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## MARKET COMMENTARY

January, 2006

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2006 should be a good year for stocks, given attractive equity valuations, a healthy and resilient U.S. economy, and good prospects for continued solid growth in corporate profits. While 2005 proved a frustrating year for investors, it did mark the 3rd consecutive year of positive returns. Though equity performance has been restrained – a “stealth” bull market – the stage has been set for better performance in 2006 as the improvement in fundamentals continues to outpace the increase in stock prices. Corporate profits are up 35% over the past 2 years (+ 13% in 2005 following + 22% in 2004), while the S&P 500 has risen less than 14% over the same period. Prospects for stocks are brighter due to the favorable combination of strong fundamentals and attractive valuations.

U.S. GDP has been a steady 3%-4% for eight consecutive quarters, but is likely to moderate to a 2 ½ % - 3 ½ % range in 2006. Given the current robust health of American industry – record profits and cash flow, and corporate balance sheets that are the strongest in decades – economic growth near 3% should be sufficient to enable corporate earnings to increase another 7% or so this year. This is below the torrid pace of the past two years, but is still very respectable growth in line with the long term averages.

### Goldilocks Returns

As we have discussed before, a mid cycle slowdown in economic growth is typically good for both stocks and the inflation outlook, and serves to prolong an economic expansion. Thus 2006 could see the return of the so-called “Goldilocks” economy – not too strong, not too weak, but just right for subduing inflation and sustaining corporate profits. This is an ideal environment for stocks.

Recent inflation data has been very tame, with the Core Price Consumption Deflator declining to below 2% in recent months, and U.S. labor costs also moderating. In addition, the housing market has already begun to cool, which should further moderate the pace of economic growth and inflationary pressures. The big picture – slower but still steady economic growth, low inflation, and 6%-7% earnings growth from a strong corporate sector – is positive for stocks and could lead to higher PE multiples for equities in 2006.

### Attractive Market Valuation

With the S&P 500 currently trading at about 15.5 times 2006 consensus operating earnings, we believe the market could reverse the trend of the last two years and actually outperform the underlying rate of growth in corporate earnings. The current S&P 500 PE represents a 10 year low. A modest expansion in the PE multiple to around 17 would still leave the market quite reasonably valued by historical standards. This is even more feasible in light of the current low interest and inflation rates, and the low 15% dividend tax rate. Moreover, robust fundamentals across U.S. industry from surging earnings and free cash flow to balance sheet quality and liquidity, support the case that U.S. equities are relatively undervalued today. Thus, both equity valuation measures and equity fundamentals are unusually favorable as we start 2006. A one point rise in the S&P 500 PE multiple translates into a better than 6% rise in the S&P 500 index, based on consensus earnings. The combination of earnings growth and some expansion in multiples provides a reasonable basis for double digit market returns.

**2005 Revisited:  
U.S. Economy - Man of the year**

If the Fed was the market's bad cop in 2005, relentlessly raising rates to forestall inflationary pressures and quelling any animal spirits in the market, the U.S. economy was the star of the year. The U.S. economy never wavered through an obstacle course of rising energy prices, rising interest rate, epic hurricanes and natural disasters, and war in the Middle East. The Fed has finally indicated that it is near the end of its rate hikes, absent an unexpected reacceleration in economic growth or inflation. New Fed Chairman Ben Bernanke will certainly raise rates at least once more to 4.5%, but the end of the rate tightening cycle is clearly near. Stocks should begin to perform better as the market anticipates the removal of this headwind.

When considering the outlook for 2006, we believe it would be a mistake to underestimate the fundamental strength of the U.S. economy. In addition to the health of the corporate sector, discussed above, we would highlight the U.S. consumer and the global economy as major underlying strengths that are not fully appreciated.

*Dynamic Global Economy*

The U.S. economy is part of a dynamic and rapidly growing world economy. While the U.S. economy is far and away the star performer among the industrialized nations, thanks to more rapid growth in China, India, Russia and Eastern Europe the world economy is actually growing faster than the U.S. economy. Global growth is no longer so dependant on the U.S. economy. For example, according to the ISI Group and the IMF, U.S. imports as a percentage of total world imports is down from about 20% five years ago to 15.8%, roughly the same as it was in 1984. China's percentage of world imports has risen from 1% to 7% over the same time frame, and has more than doubled over the past 5 years.

The ISI Group also points out that with some 3 billion people recently joining capitalism and market oriented economies (China, India, Russia

and Eastern Europe, Brazil), the world now has a surplus of labor. This has enormously positive implications for both inflation and future global economic growth. Both these trends, the revolutionary growth in the global labor force, and the dynamic growth in rapidly developing international economies, are major positives for U.S. multinational corporations.

*U.S. Consumer*

Closer to home, the U.S. consumer remains healthy. Consumers have \$5 trillion in cash savings and a net worth of almost \$52 trillion (FRB). Unemployment now stands at 4.9%, equaling a 4 year low. This should cushion the consumer from a cooling housing market and the economy from a decline in mortgage equity withdrawals, which have been a big source of consumer spending.

**Summary**

Decent economic growth, low inflation, and 6%-7% growth in corporate profits could produce double digit market returns in 2006. But please do not tell anyone, not yet anyway, you might want to keep the stealth bull market a secret for a while longer. Investors have not returned to stocks after experiencing the nasty bear market which followed hard upon the heady returns of the 1980s and 1990s. Moreover, 2006 is likely to be a bumpy year, with greater volatility than 2005. But eventually, investor confidence will return and stocks will once again be embraced. Your portfolio had a solid 2005 and is positioned to do better in 2006. With the booming U.S. housing and real estate market now cooling, and aging baby boomers of necessity seeking out liquid assets that can provide growth and income, the trend toward high quality equities is inevitable. High quality, dividend paying growth stocks started to differentiate themselves in 2005 and are poised to perform even better in 2006. Quality growth stocks that are also good dividend growth vehicles will become highly prized in the years to come. Investors will not reach this conclusion in a sudden rush, all at once, but long term investors should be well rewarded.

## Market Balance Sheet

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates	→	Budget Deficit/Surplus
Economic Growth/Industrial Production	Liquidity (Monetary Growth)	
Economic Growth/Consumer Spending	→	Geopolitical Stability
Fiscal Policy	Inflation	
Valuation	Dollar	
Profit Growth/Margins	→	Energy Prices
Productivity	Employment	
Demographics	Free Trade Protectionism	Regulatory Environment

### POSITIVE

Interest Rates	Still historically low and favorable to equity valuations. Inflation expectations have risen with the spike in energy prices and outlook for increased federal spending due to hurricane Katrina and rebuilding of New Orleans. While the Fed Funds rate is likely to rise from the current 4.25% to at least 4.5%, we are near the end of this cycle of rate increases.
Economic Growth	Should remain in a healthy 2.5% - 3.5% range for the next few quarters. <ul style="list-style-type: none"> <li>➤ Profits and corporate liquidity are surging, providing a strong foundation for 1) increased business investment and higher employment; and 2) rapid dividend growth and share repurchase.</li> <li>➤ The economic growth driver has shifted from the consumer to capital spending and industrial production, and toward innovation, small business, and more entrepreneurial activity.</li> </ul>
Fiscal Policy	Taxes on dividends and capital gains at lowest levels in over 60 years, not in jeopardy of change prior to 2009. Bush will push hard to make the tax cuts permanent, but this is made more difficult by the current surge in Federal spending (Katrina, Iraq with no offset from reductions in domestic spending) and concerns over budget deficit.
Valuation	Very reasonable at 15.5 times estimated 2006 S&P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields only 4.35%, and is thus valued at roughly 23 times “earnings” (its coupon).
Profit Growth/ Margins	Profit growth should moderate to 6% - 7% range during 2006; profit margins at high levels and supported by continued gains in productivity, but under some pressure from rise in energy costs.
Productivity	Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; will moderate somewhat as economic expansion lengthens and we move closer to full employment.
Demographics	Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.
Liquidity (Monetary Growth)	Money growth has picked up in recent months, running at levels at least in line with nominal GDP.

## **NEUTRAL**

Inflation	Remains low, but inflationary pressures are still a concern. Hurricane related surge in natural gas prices has receded, but we still face the huge cost of rebuilding New Orleans and the Gulf Coast. Lack of fiscal discipline was already a concern – the war on terror and Iraq reconstruction coupled with high levels of domestic spending – even before these events. Still, we believe higher inflation will prove temporary, as the global economy exerts relentless pressure on prices. In particular, China remains the dragon slayer of inflation, exerting downward pressure on U.S. wages and manufacturing. Low global bond yields (rates in Western Europe, Canada, even China and the Czech Republic are all below the U.S. ten year bond) and a flat yield curve in the U.S. also indicate inflation remains well contained.
Dollar	After an almost 3 year period of weakness, the trade weighted dollars strengthened about 13% in 2005. A return of dollar weakness, however, could lead to higher short term interest rates in order to lend support to the dollar. The weaker dollar helps U.S. multinationals, but our trade deficit remains stubbornly high despite the competitive advantages of a lower dollar. It is also worth noting that about 30% of our trade deficit is due to imported oil (net energy imports are currently running at an annual rate of around \$270 billion). This is a structural deficit, which has exploded in the last couple of years due to the declining dollar and doubling of global oil prices.
Employment	The employment picture remains quite healthy, with 31 consecutive months of job growth given September 2005 positive revision. The 4.9% overall unemployment rate is low by historical standards, and equals the 4 year low. Still, employment growth has been less robust than in typical recoveries, and the pace of job growth is likely to moderate further over the course of the year.
Free Trade/ Protectionism	Free trade and free market oriented reforms were given a recent boost by 2005 election results in Japan and Germany. CAFTA also a nice positive for increased free trade in the Americas.

## **NEGATIVE**

Budget Deficit	Still a concern at 3% of GDP but was in an improving trend before hurricane Katrina. Would like to see more spending restraint in 2006. Tough to rebuild Iraq and New Orleans at the same time, but need for spending discipline has at least been recognized in Washington. Bigger issue is the persistent growth of medical care costs and the long term liability of retirement in our aging society.
Geopolitical Stability	Despite successful elections, Iraq continues to be plagued by terrorism. The global terrorist threat will be with us for some time. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.
Energy Prices	Up 40% in 2005, oil is likely to remain above \$45 for some time. Without a global economic slowdown, it is difficult to make a convincing case for a collapse in energy prices. While high energy prices act as a drag on the global economy, on an inflation adjusted basis, oil prices have just now, at about \$64, moved above the prior 1980 peak. We continue to find the sector fundamentally attractive from an investment standpoint.
Regulatory Environment	Federal and state investigations continue to impact individual corporations and entire industries. The pendulum of regulatory scrutiny appears to have swung from pre-Enron laxity to downright anti-business regulatory and governmental activity. Perhaps 2005 will mark the zenith of regulatory scrutiny and high profile investigations.