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Aureus Asset Management, LLC
Investment Perspectives
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Investment Policy Update

I. Summary

The financial markets have begun to anticipate change. As market psychology has shifted from hopeful to risk averse, there are those who have interpreted this recent change as a major inflection point in market direction. Our near to medium term outlook has been tempered by this shift in market dynamics, to a less vigorous second half of 2006 than originally thought. However, our outlook is less dire than that of other observers, some of whom forecast a particularly sharp slowdown globally. Therefore, we continue to believe that a properly diversified portfolio, still weighted towards equities and equity-like investments, is the prudent approach for investors in a time of relative uncertainty.

Public comments from Mr. Bernanke, the newly appointed Chairman of the Federal Reserve, as well as by several other members of the Fed, brought a realization to the investment community that inflation fighting was now the Bank's prime task, implying the possibility of more rate hikes. In addition, in May, there were statements from the European Central Bank and the Bank of Japan hinting at tighter monetary policies. As a result, stock markets fell and risk premiums widened.

Central banks pay close attention to markets, however, as market indicators are among the primary sources of information about future fears of inflation. Given the swift reaction of global stock markets in May and June, we believe there are increased fears of global recession, which may influence future monetary policy decisions.

Change can have unpleasant consequences, but this time the transition to neutral or tighter money should be manageable. With valuations now more reasonable than a few months ago, globally diversified equities still seem attractive.

II. What has changed

The world has enjoyed a little over three years of very low inflation, high gains in corporate profits, and low market volatility. All three factors are undergoing some level of change.

The initial hints of change appeared last year. Inflation began to inch up in the US in 2005, and more so in early 2006. The Federal Reserve started to raise short-term rates, from an extremely low level of 1% in late 2004, in steady increments to today's rate of 5%. After the Fed began to modify its policy, the Bank of England, the Bank of Japan and the European Central Bank also moved toward the direction of either monetary neutrality or actual tightening.

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In the past thirty years, there have been four periods of monetary tightening which lasted more than two years. After the Fed stopped raising rates, in two of these cycles the economy displayed a distinct slowdown in growth (but not recession), one ushered in a sharp recession (1974-5), and one resulted in only a slight moderation of positive real growth. Past experience would indicate that a slowdown is a reasonable supposition, but that a slowdown should not necessarily beget recession.

In the first quarter, US earnings grew at an annualized pace of nearly 20%. We should now anticipate a marked reduction in profits growth. As higher interest rates affect demand, and as companies find it hard to pass along commodity price increases because of competition, margins will be hard pressed to improve and may well contract. Yet modest gains in corporate profits should be maintained, based on our current projections of demand growth and margins.

Stock market volatility jumped in May and June, back to levels more consistent with historic averages. Investors now regard risk with increased concern, which has been exemplified by sharp declines in small and mid capitalization stocks and in the emerging markets.

III. What has not changed

Two major positive developments remain, as well as one crucial challenge. The positives are: record strength in global corporate balance sheets; and, equally impressive strength in many emerging countries balance sheets. The challenge is record deficits in our own country's trade and budget figures.

The large gains in corporate earnings since 2002 have not been squandered. To the contrary, companies have been wary of excess capital spending, having been burned in 2001-2. Corporations have bought back enormous amounts of their own stock, have boosted cash dividends by 14% last year, and have initiated a surge of acquisition activity. Record amounts of cash remain on corporate balance sheets.

Perhaps even more impressive has been the improvement in the balance sheets of most of the world's developing countries. Countries such as China, Russia, India, Korea, and Taiwan have allowed their reserves to reach record proportions, and have invested those reserves mostly in US Government obligations. Currently, over 50% of emerging country debt is ranked as investment grade as opposed to only 10% in 1998.

The very noticeable improvement in most countries balance sheets has been unfortunately offset by a deterioration in the US balance sheet. For the first time, foreigners now own more than 50% of our debt. This results from government tax and spending policies, which have produced large budget deficits, and consumer spending decisions which have produced an equally large trade deficit. Since the dollar is the reserve currency of choice, we have been able to run large deficits for many years, because foreign countries and companies have been satisfied to hold ever larger amounts of dollar denominated assets. Some further decline in the value of our currency in relation to other major currencies is to be expected, however, as countries try to diversify their reserves.

IV. Outlook

The shift in investor sentiment since early May has focused attention on change in both economies and financial markets. We recognize the importance of carefully monitoring the following developments:

1) Central bank policies regarding the level of short-term interest rates, as they attempt to balance inflation fighting while averting global recession;
2) The coming slowdown in the US, led by the consumer, and the consequent topping of profit margins;
3) The level of stock market volatility, and investor tolerance for risk.

V. Conclusion

In our opinion, the recent declines in the global financial markets should prove an effective warning signal to the central banks, thereby forestalling the need for too tight a monetary policy. However, a slowdown in global economic activity seems all but certain, which should eventually reduce inflationary pressures.

We believe that we can manage our way through this period of uncertainty, as the strengths of corporate and emerging country balance sheets are such that the world has a very large shock cushion in place. A careful investment policy of wide diversification, with an equally diligent selection process, will be the keys to relatively strong long-term investment results.