



# Market Update

Asset Consulting Group, Inc.

www.acgnet.com

Monthly Report

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Asset Consulting Group, Inc.  
231 South Bemiston Avenue  
14th Floor  
St. Louis, Missouri 63105  
TEL 314.862.4848  
FAX 314.862.5967

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- May 31, 2006

## The US Economy

The U.S. economy grew at an annual rate of 5.3% in the first quarter of 2006, faster than the 4.8% the government originally forecasted. The strong growth prompted the Fed to raise its target for the federal funds rate by 25 basis points to 5% during its May 10<sup>th</sup> meeting. In their minutes from the meeting, the Fed stated, "The Committee sees growth as likely to moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices." May economic data suggests the U.S. housing market has in fact begun a gradual slowdown and higher energy costs have reduced consumer discretionary spending. This left the Fed in a quandary whether to raise rates again at its June 28<sup>th</sup> meeting in order to tame inflationary pressures or pause to determine the impact of the 16 consecutive rate hikes, the longest string in history, on a slowing economy.

### *Rising mortgage rates are taking a bite out of the nation's housing market...*

Mortgage rates for a 30-year loan were 6.67% on June 1, a 7% rise from 6.21% at the start of the year. This rise in mortgage rates did not impede, however, a still healthy rise in new home sales in April. Sales of new homes in the U.S. rose at an annual rate of 4.9%, a considerable drop from the 12% increase in March. Sales of existing homes declined 2% from March levels and dropped 5.7% from

a year earlier. Although new homes sales managed a gain, the level of homes available for sale reached record levels. There were 565,000 new homes available for sale at the end of April, the most ever. Also, the supply of existing homes for sale rose 5.8% to 3.38 million, the highest reading ever. Further signs of a cooling housing market can be found in mortgage applications. Mortgage applications, considered a leading indicator for the housing market, reached a 52-week low at the end of May. In addition, the Mortgage Bankers Association Refinancing Index has been on a steady decline since the start of the year, consequently reducing what had been a major supplement to consumer incomes during the current economic expansion. As such, there is now solid evidence of a slowdown in housing that could restrain household wealth accumulation and dampen consumer spending in coming months.

### *Higher energy prices are taking a toll on consumer buying power...*

Employers added 75,000 workers to payrolls in May. It was the lowest monthly total in seven months but still allowed the unemployment rate to slip to 4.6% from 4.7% in April. Job growth has averaged 146,000 a month this year propelling personal incomes higher, as demonstrated by an increase of 0.5%

in April. Unfortunately, the rise in energy and fuel prices is offsetting this income growth and leading to a reduction in consumer discretionary spending. Average regular gasoline prices reached \$2.93 a gallon on May 15<sup>th</sup> and closed the month 29% higher from the start of the year. These rising fuel costs were reflected in consumer spending patterns in May as retail sales increased 0.1% overall but fell 0.1% excluding gasoline sales.

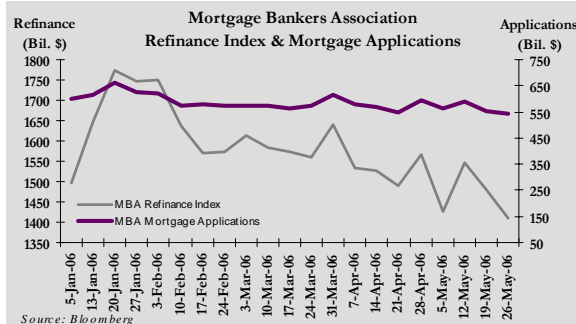
### *Inflation is gathering momentum, pressuring the Fed to maintain a tightening bias...*

The Consumer Price Index rose 0.6% in April and has been rising at an average annual rate of 5.1% so far this year, mainly caused by an advance of 30.1% YTD in energy prices, as compared to a 17.1% increase in all 2005. Core prices, which exclude prices of food and energy, climbed 0.3% and have been rising at a 3% annual rate. Corporations have been able to spread the rising energy costs and higher wages across more units of output as they have achieved greater efficiencies through higher productivity, which rose at a 3.7% annual rate in Q106. This has helped contain core inflation as companies have not yet passed along huge price increases to consumers. Nonetheless, inflationary pressures are mounting and pose a threat to consumer spending going forward. This creates a dilemma for the Fed. They might choose to proactively raise rates to tame inflation, thus running the risk of knocking the current economic growth cycle off course.

## Economy at a Glance

Recent growth indicators	Feb	Mar	Apr	May
ISM manufacturing	56.7	55.2	57.3	54.4
ISM non-manufacturing	60.1	60.5	63.0	60.1
U. of Michigan Consumer Confidence	86.7	88.9	87.4	79.1
Change in Payrolls (m-o-m, 000)	200	200	138	75
Personal Income (%m-o-m)	0.3	0.5	0.5	
Personal Spending (%m-o-m)	0.2	0.6	0.6	

Source: Bureau of Labor Statistics, ISM, Bloomberg



## Global Equities

### US Equities

After blossoming in early May to new highs, U.S. equity markets ended up wilting by the end of May. The Fed's rate hike and the higher than anticipated CPI data led to a risk re-pricing across all market capitalizations and increased stock market volatility. The Chicago Board Options Exchange SPX Volatility (VIX) index, which reflects a market estimate of future volatility, hit a 52-week high of 18.66% on May 30<sup>th</sup>, a large increase from the average volatility of 12.04% in the first quarter. This increased volatility had a negative impact on equity prices. The S&P 500 closed on May 8<sup>th</sup> at 1326.70, a 52-week high, representing a 14% gain from the lows set on October 13<sup>th</sup> 2005. However, by the end of the month, the index declined 5% from its 52 week high and dropped 2.88% for the month. The index still recorded a gain of 2.56% YTD<sup>1</sup>. Despite signs of slowing economic growth, corporate fundamentals remain sound. As of May 22, Standard & Poors estimated that the S&P 500 (old) Industrials, which exclude the Transportation, Financials and Utilities issues, had \$643 billion in cash and equivalents on their balance sheets. These cash reserves coupled with rising interest rates are generating soaring levels of interest income. Standard & Poors calculated that interest income within S&P 500 companies increased 37.9% in 2005 and is forecasting growth of 64% in 2006<sup>2</sup>. Higher interest income levels and share buybacks continue to lend support to sustained corporate earnings growth. Ninety eight percent of the S&P 500 companies have reported an average increase of 16.6% in operating earnings on a share-

weighted basis in Q106, beating the consensus estimates of 14.95%. Equity investors turned defensive in May as the two top performing economic sectors within the S&P 500 were Utilities (+1.13%) and Consumer Staples (+0.48%), both of which offer stable business models during any type of economic cycle<sup>2</sup>. Value outperformed growth in the month, another indication of investor's changing risk sentiment. The Russell 1000 Value index lost 2.53% for the month, but was up 5.87% YTD, while the Russell 1000 Growth index was down 3.39% in May and erased all annual gains, closing down 0.53% YTD<sup>1</sup>. The small cap Russell 2000 hit an all time high on May 5<sup>th</sup> closing at 781.83, which left the index with a 16.51% advance YTD. However, heavy selling over the next two weeks eliminated 7.71% of those gains. The index lost 5.62% for the month, but still remained 7.51% higher YTD<sup>1</sup>. Value outpaced growth in small capitalization as well. The Russell 2000 Value index lost 4.14% in May, but still gained 9.09% YTD<sup>1</sup>. The Russell 2000 Growth index lost 7.04% in May and was up 6.01% YTD<sup>1</sup>.

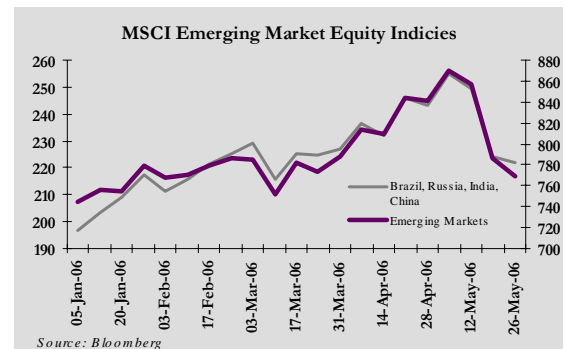
### International Markets

Similar to U.S. equity benchmarks, international equities also reached multi period highs in May. The MSCI Emerging Market index climbed to an all time high of 881.52 on May 8<sup>th</sup>, only to tumble 15% by May 24<sup>th</sup>. The index lost 10.45% on a USD basis in May, but was still 7.56% up YTD<sup>1</sup>. The slide in emerging markets in May was the steepest since an 11% drop in September 2002, when the U.S. signaled to the United Nations it might invade Iraq. Investors fled once again to the safety of less risky assets on

the prospects of higher global interest rates, which could slow economic growth, and of the slumping commodity prices, which could negatively effect some resource oriented emerging economies. However, it appears that what transpired was more of a sign of the sheer weight of money moving in and out of markets and a reversion of risk premiums towards their mean rather than a change in emerging markets economic fundamentals, which continue to be strong. Inflation in emerging markets is relatively weak (less than 5% on average), growth is still strong and governments are solvent. Strong economic fundamentals seemed to remain intact in Europe and Japan as well. European business and consumer confidence

rose to a five-year high in May led by a jump in German retail sales (up 2.8% in May) and a drop in unemployment. A European Union index of economic sentiment of corporations and consumers rose 0.95% from April's reading. The European Commission forecasted the economy would expand 0.7% in each of the next three quarters, after registering growth of 0.6% in the first quarter. That would equate to growth of nearly 2.3% for 2006, the fastest pace since 2000. The European Union unemployment rate in April was 8%, the lowest in more than four years, after March's revised 8.1%. However, this expansion has led to an acceleration in

inflation. Consumer prices in April rose 0.7% from March. Rising inflation and the fastest growth in money supply in three years (up 8.8% in April) led central bankers to make hawkish comments on the future direction of interest rates. Similar to the US and emerging markets, prospects of higher interest rates sent European equity markets spiraling downward. The MSCI EAFE index closed at 1980.26 on May 9<sup>th</sup>, a 5-year high and then subsequently dropped 9% by May 22<sup>nd</sup> before recovering to close the month off 3.76% in USD. The index was still



Source: Bloomberg

up 10.46% YTD on a USD basis<sup>1</sup>. Japan's economy expanded at an annual rate of 3.1% in the first quarter as business and consumer spending rose 3.1% and 0.5%, respectively. The Nikkei 225 index lost 7.34% on a USD basis in May, but had a slight gain of 1.26% YTD. Despite robust U.S. economic growth during the first quarter, currency traders were clearly more focused on the direction of global interest rates. The US dollar fell 1.04% and 1.38%, against the yen and euro, respectively, in May. This is the second consecutive month of declines as traders bet interest rates would rise more in Japan and Europe than in the United States.

## Global Fixed Income

Global bond investors are facing the increasing inflationary pressures and new risks emerging from changing global financial conditions. The rise in the target fed funds rate to 5% led yields on 10-year Treasuries to close higher for the fifth consecutive month in May. U.S. 10-year yields ended the month at 5.13%, up from 5.05% at the end of April and 4.39% at the start of the year. Still, Treas-

uries handed investors a monthly gain, with the Merrill Lynch U.S. Treasury Master index up 0.053% in May, the first monthly gain since a 0.16% return in February of this year. YTD, the index was down 1.51%<sup>3</sup>. Foreign central banks have signaled their staunch intentions to stave off inflation, caused by recent economic and money supply growth, through tighter monetary policy. European bond yields are reflecting this change in monetary

policy. The German 10-year government bond yielded 3.31% at the start of the year and ended the month yielding 3.98%. Yet, U.S. corporate credit spreads have been slow to reflect these potential risks. The spread on the Lehman Brothers U.S. Aggregate index rose to 45 basis points by the end of May from the years low of 39 basis points in February. In contrast, the Lehman Brothers High Yield index spreads remain tight, 298 basis points at the

end of May versus 357 basis points at the start of the year. Nonetheless, the changing risk environment weighed on major U.S. bond index returns in May. The Lehman Brothers U.S. Aggregate index closed down 0.11% for the month and was 0.93% lower YTD<sup>4</sup>. The Lehman High Yield index closed with a slight loss of 0.01% for the month, but was up 3.51% YTD<sup>4</sup>.

## Hedge Funds <sup>5</sup>

After a tepid year in 2005, hedge fund performance overall is off to a healthy start in 2006. Even with the negative performance associated with most hedge fund strategies during the month of May, hedge funds have delivered reasonable year-to-date performance on an absolute and relative basis when compared to long-only indices. The HFRI Fund Weighted Composite Index, an equal weighted index hedge fund compiled by Hedge Fund Research, Inc. ("HFR") produced a return of 6.72% through May. The HFRI Fund of Funds Composite Index, one of the ba-

rometers of fund of funds performance, also showed solid performance YTD with a return of 4.58%. Key contributors to performance in 2006 have been strategies that focus on trading instruments related to commodities, in particular oil and natural gas, as well as emerging markets and technology stocks. Unfortunately, these were some of the areas that took the hardest hit during the month of May, which affected long-only and hedge fund investors alike. The HFRI Emerging Markets Index was down nearly 4% in May while the HFR sector indices focused on technology and metals and mining were down over 5% and 7%, respectively. The best performing strate-

gies in May were those that involved short selling (+3.65%) and credit-oriented strategies, such as high yield (+0.94%) and distressed (+0.80%). Even with the declines experienced in May, many emerging markets hedge fund strategies, as tracked by HFR, still delivered returns in excess of 10% YTD while the HFR sector index focused on metals and mining returned in excess of 14% in the same period. One surprising development in the hedge fund space has been the reemergence of convertible arbitrage as a profitable strategy. This strategy had historically been a strong performer but suffered in recent years due to a variety of technical and other factors. The nega-

tive performance over the past few years caused many participants to look elsewhere for opportunities while many hedge funds dedicated to the space closed down. For a variety of reasons, including an improved supply of new convertible deals, more reasonable valuation levels, renewed issuance by small and mid cap issuers and a modest increase in equity volatility, convertible arbitrage has become a more attractive strategy today. Evidence of this is seen in YTD performance (through May) for the HFRI Convertible Arbitrage Index (+6.31%). This is a substantial improvement over index performance in 2005 (-1.9%) and 2004 (+1.2%).

### Footnotes:

All data from Bloomberg except for:

1- State Street

2- Standard & Poors

3- Merrill Lynch

4- Lehman Brothers

5- Hedge Fund Research, Inc.

## Indices Report

### Asset Consulting Group, Inc.

#### Monthly Indices Report

Periods Ending May 31, 2006

Index Name	Style	Returns							
		Month	Qtr	YTD	2 Qtrs	1 Year	3 Years	5 Years	10 Years
<b><u>Domestic Equity Indices</u></b>									
S&P 500	Large Cap Core	(2.88)%	(0.36)%	2.56%	2.60%	8.63%	11.64%	1.97%	8.35%
S&P Equal Weighted	Large Cap Core	(2.89)%	(0.05)%	4.27%	5.06%	13.72%	17.17%	7.68%	11.22%
Russell 1000	Large Cap Core	(2.95)%	(0.39)%	2.62%	2.77%	9.38%	12.49%	2.62%	8.56%
Russell 1000 Growth	Large Cap Growth	(3.39)%	(2.10)%	(0.53)%	(0.84)%	6.15%	8.99%	(1.15)%	5.48%
Russell 1000 Value	Large Cap Value	(2.53)%	1.30%	5.87%	6.51%	12.59%	15.93%	6.28%	10.78%
Russell Mid Cap	Mid Cap Core	(3.37)%	(0.28)%	4.72%	5.80%	16.58%	20.23%	9.69%	11.87%
Russell 2000	Small Cap Core	(5.62)%	(1.06)%	7.51%	7.02%	18.22%	19.15%	9.09%	8.52%
Russell 2000 Growth	Small Cap Growth	(7.04)%	(2.80)%	6.01%	5.85%	18.21%	16.99%	4.03%	3.42%
Russell 2000 Value	Small Cap Value	(4.14)%	0.77%	9.09%	8.25%	18.21%	21.19%	13.70%	12.98%
Wilshire 5000	Broad Equities	(3.21)%	(0.33)%	3.18%	3.33%	10.61%	13.47%	3.64%	8.34%
HFRI Equity Hedge	Long Short Equity	(1.67)%	2.74%	6.79%	9.27%	18.41%	13.20%	7.73%	13.27%
<b><u>International Equity Indices</u></b>									
MSCI World	Broad Global	(3.33)%	1.90%	6.35%	8.74%	18.56%	18.10%	5.56%	7.41%
MSCI EAFE	Developed Markets Intl	(3.76)%	4.28%	10.46%	15.61%	28.75%	25.43%	9.52%	6.81%
MSCI EAFE Growth	Developed Markets Intl Growth	(4.14)%	4.20%	9.38%	15.17%	27.20%	22.07%	7.36%	4.20%
MSCI EAFE Value	Developed Markets Intl Value	(3.40)%	4.36%	11.53%	16.04%	30.32%	28.79%	11.63%	9.30%
MSCI Emerging Markets Free	Emerging Market	(10.45)%	(3.20)%	7.56%	13.93%	40.90%	37.38%	21.09%	N/A
<b><u>Domestic Fixed Income Indices</u></b>									
Treasury Bills	Cash	0.40%	1.15%	1.80%	2.13%	3.82%	2.28%	2.23%	3.82%
Merrill Lynch 1-3 Yr Treasuries	Treasuries	0.15%	0.60%	0.85%	1.24%	1.83%	1.39%	3.11%	4.81%
Lehman Muni 5 Yr	5 Yr Municipal Bonds	0.35%	0.18%	0.59%	1.07%	1.26%	1.71%	4.05%	4.85%
Merrill Lynch High Yield	High Yield Bonds	(0.08)%	1.11%	3.38%	4.33%	7.01%	9.49%	7.99%	6.90%
Lehman Aggregate	Core Bonds	(0.11)%	(1.27)%	(0.93)%	0.01%	(0.48)%	1.91%	5.01%	6.34%
Lehman Government	Government Bonds	0.02%	(1.16)%	(1.17)%	(0.25)%	(0.88)%	1.04%	4.76%	6.14%
Lehman U.S. Credit Index	Corporate Bonds	(0.17)%	(1.93)%	(1.70)%	(0.73)%	(1.43)%	1.83%	5.74%	6.66%
Lehman Muni 10 Yr	10 Yr Municipal Bonds	0.68%	(0.54)%	0.37%	1.28%	1.17%	2.67%	5.07%	5.86%
HFRI FOF Conservative	Low Volatility	(0.03)%	2.51%	5.23%	6.62%	10.91%	6.89%	6.01%	N/A
<b><u>Real Estate Indices</u></b>									
NCREIF Property	Real Estate	0.00%	3.62%	3.62%	9.25%	20.19%	15.07%	11.31%	12.01%
NCREIF Classic Property	Real Estate	0.00%	3.63%	3.63%	8.87%	20.73%	14.44%	10.46%	11.97%
NAREIT Equity	Real Estate	(2.85)%	(1.74)%	7.32%	7.11%	18.84%	24.91%	19.53%	14.70%

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