



Thoughts on the Economy

The economy rebounded nicely in the first half of 2006 after suffering a weak fourth quarter of 2005 due to the effects of the hurricane damage and dramatic energy price increases. The severe weather has passed but the high energy costs will be with us for a long time. Oil finished 2005 around \$60 per barrel and has recently set a new record of \$75. We expect the strong 5.6% growth in GDP in the first quarter to moderate to a rate of 2.5 – 3.0% in the second quarter and run at about a 3% rate in the second half of 2006.

Housing will continue to slow with the economy shedding construction jobs and real estate prices flat to lower over the next few years. We continue to advise caution in making real estate purchases and recommend being realistic with your pricing if you are a seller.

The Federal Reserve appears nearly finished raising interest rates but has probably gone too far and will slow the economy more than they expect. The lagged affects of the 17 interest rate hikes as well as continued high energy prices and a weakening housing market may conspire to produce a mid-cycle slowdown that approaches a recession level. Consider the fact that each previous significant increase in energy prices has preceded a recession. Also consider the Fed often overshoots in its rate raising cycle and induces a slowdown that is deeper than what they had anticipated. Mr. Bernanke has been focusing on cyclical inflation numbers which he characterizes as being “above his comfort zone,” which is widely presumed to be 1 – 2% at the core level. The trailing 12 months core rate in June of 2.1% should be viewed in light of the weakening of more forward looking indicators. We could be near the cyclical peak in core inflation and contend

longer term secular trends in inflation remain to the downside. The reason we believe this to be the case has to do with the labor component of the cost structure in the U.S. Labor costs represent about 70% of total costs and therefore trends in the markets for labor are far more important than those in materials.

The Globalization of labor markets in recent years has added hundreds of millions of laborers to the labor pool available to free market economies. Most of these are in China, India and the former Soviet Union. The internet and outsourcing trends allow American businesses to access this labor pool and therefore hold their labor costs in check. The trailing 12 months year-over-year rate of wage growth in the U.S. was 3.9% with labor productivity growing by over 3% so unit labor costs increased by less than 1%. It is the strong growth in productivity which has set the U.S. economy apart from its developed country peers in the last decade and which continues to advance by 2.5 – 3.0% per year. This rate allows standards of living to roughly double every 20 years.

Overall we expect the U.S. economy to grow at 3% in 2006 with inflation at the core level peaking below 2.5% and corporate earnings growing by 8 – 11%.

Our view of the Financial Markets

The first half of 2006 was slow for the U.S. financial markets. The S&P 500 gained 2.76% and the Lehman Aggregate Bond Index suffered a decline of .72%. Harbor clients in general fared well in both areas and dramatically so on the fixed income side.

We judge the odds of a recession in the next twelve months to be less than 50% and our remarks about our outlook for each of the markets is based on this fact. The valuation

(p/e multiple) of the broad stock market has declined each year since 2000 even as corporate earnings growth has scored its longest stretch of double digit quarterly earnings growth reports in decades. There will be a point at which value has been restored by this process, and we believe we are about there now with a forward P/E multiple of 14 times on the S&P 500 and interest rates of 5.25% on the ten-year Treasury Note. The market is not highly valued.

We think the high quality, blue chip multinationals which are held widely by Harbor clients are particularly attractively priced. We expect the U.S. dollar to resume its slow, steady decline as the Fed stops raising rates and a declining dollar is good news for multinationals. A weakening dollar both boosts U.S. competitiveness abroad as well as enhances overseas earnings as translation rates rise.

Economic growth outside the U.S. is higher now than at any time in recent memory as Japan snaps out of its 15 year slump, China continues to crank out 10% growth and Europe begins to grow at closer to 2% than 1%. This will lead to higher export growth which also benefits the multinationals and takes pressure off the U.S. consumer who needs to slow his/her personal consumption expenditure growth after carrying the world economy for the last five years. We continue to believe that, if the economy averts a recession, the U.S. equity markets could show a total return of 7 - 10% in 2006.

The fixed income markets continue to suffer from two years of relentless Fed rate increases taking short rates from 1% to 5.25% currently and taking 10-year rates from a low of 3.0% to the current 5.15%. Fixed income returns,

Nod to the ubiquitous disclaimer:

While we are not infrequently, and always quite accurately, accused of being of strong opinion...we want to let the reader know we've been wrong before...will be again and please don't hold it against us. The forward looking parts of the letter are the best educated efforts of fallible humans here at Harbor.

as measured by the Lehman Aggregate Bond Index, have annualized at 2.05% in the three years ended June 30th. Harbor adopted a more strategic fixed income strategy in 2001 as we anticipated the 20-year decline in rates had run its course, and we prepared for the eventual return to higher rates.

Harbor clients have enjoyed substantial fixed income returns over this period, and we continue to be optimistic our strategy will prove successful in the current environment.

529 Plans Get Even Better!

We mentioned last year the more attractive status of 529 Education Plans with respect to financial aid applications. Since that time the U.S. Department of Education has made the changes official as part of the Deficit Reduction Act of 2005. 529 accounts are considered assets of the account owner and if that person is a dependant student or has an UGMA/UTMA account, those assets are excluded from the "EFC" (expected family contribution). This allows these monies to fall outside the punitive 35% rate at which a student's assets are expected to be used to fund their educational costs.

HARBOR ADVISORY

Corporation

**500 Market Street, Suite 11, P.O Box 4520
Portsmouth, NH 03802-4520
Tel: 603-431-5740 | Fax: 603-431-2927**

www.harboradvisorycorp.com

Jack De Gan (Editor)

Weld Butler

Joan Gordon

Jan Yeaman

Cheryl Crowley