



Thoughts on the Economy

The U.S. economy slowed in the first quarter to a .7% GDP rate of increase as businesses reduced inventories sharply, anticipating weak demand. That weak demand never arrived and production increased sharply in the second quarter which leads us to believe the economy will achieve a full year rate of growth in GDP in the 2-3% range.

Export demand is growing at a low double digit rate as worldwide growth is on track to gain 5% this year. The exchange value of the dollar continues to weaken which should reinforce strong export growth. Commodity prices and the energy commodities in particular are nearing record high prices again this year. The potential inflationary impact of the downstream effects of these high prices are being closely watched by the Federal Reserve. Over 60% of the cost structure in our country is based on labor costs and the labor market continues to create 145,000 new jobs per month and year over year wage gains are running in the 3% range. Future changes in monetary policy will likely be driven by trends in labor costs. We still think there may be monetary easing later this year.

The economy is dealing with the severe recession in the housing and construction markets in a very orderly manner. The credit contraction that caused the virtual collapse of the sub-prime mortgage financing market has thus far been contained to that area of finance. We believe a general, more widespread contraction in credit availability and terms is underway and that this will provide more significant headwinds for the economy and the financial markets. Liquidity has been a primary driver of economic growth, consumer spending and financial market activity in recent years and we see a reversal in those conditions.

Corporate earnings growth is on track to advance by 6-9% this year and balance sheets remain flush with record cash balances as managers remain conservative.

Our view of the Financial Markets

Equity markets around the world are having another good year as corporate earnings growth remains solid and investment banking activity reaches record levels. The strategic mergers and acquisition activity as well as private equity purchases continue to remove share equity from the public markets. Corporate share repurchases are also at record levels which further reduces outstanding equity. We continue to believe U.S. shares can provide a total investment return on the order of 9-12% for the full year.

We are concerned however, that the contraction in liquidity that we see could accelerate and cause volatility in financial markets. Certainly credit spreads could widen on a variety of risk assets from the recent historically low levels.

International markets should remain strong as growth outside the U.S. is at the highest level in decades. As the value of the dollar should remain under pressure, performance of international equity investments when converted to dollars will likely be impressive.

The fixed income markets are feeling the pressure of widening credit spreads across multiple market segments.

Financing rates and terms for takeovers are becoming more restrictive and the market prices for outstanding bonds from previously completed deals are declining. Interest rates on treasuries took a step up in June to the highest level in two years. Current expectations are for the rates on ten-year

U.S. Treasury rates to trade in a range of 5-5.5% through the end of the year.

The mortgage and mortgage derivative markets have been hard hit by the sub-prime meltdown with a contagion affect on other U.S. fixed income segments. The risk is that this contagion could accelerate further adding to the general contraction in liquidity with a negative impact on financial markets in general.

Full year returns for fixed income investments will probably be limited with our best guess being low to mid single digits. Our strategic and somewhat opportunistic approach to the fixed income markets should provide a more volatile but possibly more significant return for our clients.

Rants/Raves

Your friendly counselors are nothing if not opinionated and in an effort to bring light to areas we think you might enjoy hearing from us on, we are adding a new section to Harbor Views. Rants/Raves will air two topics of interest to clients each quarter, one with which we take issue and one that qualifies as 'honest to goodness good news!'

Rant

The 1990's bested many records for historical economic extremes. One of the most vivid was the massive compensation packages given to executives of corporations. Annual pay to some CEO's has exceeded hundreds of millions of dollars in a single year. Typically these arrangements are primarily stock options granted for future exercise. Since the internet bubble burst in 2000, company directors on compensation committees, activist institutional investors, and a chastened group of auditing firms have each played a part in restraining these outrageous squanderings of shareholder assets. Finally, these options are expensed (if at somewhat guesstimated values) where before they had appeared "free" from any effect on companies' income statements.

Still the gambit continues. Salary.com reports 2006 CEO compensation for the 50 largest U.S. corporations increased 38% to average over \$15 million. Critically, a recent Bloomberg study reported "hardly any" correlation between CEO 2006 raises and performance of their company stock returns.

Where directed, Harbor reads and votes proxies on behalf of clients. Be assured we take a hard stance on compensation issues that come before a shareholder vote.

Rave

Thirty years ago, our country was briefly mobilized by high energy prices to investigate alternative energy sources. Alas, the technology was not ready for primetime and a quick reversal in oil prices and negative returns on venture capital invested in alternative energy put the sector in a three decade hibernation. The Rave is that alternative energy is back and this time it is for real. Solar power is the one we find most interesting and both economically and technologically achievable. Harnessing the sun's energy is the Holy Grail in lessening our energy dependence on fossil fuels. Politicians have noticed the benefit of going green and incentives to use solar power are emerging around the world. Consumers are ready to pay a small premium for green energy and the technology could make solar power at economic breakeven with fossil fuels by 2010-2012. We have been researching solar companies and are very interested in 'SunPower' which we feel is the class of the industry. If the valuation contracts a bit you may find the shares in your portfolio.

Safe Harbor during Global Warming

Most of our clientele come to us from existing clients or professionals who know our work.

If you know of a family who is seeking counsel and might appreciate personalized and attentive financial advice from an independent firm we would welcome the opportunity to serve. If Harbor can serve as a resource on how to find professional guidance other than our services we would be delighted to help with that as well. Give us a call.

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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.