

BOND INVESTORS

Interest rates keep rising ever so slowly as the Federal Reserve attempts to find the economic "sweet spot". After making a number of confusing statements in May, Ben Bernanke, the new Fed Chairman recently delivered no less than 3 speeches to mollify jittery stock and bond markets. The bond market is pricing in another Fed Fund rate bump from the current 5% to 5.25% at the June 29 meeting. Given the economy's surprising strength (1st quarter GDP rising 8.8%) an additional .25% is expected in August. The yield curve is now officially inverted with the 1-year U.S. Treasury Note yielding 5.18% and the 10-year Note at 5.13%, up from 4.39% at the beginning of the year. Inverted yield curves have preceded the last four recessions, however, the inversions have been much more severe than the current slight .05%.

Out guessing and fine-tuning the economy is always a dangerous enterprise. Of course, we know - that is exactly what the Federal Reserve does - live dangerously. This often leads to arbitrarily imposed miss-pricing of securities and economic chicanery. Example: in an attempt to slow the "irrationally exuberant" / "bubble" stock market in late 1999, the Fed pushed rates up to 6.5% in early 2000, a shock to an already slowing economy in a global deflationary environment. Then, in response to the stock market crash and ensuing recession, they sat on the panic button, aggressively lowering the rate all the way down to 1% by June of 2003, keeping it there until June of the following year. Instead of a slow unwinding of the over-charged tech driven stock market, billions were wiped out in the crash. Three and a half years after the correction, investors still avoid technology stocks. The Fed misread has also weakened the dollar.

But, it is not the over-reaction that is the problem - it is rather, the presumption that a committee of supposedly brilliant, highly educated individuals can replace the collective genius of trillions of daily decisions of millions of people in the global marketplace. Now the Fed is on the raise wagon again, obviously responding to what they believe is a potentially inflationary, hot economy. They also seem intent on rebuilding enough rate margin to allow for lower rates later to revitalize the economy in the event they over do the current increases. The financial media dutifully plays along, literally prizing every word from the Fed because they have imposed such a heavy handed influence on the economy. Rather than play this complex game, the Fed should go back to Paul Volcker's monetarist standards of simply paying attention to money supply. We look for the Fed to over play its hand again, raising rates too high - continue to emphasize short maturities.

STOCK INVESTORS

The recent sell-off has pushed the market's price to earnings (PE) ratio down to 14 times 2006 expected earnings. At that level, the stock market is reasonably priced - actually on the inexpensive side. This is especially true for large cap growth stocks, on average, sporting and even lower PE. Current market weakness however could extend further, possibly falling 10% or so from the high set in March. Short-term uncertainties prevail - continuing Fed interest rate hikes, slowing job creation, lackluster retail sales, rising real

estate inventories and tapped out consumer spending (which represents 70% of the economy). Off-setting these challenges, corporations have been avidly buying back stock, finding their own stock values better than other competing investment opportunities. Equity supplies are shrinking - very positive for long-term prices as rising earnings are divided among fewer shares, i.e. more earnings per share. Business capital spending has also picked up, possibly replacing the consumer on the demand side of the equation. Corporate earnings growth remains strong, the ultimate engine of share value.

First quarter earnings were up an average 24% over the first quarter of '05, and this is on the heels of double-digit growth for each of the previous 4 quarters! Profit margins (revenues minus costs) are also as healthy as ever, rising 18% last year. We think that inflation fears (the main reason cited for the sell-off) are over-blown. A high inflation rate is the ages old bane of both stock and bond markets - countless bull markets have been slain by the inflation beast. The recently announced CPI of 5.2% is scary, especially when compared to '05's 3.4%, but the trailing 12-month core rate is still a reasonable 2.4%. The Federal Reserve's rate increases also seem to be slowing the economy, which will ultimately keep a lid on prices.

Inflation should not become excessive unless the Fed over-expands the money supply through its open market transactions. Rising prices are a symptom of inflation. Real inflation is a monetary event caused by too much money chasing a smaller volume of goods and services produced in the economy. As long as money growth does not exceed GDP growth, there is no inflation. This was proven in the early 80's when Paul Volcker, a "monetarist" (economists believing in the excessive money supply theory of inflation) took office as the new Fed Chairman. Inflation was raging at 13%. Instead of incrementally raising interest rates over a long period of time (the Greenspan / Bernanke method of fighting inflation), Volcker went economic "cold turkey" and immediately restricted money growth, getting it in line with the then tepid GDP growth. Interest rates exploded (the prime rate soared to 18%) and a deep recession ensued. But inflation was dead within just a couple years. The economy took off from this very solid base and Volcker left Greenspan a very healthy economy by the mid 80's.

Earnings are expected to grow another 10% to 12% in the second quarter, the 12th straight quarter of double-digit growth. Productivity remains strong, business spending is rising (offsetting lower consumer spending) and unemployment is low. Our advice is to use market declines to increase equity holdings.

ECA's 20th ANNIVERSARY

In August of this year, we will celebrate our 20th Anniversary from very humble beginnings. At the sagacious suggestion and invaluable early assistance of Cindy Crooks to her husband, Ed Crooks, E. S. Crooks & Associates started in Hanover, PA with one office, a telephone, a Rolodex, a chair and a three-legged desk (the 4th leg was secured with duct tape). Unending love and gratitude to Cindy and a big thank-you to Mr. Darryl A. Noble, CPA of bmc (Miller &

Company in those days) for "believing" and letting us share his office and staff. Also, a huge thank-you to key early clients (you know who you are) who showed courageous confidence and faith in a small start-up investment firm.

ECA's early growth was very slow, but perseverance, hard work and adherence to disciplined asset allocation planning for clients assured a healthy beginning. An important milestone occurred in 1997 when Mr. Brian D. Selby (a well known, talented portfolio manager at York Bank & Trust Co.) joined the firm with an equity interest. Brian brought (and continues to deliver) significant knowledge, experience, influence and integrity to the firm. Brian was also our entrée into the important York market. Soon after Brian joined the firm, we opened an office in York, contributing to continued growth. The most recent milestone was the formation of Counsel Trust Company in 2002. This stand alone, independent trust company has enabled us to deliver sophisticated asset allocation and top-flight investment management services to our clients. Today, combined assets of ECA Investment Group, Inc. and Counsel Trust Company (our affiliate) are about \$375 million with oversight provided by 10 very capable associates.

Looking back, the most significant factor in surviving and prospering in this volatile and unforgiving business is the practice and application of asset allocation. In the vulnerable early days, it especially helped a young ECA to temper the trauma of the 1987 stock market crash, a crash that wiped out many investment firms, especially those just starting. Of all market corrections and crashes in the 20th Century, the crash of 1987 was particularly brutal because of its suddenness - down 23% in a single day, October 19th - "Black Monday". The crash was widespread - most of the major global equity markets were similarly hammered that day for no seemingly valid reason.

Not to suggest that events in October 1987 will necessarily repeat this year, however, many conditions present then are present now. In 1987, the U.S. dollar had been declining against other major currencies - also true today. In an effort to reduce the trade deficit, Treasury Secretary James Baker suggested that the dollar should slip further (a cheap dollar encourages foreign buying of U.S. goods). We hear the same kind of rhetoric today from various government officials in an effort to boost U.S. exports. In 1987, Congress tried to limit corporate deductibility of interest to dampen takeovers (particularly leveraged buy-outs - very popular in those

days). In a similar fashion, today, there is talk in Congress not to renew the tax cuts of 2003 (an effective tax increase). Last, interest rates in the U.S. had been rising since early 1987. The same is occurring now - the Federal Reserve has raised rates 16 times and will likely raise again this month.

The point is - no one knows what negative factor (or combination of factors) will scare investors into an emotional selling frenzy. That is why ECA's emphasis on asset allocation is so important. Asset class leadership changes year to year are often dramatic and unpredictable. Rarely do the classes repeat the same performance of the previous year. It is impossible to denote any kind of pattern - where a previous year's leader becomes the current year laggard or vice versa. For example, in 2001, U.S. small stocks were up 3%. The next year they were down 21% and in 2003, they were up 47%! Talk about a wild ride. There is simply no pattern and no predicting. It is not possible for even the most sophisticated and knowledgeable market gurus to divine asset class timing - artfully shifting from one area of investing to another in an effort to maximize performance.

Asset allocation solves the "no pattern / prediction" problem - it is the efficient quantitative combination of asset classes to achieve maximum risk-adjusted performance. This is made possible because many of the asset classes move up and down counter cyclically to one another. In other words, they can have low or in some cases, negative correlation with other classes. This process can be quantified to find the best combination of asset classes. The result leads to an efficient portfolio with higher returns and significantly lower risk. In fact, it is possible to efficiently combine low correlated, high - risk asset classes in a portfolio that on an overall portfolio basis has lower risk than an all bond portfolio! Finding this optimum combination of asset classes is referred to investing on the "efficient frontier" - the lowest possible risk, given various levels of return.

All client needs are, of course, different. However, we make an effort to customize and design every client portfolio to approach or actually reside on the efficient frontier, where returns are maximized for every acceptable unit of risk.

By: ECA Investment Group, Inc.

FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

	1 Year Ending <u>3/31/06</u>	3 Years Ending <u>3/31/06</u>	5 Years Ending <u>3/31/06</u>
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This quarter's featured Investment Manager is:

Polaris Capital Mgt. (ECA International Manager) **28.2%** **41.2%** **23.3%**

STOCK AND BOND MARKET INDICES:

S & P 500 Stock Index	11.7%	17.2%	3.9%
MSCI EAFE (International) Index	24.9%	31.7%	10.0%
Lehman Bros. Govt/Credit Bond Index	2.0%	2.8%	5.2%
Balanced Index (EAFE & Bonds)	13.5%	17.25%	7.6%
90 Day U.S. T-Bills	3.7%	2.2%	2.1%
Consumer Price Index	2.8%	2.6%	2.4%

OUR SERVICES TO YOU

-Investment Management
 -Asset Allocation Consulting and Performance Measurement
 -Cost Tracking and Control
 -Personal and Institutional Trust Services through Counsel Trust Company

-Investment Manager Search and Selection
 -401(k) / Employee Benefit Plans
 -Manager Monitoring

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