

SEPTEMBER 2005

**Katrina: Special Report
September 19, 2005**

There are literally hundreds of views on the subject of the economic impact of hurricane Katrina on the U.S. economy. We thought it would be most helpful to condense our views to a few major areas of concern for our clients.

As of mid-September, the economic consensus suggests Katrina will certainly impact the economy, however the extent of the impact is generally viewed as small. The impact to 2005 GDP ranges from a 0.5% to 1.0% drag on growth GDP (Congressional Budget Office and others). In 2006, it is expected that Katrina will actually add to GDP in the first two quarters as massive reconstruction of the impacted area moves into full swing. The bottom line is nobody is suggesting that Katrina will be a catalyst to recession or a real estate market collapse.

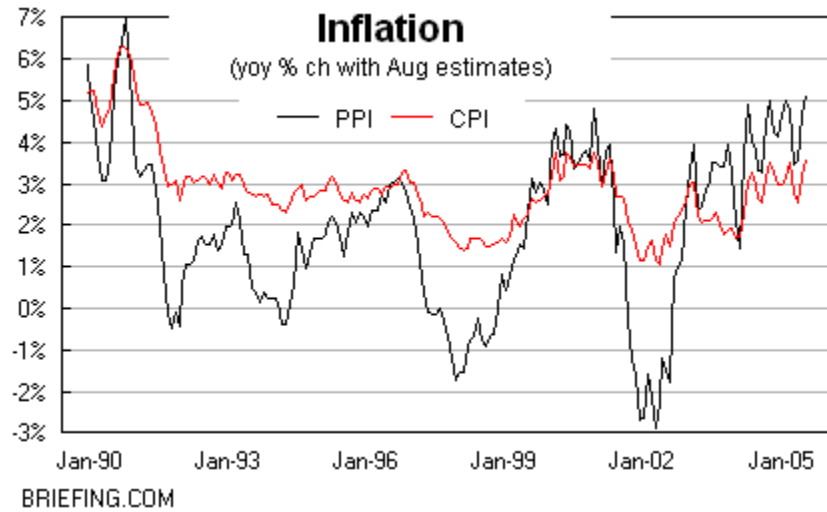
GDP IS A HOUSE MADE OF BRICKS

An increasing GDP in the face of Katrina's aftermath feels counterintuitive given the higher energy prices the storm caused. But according to economist, Tim Rodgers, "The facts are: gasoline and other energy prices make up only 2.4% of total GDP and only 3.4% of total personal consumption. A jump in gasoline prices of even 50% would only take 1.2% from other sectors of GDP. Higher gasoline prices here are thus clearly an important economic issue, but not overriding. An extreme scenario would be for higher gasoline prices to slash as much as 1% off GDP growth for a period of time, due in part to the impact on business investment as well as consumption, but it will not be permanent. This comes at a time when economic growth was accelerating from the 3.5% growth in the first half of the year."

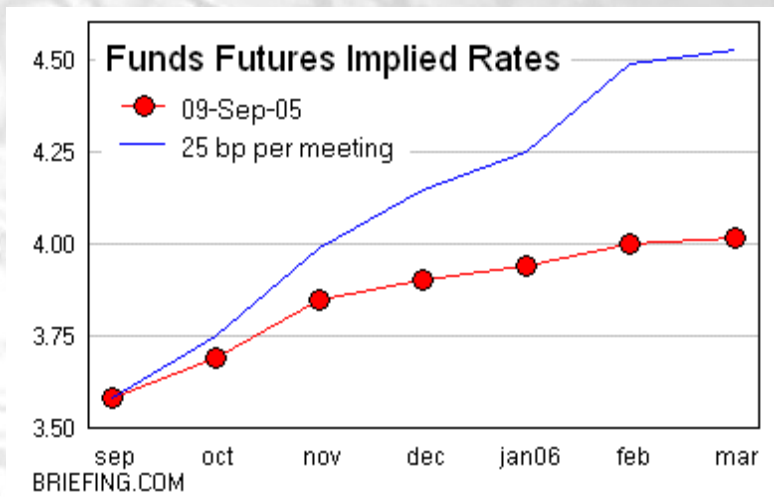
The bottom line is that the acceleration in earnings combined with relatively lower rates and inflation (maybe) will drive GDP over the hurricane's drag. From an equity market perspective this is very constructive.

INFLATION PROBABLY, HIGHER RATES POSSIBLY

While GDP seems to be able to withstand the brunt of Katrina, inflation is still of great concern to investors. It doesn't take more than one trip to the gas pump to know how directly the cost of fuel impacts our daily lives. Yes, gas prices are off their highs, but they are still significantly more than just a month ago. And don't forget, we aren't even in the winter heating oil season. Some estimates suggest our home oil and gas heating bill could be double what they were last winter. Does this sound inflationary yet? The near-term inflation data (August, pre-Katrina) is expected to show the strongest year-over-year rise in PPI in 15 years and the strongest CPI in 5 years.



So what does the market think about all this? Based on the federal funds futures contract (below), the market is expecting a 75% to 80% probability of a 25 basis point hike in the funds rate on Sep 20 FOMC meeting, but far less conviction for rates hikes in November. Indeed, the catch word circulating the market these days is "one and done" from the Fed. Fed watchers now suggest that the GDP slow down caused by Katrina will ultimately do a good amount of the Fed's work.



On the interest rate front, little has changed with respect to the hurricane. Even higher oil prices do not seem to be strong enough incentive for bond investors to push rates higher. To the contrary, the 10-year Treasury remains suspended just above the 4% mark. The influence of a stronger dollar, domestic and overseas bond demand and now the prospect for the end of Fed hikes has all but extinguished any significant rate movement.

MUNICIPAL BONDS PRICES STEADY

The municipal bond market has been of great focus through the Katrina disaster. The destruction of municipal infrastructure as well as displacement of entire city populations has many in the municipal bond world on the edge of their seats. The expected first reaction from the municipal bond markets should have been a spike higher in yields with expectations of downgrades and default. Again, counter

to the expected, municipal prices and yields moved very little. Bonds of issuers specifically in those hard hit regions were generally smaller and less widely held. Yields on those issues did rise where they were actually traded. On the national front, municipal yields held steady. Why?

The basic reason for stability in municipals, despite a municipal disaster, has to do with the levels of yields and demand. Because municipal yields, like Treasury's have been held at very low levels (the "conundrum"), any lift has been seen as a buying opportunity by managers holding cash in short-term paper. Indeed, the property and casualty firms, which are very large institutional buyers of municipals (interest exemption advantages), have been expected to sell municipal to cover their claims. This added supply at possibly higher yields is eagerly awaited from managers wishing to buy bonds with yield opportunity. In addition, it is now estimated that of the huge \$100 bil plus price tag of the hurricane, only a small amount would be claims liability. The end result is very little upward shift in municipal yields.

Finally, the hurricane emphasizes the importance of actively managed diversification and the inherent risk in a single state portfolio.

ALLOCATION STRATEGY REMAINS IN PLACE

Despite the market interruption, we do not see any strategic opportunities in the market. We continue to believe that broad diversification across domestic and internal equity as well traditional fixed income and alternative investment will continue to provide the best return opportunity and overall risk management. Therefore, we have not made any shifts in our overall allocation strategies

This is of course an evolving and complex topic with many unknowns. We will be regularly updating you on these and other key events relating to your investments with us. With Hurricane Rita only days away from impact, we will continue to keep you informed on any arising implications.

As always, we appreciate your support and trust. If you have any questions, please feel free to contact us.

Best Regards,



John M. Krambeer
President

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