



Thoughts on the Economy

We think the economy will prove to have had a very strong first quarter recovering from a weak fourth quarter in 2005. At the end of last year defense spending fell by 14%, clearly a statistical anomaly which is normalizing this year. Consumer spending was also weak at 1.1% growth as incentives by auto manufacturers became less generous and as the drag from the hurricanes hit consumers.

Consumer spending is robust so far this year as the auto companies roll out new models and new incentives and as the rebuilding process picks up momentum in the south. Job creation has been strong, running at 200,000 new non-farm jobs per month in the first quarter. New jobs created in the last two years are above 5 million. Income growth in the last twelve months grew by 3.5% further adding to personal income.

We believe the Fed is close to completing its two-year cycle of raising interest rates. The effects of this tightening cycle are being felt in the housing and construction sectors with higher financing costs slowing sales. The inventory of unsold houses is now at an eight year high and home price increases have ground to a halt on a year-over-year basis. The next shoe to drop will be home prices which we feel can decline modestly over the next few years.

Price declines may be more severe in the markets that have seen the greatest appreciation in recent years such as Florida, Arizona and California. The housing market is important for two reasons. First, we continue to expect flat or lower home prices to create a drag on consumer spending as homeowners can no longer extract equity (a boost to retail spending in recent years) from

refinancing their homes. Second, we want to again caution against speculative real estate purchases especially in the markets most affected by the recent run up in prices.

We continue to estimate GDP growth in 2006 in the range of 3 – 3.5%, earnings growth of 7 – 10% and inflation at the core level of 2 – 2.2%. We expect energy prices to remain high and to increase in an uneven fashion during the year.

Our view of the Financial Markets

We remain optimistic about the prospects for stocks in 2006. We expect the combination of growing corporate profits and the slight expansion of valuations (P/E multiples) to lead to a total return for stocks of 10-12% this year.

The Fed should signal they have achieved a neutral policy stance in the second quarter allowing stock valuations to expand a bit. Financial stocks are generally one of the best performing sectors following the end of a tightening cycle and financials are the largest sector by capitalization in the S&P 500. They are also well represented in Harbor portfolios. We have raised our exposure to the energy sector as we expect the high energy prices to continue to lead to strong earnings in the sector allowing for higher dividends and share repurchases.

Harbor equity portfolios performed well in the first quarter and we believe we are well positioned for the remainder of the year.

We have begun to trim our REIT holdings. The sector has been a tremendous performer in recent years. We remain overweighted though, and expect industry fundamentals to improve in the CBD (central business district) office sector. Vacancy rates are falling and

rents are increasing. Private market values for the office buildings owned by our REITs continue to exceed the value the companies trade at on the exchanges. This is evidenced by record privatizations of REITs by the private equity firms such as the Blackstone Group and by GE Financial.

The fixed income markets continue to face a serious headwind from increasing interest rates. Returns from broad bond holdings such as our benchmark, the Lehman Aggregate Bond Index, will probably again be in the low to mid-single digits. Harbor remains uniquely positioned with inflation adjusted treasury notes, inflation indexed corporate bonds, adjustable rate preferred stocks and special situation corporate bonds. The auto finance companies (GMAC and Ford Motor Credit) remain overweighted in Harbor accounts as these very profitable finance firms are the "crown jewels" of the troubled U.S. auto sector. We believe these bonds to be "good money" and the current returns in the sector are a generous 9-10%. Initial fulfillment of the first leg of our strategy came in early April. GM announced the sale of a majority stock position in GMAC to a group led by Cerberus Capital and Citigroup. Completion of this deal later in 2006 should lead to upgrades to the credit quality of the bonds with higher bond prices to follow.

401(k) Contribution Limits

The amount you can contribute to your 401(k) increases in 2006. The elective deferral limit increases from \$14,000 to \$15,000. The catch-up contribution (you have to be over 50) increases from \$4,000 to \$5,000.

Medicaid Planning

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.

The Deficit Reduction Act of 2005 increases the look-back period for asset transfers prior to applying for Medicaid. The look-back has been extended to five years from three and the period begins upon application for Medicaid as opposed to the date of the transfer.

You should get professional legal advice before planning any transfers or before applying for Medicaid.

529 Plans get even better!

New federal bankruptcy laws enacted last fall place 529 Plans and ESAs outside the reach of creditors in bankruptcy.

The Deficit Reduction Act recently adopted included a section known as the Higher Education Reconciliation Act of 2005 which provides favorable treatment for 529 Plans and Educational Savings Accounts (ESA) in the federal financial aid formula. These accounts cannot be considered assets of the student and therefore the inclusion ratio drops from 35% to 5.64% or less. This means your chances of receiving financial aid will not be unduly influenced by having assets in either a 529 or an ESA.

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