declines seen in the tech-heavy Nasdaq composite (-7%), the small cap benchmark Russell 2000 index (-5%), and the cyclical SOX (-12%). By mid-May, oscillating fears over inflation and an economic slowdown stopped the market in its tracks, with riskier asset classes underperforming more defensive investments. However, market leadership was virtually non-existent as most sectors posted negative returns in the quarter. Then, after an 18-month hiatus, volatility reared its head with the VIX (CBOE Volatility Index) more than doubling by mid-June reflecting investor skittishness as rising interest rates, inflation, and future growth concerns trumped solid earnings growth.

We don't think this dynamic will last. Broadly speaking, equity valuations are attractive and prospects for further earnings growth are still intact. In fact, earnings expectations for the market (S&P 500) increased during the quarter. However, the appetite for risk has changed, and therefore prudence is

warranted. Despite the seemingly precarious macro backdrop, we are optimistic about the second half of 2006, and continue to focus on higher quality growth stocks for which we forecast above consensus results. While our equity portfolios generated negative returns in the quarter, we remain ahead of or slightly behind our respective benchmarks and turnover remains low. During the quarter, our Consumer Discretionary underweight helped, while our slightly more aggressive stance on Technology and Health Care were the biggest detractors. Return dispersion within industry groups was low as both high and low quality stocks suffered in the quarter. As such, we are taking advantage of the sell off to add to our highest conviction ideas and in some cases rotate into previously expensive, higher quality names.

It looks to us as if the global economic data points neither to imminent inflation nor to recession, but we recognize that both warrant continued consideration. We believe equity valuations are attractive and continue to prefer the Growth over Value trade. Our equity portfolios reflect our expectation that superior performance over time lies in longer-term fundamental investing in high quality growth stocks, a philosophy to which we remain committed in these volatile times.

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some additional wiggle room for the August meeting. In the end, the Fed needs to believe that its economic forecast is coming to fruition, which awaits further data indicating a re-opening of the output gap.

The Fed has currently painted itself into a corner by focusing the market's attention on inflation more than we feel is necessary. Even with the recent misplaced focus on lagging core inflation figures, there are no signs of a self-reinforcing wage-price spiral. However, if there is a risk to our outlook it would be that the end point of this tightening cycle could be a weaker economy than we envisioned when we wrote the last quarterly, thanks to the Fed's intention to be seen as tough on inflation. That being said, we'll stick with our 2½ - 3% GDP call for the second half of 2006 for now, and watch the data like everyone else.

We didn't expect to see a 5.25% yield on the 10-year Treasury, and given our views on the economy and inflation for the rest of the year, current valuations look attractive on a 6 to 12 month time horizon. Shorter term, though, the key will be the emergence

of a clear catalyst that leads the Fed to conclude that its work here is done; this means data that clearly indicate inflation is rolling over or the consumer is pulling back meaningfully. Once that happens, bond market sentiment could change in a heartbeat, so our trading desk will stand at the ready. While we would favor a pause at the next meeting, an extra 25 bps after a full 425 is probably not enough to get worked up over. The more the Fed tightens now, the more easing will be needed later. Either way, the end result should translate into a flat to mildly inverted yield curve well into the summer.

With foreign central banks becoming more intent on lifting rates at the same time that the U.S. is nearing the end of its own tightening cycle, we continue to expect the dollar to come under pressure when it's clear that the Fed is finished, and when the near-term oversold condition of the dollar is alleviated. We do, however, expect the dollar decline to be gradual due to the phenomenon of competitive currency devaluation that we have written about in past commentaries, which we believe will continue to be an important feature the global landscape going forward.

This commentary is the opinion of the adviser. There is no assurance that the adviser's opinions or expectations will be correct. This report is intended for informational purposes and not as investment advice.

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