H.M. Payson & Co.

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In this age of instant information, we recognize that many clients would prefer more frequent and timely insights. Although our newsletter, Perspectives, will continue to explore longer-term investment themes, wealth management issues and other topics of interest, we introduce Research Notes as a vehicle for conveying brief, periodic comments on a variety of issues that arise through the course of our daily investment work..

Despite continued strong economic growth, most investors saw very modest returns for the first half of 2006. Although the major stock indices showed meaningful gains earlier in the year, the market corrected in May and June in response to inflation concerns and higher interest rates. As of June 30th, the Dow Jones Industrial Average and the S&P 500 Index produced total returns of 5.22% and 2.71%, respectively.

Repeating a familiar paradox, the root cause of the recent correction has been stronger than expected economic growth. In May, stating that economic statistics implied a level of inflation "at the high end of (his) comfort range," new Federal Reserve Chairman Ben Bernanke signaled a continuation of the more restrictive monetary policy that began two years ago. In the last twenty four months, the Fed has steadily raised its target short-term interest rate from 1.00% to 5.25%, and other central banks have begun to follow suit. So far, resilient economies and strong corporate profits have helped to keep stocks moving in a generally positive direction, but the prospect of reduced liquidity worldwide has rattled markets around the globe.

As we expected, the sectors most affected in this correction have been those which were showing clear signs of speculative excess: basic materials, energy, emerging markets and small capitalization stocks. By contrast, larger U.S. equities have generally fared relatively well. In our recent communications, we have observed that the valuations of these stocks are at their most attractive levels in nearly ten years, and we have positioned portfolios accordingly. In view of the potential for further interest rate increases, we are maintaining short durations in fixed income portfolios. Because of very narrow spreads between low and high grade bond yields, we are focusing on quality as well.

As we go to press, events in the Middle East have heightened investor concern once again. While such conflicts are unsettling, the markets have survived countless crises over time, and have been driven in the long run by economic fundamentals rather than political events. We are very encouraged by the relative stability of the large cap sector through the recent decline, and will continue to seek attractive investment opportunities across all asset classes in a manner consistent with each client's tolerance for risk.