



July 25, 2006

To: Our Friends and Clients

From: Robert Bingham, CFA
SKY Investment Group LLC

Re: Second Quarter 2006 - Review and Outlook

“...the main risks to global liquidity stem from the East – from the Bank of Japan and the People’s Bank of China – not from the Fed...”

- T. J. Bond, Chief Asian Economist, Merrill Lynch

Second Quarter Review

After a prolonged period of quiet, volatility returned to the S&P 500 during the second quarter of 2006. The S&P 500 lost 1.44% during the quarter (including dividends), bringing year-to-date returns to +2.71%. Bond prices fell, reflecting steady increases in rates by the Federal Reserve. The Lehman Brothers Intermediate Government / Corporate Bond Index was up 0.21% (including interest), bringing year-to-date returns to -0.17%. The NASDAQ composite index fell 7.01% reflecting a move away from riskier assets by investors.

Early in the quarter, the domestic equity market advanced as investors concluded that the Federal Reserve was nearing an end to their cycle of raising rates. But hawkish comments made on May 11th by Fed Chairman Bernanke led investors to believe that the Fed might raise rates more than expected, and triggered a global sell-off in equities and bonds.

Outlook and Commentary

The Fed appears to be getting more serious about preventing inflation...

A tough stance by the Fed towards inflation should benefit investors in the long run by helping to quell rising inflation expectations and reducing long-term interest rates. In the short run though, it has prompted the “hot money” on Wall Street to raise cash by selling riskier assets like commodities and emerging market securities. The result was that these and other recently popular market segments plunged late in the quarter. Global market volatility has continued into July.

Bonds fell as investors became concerned that further interest rate increases were on the horizon. We expect bonds to remain under pressure until the financial markets are convinced that inflation is under control and that the current cycle of Fed interest rate increases is nearing an end.

It is possible that the Fed may need to raise rates higher than many anticipate. With the globalization of financial markets, investors can borrow anywhere in the world. This can reduce the effectiveness of domestic monetary policy. For example, Honda can borrow money in Japan to offer inexpensive financing deals to U.S. car buyers, which can undermine the Fed's efforts to slow consumer spending.

...and The Bank of Japan is starting to drain excess liquidity...

Another contributor to volatility during the second quarter was the decision by the Bank of Japan (BOJ) to raise rates. Japan has been a major source of global liquidity since 2001 when they lowered rates to zero percent and flooded their banking system with money to stave off deflation. Since then, Japan has been a cheap source of funds for global investors. Hedge funds and other speculators have borrowed in Japan to invest in emerging markets, commodities and Asian real estate, which has fueled the recent strength in those markets.

On July 14th, the Bank of Japan increased rates by 30 basis points to .40 percent. This followed their decision in March to drain \$175 billion of excess liquidity – the equivalent of 4% of GDP – from their banking system (source: The Economist, July 15, 2006). The BOJ's objective was to reduce the amount of money available to lend.

...leading hedge funds and other speculators to sell risky assets purchased with borrowed money.

As rates rise and liquidity falls in Japan, speculative investments made with borrowed Yen become riskier and less profitable. As investors unwind these trades, we expect volatility and potential losses in asset classes that have been popular with speculators during the last few years. To the extent that unwinding these Yen-leveraged "carry trades"¹ reduces speculative commodity investment, inflation trends could benefit if commodity prices fall.

Final Comments:

As market volatility rose in the second quarter, investors retreated to attractively-valued, high-quality stocks and bonds. The trend has continued in the third quarter. Global growth is slowing as central banks around the world try to reign in inflation. In such an environment, quality stocks with predictable earnings, strong financials and good dividends have historically outperformed.

Recent Purchases:

We have started to acquire shares of **UBS**, the Swiss-based global bank (UBS, \$52.05, 7/24/06). UBS has been the beneficiary of strong investment inflows (totaling roughly \$80 billion during the fourth quarter of 2005 and the first quarter of 2006) as the number of super-rich has risen in Asia and the Middle East. High commodity prices have helped too, as many of UBS's emerging market customers are benefiting from high oil, mineral and other commodity prices and are seeking a safe haven for their excess capital.

UBS's investment banking business is likely to accelerate as large corporations seek mergers in an environment where interest rates are low, capital is abundant and stock prices are cheap. We also expect a number of large, government-sponsored, commercial enterprises to be taken public. UBS

profits from the rapidly growing hedge fund custody business, too. Given the abundant cash UBS generates and their strong balance sheet, we expect they will continue to buy businesses that can contribute to their global wealth management and investment banking platform.

We welcome your questions and comments.

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¹ The “**carry trade**” is when an investor borrows at low rates in one market and reinvests the proceeds at higher rates of return in another market. With the development of global capital markets, the carry trade is now routinely carried out across borders. In the case of Japan, because global investors have been able to borrow in Japan for effectively zero percent, Japan has become a source of capital for all kinds of global investment. Hedge funds use Japanese capital to invest in emerging markets and commodities. Corporations use Japanese money to build plants, especially in Asian emerging markets. Fixed income hedge funds borrow in Japan and reinvest the money in United States Treasury Bonds, profiting from the difference in rates. To the extent that borrowing costs rise, all of these activities become progressively less profitable. When they become unprofitable, investor positions are unwound and markets can become volatile.

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