QuarterNotes

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Second Quarter Market Summary

For the first month of the second quarter the markets moved up, with the Dow nearly reaching its 2000 all time high. Abruptly the markets reversed course and took back much of the year-to-date gains.

Investors appeared concerned about the direction of interest rates and the actions of the new Fed Chairman. Only in the final week of the quarter did things settle down as the Fed signaled that the end of rate hikes may be near.

The final tally showed a mixed finish. The Dow ended up a .4 %; the S &P lost 1.9%; the NASDAQ lost 7% and the Russell 2000 index of small cap stocks gained 1.4%.

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The Markets Have Turned Ugly, What is Going On?

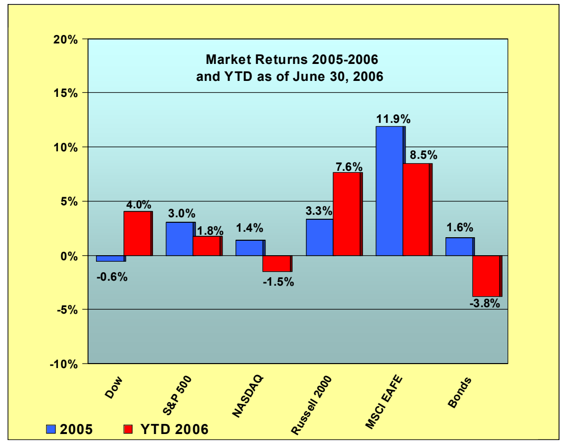
After starting with a bang, the quarter turned ugly. Although still positive for the year, the S&P finished the quarter slightly underwater and the Dow barely hung on to its year-to-date gain. In a time of record profitability and global growth, what's happening?

The markets are responding to a global effort to raise interest rates in order to fight inflation. While some inflation is the result of rapid growth in the developing markets, much of the inflationary pressure can be traced to excess liquidity provided by central banks around the world to shore up growth after the stock market bubble burst in 2000.

As an example, the Bank of Japan lowered their interest rates effectively to zero in an attempt to combat a severe multi-year recession and a deflating domestic economy. Low rates across other nations added to the global liquidity surge, which helped drive stock and real estate prices higher as more investment dollars chased these assets.

In the US, we saw interest rates plunge to record lows in June 2004. Since then, the Federal Reserve has raised interest rates by one quarter of a percent at each of the last 17 Fed meetings, leading the way to more normalized interest rates. Recently, the European Central Bank has begun to raise interest rates and Japan is taking steps in that direction. This is removing "the punch bowl from the party", withdrawing excess liquidity from the global markets.

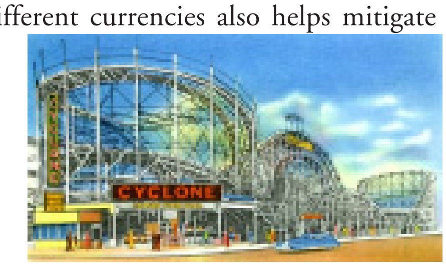
Draining liquidity is expected to slow global growth. The US economy grew by 5.6% in first quarter 2006. That is an unsustainable rate. Even so, corporate profits are expected to rise 8-10% this year and final economic growth is forecasted at 3-3½%. This is still healthy growth.



How should investors respond to higher interest rates and a slowing economy?

A recurring theme among strategists is to stay well diversified across different sectors, but seek higher quality investments within the each sector. For example, investors should continue to invest a portion of their portfolios internationally, but lean towards the larger companies in the more developed nations, and take some profits in emerging markets positions. The same theme applies domestically. The larger, "Blue Chip" companies are expected to weather any fallout from higher rates better than the smaller companies.

For bonds, the theme is to keep durations short by favoring short-term bonds and floating-rate notes. Bonds with shorter durations are not as vulnerable to rising rates which negatively affect bond prices. Diversification using assets denominated in different currencies also helps mitigate risk.



Better Yields on Money Markets

As interest rates have been rising, the differential between the various money market sweep accounts has changed. There is now a material difference between the two Schwab money market accounts for taxable accounts. We have recently made changes to take advantage, where applicable, to increase the short-term yields on these accounts for our clients.

Tax Law Changes

The *Tax Increase Prevention and Reconciliation Act of 2005* made three important changes worth noting for our clients. Income restrictions to Roth IRA conversions have been lifted, the cutoff age for the "kiddie tax" has been increased, and the 15% maximum tax rate on qualified dividends and long-term capital gains that was set to expire in 2008 has been extended to 2010.

Roth IRA conversions used to be available only to households with adjusted gross income of under $100,000. New provisions remove that income restriction starting in 2010. The taxes generated by the expected Roth conversions will offset revenues lost from extending the preferential tax rates for dividends and capital gains. The Act allows taxpayers who convert an IRA to a Roth IRA in 2010, to defer recognizing the income in that year and spread it over tax years 2011 and 2012.

Previously, a child over 14 was taxed at his/her own tax rate including all income, dividends, interest, and capital gains. Younger children were taxed at their parents' rate after a small exemption. Now the cutoff is 18 years old, which makes transfers to children less attractive.

Not yet passed into law are changes to the Estate and GiftTax. After the Senate rejected a plan to permanently repeal estate taxes, the House of Representatives voted 296 to 156 in favor of the *Permanent Estate Tax Relief Act of 2006*. The Senate will vote on the legislation later this year. The bill includes proposals that would raise the estate and gift exemption to $5 million. There are five main parts of the bill.

The current $2 million exemption would continue through 2008, increase to $3.5 million in 2009, and finally to $5 million in 2010. The act would include an amendment to index the exemption for inflation. For couples, if the exemption is not used by one spouse, the unused portion may be carried forward by the survivor, leaving the survivor with an exemption of up to $10 million. In 2010, the rate on estates from $5 million to $25 million would be equal to the 15% capital gains tax rate, and increase to 20% in 2011. Under current law, for estates over $25 million, this will be a rate of 30% in 2010 and 40% in 2011. Most assets transferred from an estate will continue to receive a "stepped-up" basis to fair market value in 2010 and beyond.

A New Fed Chairman

When Ben Bernanke was announced as the successor to Alan Greenspan as Federal Reserve Chairman, the markets rallied. The markets have since shown fear of Bernanke, concerned that he is shifting the Fed away from the goals of balanced growth and price stability set by Greenspan. The former Fed chair had viewed inflation as the result of excess money creation and made general price stability the Fed's priority without targeting a specific rate of inflation. Bernanke has pushed for the central bank to adopt more specific inflation objectives. (The Bank of England has done this with its target for a 2% inflation rate.)

The new Fed Chairman arrived at a tough time. Interest rates were in the process of being raised to more normal levels to keep inflation in check. In addition, the rate hikes helped sustain the foreign capital we need to float our large deficits. Rising interest rates lead to slower growth, and it is feared that Bernanke will go too far, slowing growth even more than the economy requires. Greenspan supporters fear this policy limits the Fed's flexibility in balancing employment and price stability.

International commodities have a big impact on inflation, but the Fed doesn't control them. Bernanke believes the best way to prevent increases in energy and commodity prices from causing higher inflation is by calming the public's long-term inflation expectations. He contends that maintaining price stability and a consistent pattern of policy responses to emerging developments would diffuse inflationary expectations. The Fed's aggressive policy of increasing interest rates is designed to tame both inflation and the inflation mindset of investors, businesses and consumers.