Highlights

- Sluggish year-end finish to 2005 followed by strong Q1
- Higher interest rates and slower housing market impacting growth
- Income trends and employment are solid
- Lower energy prices a positive for businesses and consumers
- Strength in Japan and Europe should help our trade deficit
- Resilient dollar slowing exports
- Economic indicators generally strong
- Inflation contained for now

Economy

After a sluggish fourth quarter of 2005, partly due to Katrina and certain technical factors, including the timing of government expenditures, the U.S. economy snapped back in the most recent quarter with GDP growth north of 5%. An unusually warm winter may have helped retailers and construction, but trends for capital goods also looked healthy. No one expects the 5% pace to continue but growth of 3% or better still appears sustainable through the balance of the year.

Higher interest rates, a slower housing market and weaker auto production will crimp growth during the first half. Mortgage refinancing and home equity loans, once seemingly inexhaustible sources of funds, are no longer so attractive to the consumer. Solid job growth and rising incomes, however, should offset some of the pressure on the consumer. Employment gains in January and February averaged over 200,000. The pullback in the price of oil to about $60 per barrel should benefit the consumer assuming the lower price is sustainable.

The trade deficit is another drag on the economy, however improvement is unlikely without lower energy prices. Deficit reduction is also dependent on strong growth in our major export markets. Fortunately, Japan and Europe appear to be on the rebound which should benefit U.S. exports, particularly the capital goods producers. Meanwhile, the dollar has been surprisingly resilient, removing one possible catalyst for increased export volume.

<table>
<thead>
<tr>
<th>Economic Pulse</th>
<th>Latest Date</th>
<th>Latest Data</th>
<th>Preceding Period</th>
<th>Year Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Product</td>
<td>4th Qtr</td>
<td>1.6%</td>
<td>4.1%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Personal Income (billions)</td>
<td>Jan</td>
<td>10,610</td>
<td>10,535</td>
<td>9,970</td>
</tr>
<tr>
<td>All Fixed Investment (billions)</td>
<td>4th Qtr</td>
<td>1,942</td>
<td>1,922</td>
<td>1,811</td>
</tr>
<tr>
<td>Non-Residential</td>
<td>4th Qtr</td>
<td>1,323</td>
<td>1,305</td>
<td>1,235</td>
</tr>
<tr>
<td>Residential</td>
<td>4th Qtr</td>
<td>614</td>
<td>610</td>
<td>571</td>
</tr>
<tr>
<td>Consumer Spending (billions)</td>
<td>Jan</td>
<td>9,063</td>
<td>8,986</td>
<td>8,486</td>
</tr>
<tr>
<td>Rate of Inflation (Annual Adjstd)</td>
<td>Jan</td>
<td>4.0%</td>
<td>3.4%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Employed (thousands)</td>
<td>Feb</td>
<td>143,257</td>
<td>143,074</td>
<td>140,285</td>
</tr>
</tbody>
</table>

Core inflation has remained relatively contained throughout this cycle due to high productivity gains and globalization. The consensus view is for this trend to continue and remain at levels acceptable to Federal Reserve policy makers. Pessimists, however, note that with unemployment below 5% and capacity utilization at a relatively high 81.4%, inflationary pressures could build, forcing the Fed to become more aggressive than expected in raising rates. While we do not anticipate the Fed Funds rate going much above 5%, if at all, we are certain the Fed Chairman would not hesitate to take away the proverbial “punch bowl”, although this policy risk seems remote.
Highlights

Stock market fizzes in early spring

Defensive stocks rally on leadership change from oil and technology

Rising rates, high oil prices, and worries about the real estate bubble impact stock prices

Bulls excited about Feb employment

RBS Greenwich Capital forecasting strong Q1

Dollar continues relatively strong

Financial sector strength a positive sign for equity investors

Share buybacks and dividends will boost EPS in 2006

Merger activity strong during March

Expect strong earnings during first half of year

Purchase premiums will contribute to 2006 market returns

Small cap, international, and midcap stocks continue their out performance during 2006

Equity

After starting the New Year with a bang, the 2006 equity rally seems to have run out of gas. Leadership has changed, with oil stocks and semiconductors in retreat, and defensive names like Kroger, Pepsi and Proctor & Gamble doing relatively well. During January and February, lower quality stocks with shakier balance sheets and weaker fundamentals were outperforming S&P’s “A” ranked stocks. Now, investors appear worried about rising interest rates, high oil prices, and a softening real estate market, and their appetite for risk seems to have abated. Interestingly, the softer real estate market may actually bolster stock prices as real estate investors seek alternatives.

As always, there is a bull and bear argument. Lately the bulls are excited about the February employment report showing 243,000 non-farm jobs created, along with low inflation and other strong economic indicators. Our affiliate RBS Greenwich Capital is forecasting better than 5% GDP growth for the first quarter of 2006 which is bound to support corporate earnings. And although the dollar in theory should weaken given profligate spending habits in the US, the fact is that the greenback has been strong relative to other major currencies. Despite the relatively flat yield curve, large banks and brokers still sport relatively strong stock price charts, suggesting there is a certain amount of optimism and underlying strength in the stock market. Major investment banks reported blowout earnings for the most recent quarter fueling further interest in banks and brokerage stocks.

Record amounts of cash on corporate balance sheets is routinely being used for share buybacks and increased dividends, both of which contribute significantly to returns on stock investments. As expected, large companies pressed for growth continue to purchase smaller companies at healthy premiums, providing yet another source of return to equity investors, particularly those in the small and midcap arena. In a recent two week period, more than $100 billion in acquisitions was announced, including the blockbuster AT&T/BellSouth merger. No doubt these deals are harbingers of more consolidation in media, telecom and banking.

The bottom line is that we expect companies will report strong earnings for the first half of 2006, and that should keep stocks outperforming bonds. –K.G.

YTD EQUITY RETURNS as of March 14, 2006
Bonds

Bond yields have been trending higher since year end. The 10-year Treasury note now yields approximately 4 ¾%, the highest level since June 2004. As inflation seems largely under control at present, the rise in yields reflects a rise in real interest rates in response to healthy global growth. Even in Japan, real GDP growth is forecast at about 3% this year and continental Europe is looking stronger as well. As a result, the Bank of Japan and the European central Bank are embarking on a tightening regime, bringing their monetary policy in sync with the Federal Reserve.

We may be witnessing the resolution of Greenspan’s conundrum as higher rates abroad help boost yields on U.S. term debt. Monetary policy makers have seen their control over the domestic policy negated by globalization. Despite a prolonged period of Fed tightening, long-term interest rates remained low due to foreign demand for U.S. taxable fixed income. The yield curve in the U.S., which had inverted, is now losing its kink and flattening again as rates here and abroad move higher. The impact of foreign investors in the US bond market was illustrated by the fact that the municipal bond yield curve has retained a normal positive slope. Foreigners typically do not purchase municipal bonds.

Hopefully, the increase in bond yields will allow the Federal Reserve to declare victory over the next few months and conclude its tightening policy begun almost two years ago. Higher yields should at last give the Fed confidence that real estate speculation and easy mortgage credit will be brought into check. The market expectation is for the Fed to raise the overnight rate to 5% by summer. Bond yields are likely to move higher and a 5% yield on the 10-year Treasury would not be a great surprise. However, as growth is likely to slow after an above trend first quarter, a sharp spike is unlikely. The inflation outlook is benign and the recent drop in commodity prices is encouraging. It must be conceded, however, that capacity utilization is high and slack in the labor markets is being absorbed. With the breakeven on 10-year TIPS at 2 ¼% (i.e. if CPI is above 2 ¼%, TIPS will provide a better return than conventional 10-year Treasury notes), hedging away some inflation risk is not a terribly expensive proposition. –M.B.

Global growth pushing bond yields higher

Major central banks all pursuing tighter monetary policy

Fed impact on rates somewhat negated by globalization

Inverted curve in US now flattening as yields move higher

Municipal curve still positively sloped due to absence of foreign buyers

Fed tightening to halt in summer with fed funds rate hitting 5%

Benign inflation and slower growth in second half of year should mitigate increase in 10 yr. Treasury yield

TIPS breakeven at 2 ¼% makes this security a reasonable addition

Short-end of curve steepens dramatically during Q1

![U.S. Treasury Yield Curve](chart.png)
Many are familiar with the old adage, “Blessed is he who receives, but twice blessed is he who gives”. All of us know that “he who gives” is also eligible for a tax deduction. Many financial decisions are made in haste at year end as we write checks to get that last minute tax write-off. A simple cash gift, however, isn’t always the best approach. A comprehensive financial plan should incorporate philanthropic intentions, since a little forethought about “planned giving” can dramatically increase tax savings for donors while increasing proceeds for the charities.

For individual investors, charitable giving is a terrific, tax friendly way to manage exposure in low cost basis stock positions. The IRS allows you to give your stock directly to the charity and take an income tax deduction for the current market value of the stock. Furthermore, no capital gains tax will be due from you or the charity upon sale of the shares. Were the investor to sell stock to raise cash for the gift the resulting long term capital gain could be taxed up to 20% by federal and state authorities. (The tax code restricts this added benefit to long term gains.) In short, equity investors should consider transferring portfolio positions rather than using their checking account for the bulk of their charitable contributions.

In addition to the tax deduction and a means to avoid capital gains tax, charitable giving during one’s lifetime obviously reduces one’s taxable estate as well. Many folks also wish to leave bequests to charitable institutions via their wills upon their demise. Such bequests are exempt from estate taxes. However, there may be a better way to make this gift.

Substantial wealth has been accumulated in tax deferred accounts such as 401k plans, IRA’s, and variable annuities. These vehicles are subject to estate tax, and the beneficiary will also be responsible for the income tax due on the tax-deferred income. The effective combined estate and income tax rate could approach 70%. If you plan to leave a charitable bequest, it often makes more sense to designate the charity as the beneficiary of a tax deferred account rather than naming the charity in a will. The charity will not be liable for income tax and the asset will likewise be removed from your taxable estate.

While making an outright gift to charity is both simple and satisfying, it doesn’t always meet the needs of a donor or the donor’s heirs. There are a number of structures which allow a donor and/or heirs to retain a beneficial interest in a gift and also reap significant tax benefits. Most often these structures are intended to allow the donor and/or designated beneficiary to receive an income stream from a gift. Other times, the charity will receive an income stream and the corpus of the gift will revert to one’s heirs at a future point.

The simplest of these structures is the charitable gift annuity, offered by many charitable organizations. In exchange for the funds you give to the charity, you will be provided with a fixed income stream for your lifetime (and the lifetime of another if you choose). The charity will retain the remainder upon death. The annuity rate is determined by the National Council on Gift Annuities based on actuarial calculations intended to leave the charity about 50% of the original donation. Therefore, the older the donor, the higher the annuity rate. The annuity can be quite attractive especially in that a large percentage of the cash flow can be tax exempt. A substantial deduction can also be taken in the year the gift is made.

There is a virtual alphabet soup of other more complex structures, including Charitable Remainder Trusts and Charitable Lead Trusts, which allow a donor to retain a beneficial interest in a gift. These vehicles require the assistance of an estate planning attorney to draft a trust document and you are also likely to want advice from your CPA /Tax advisor.

Generally speaking, charitable trusts, appropriate for larger gifts, can provide substantial income and estate tax benefits. As they can be funded with appreciated stock, they offer an excellent means to achieve portfolio diversification. Citizens Investment Management Services has years of experience administering and managing these types of trusts. Feel free to consult with your Citizens team as to how we can work with you and your advisors regarding planned giving.