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October 2005

Investment Outlook Fourth Quarter 2005

A respectable summer rally in the US stock and bond markets came to a sudden halt following the release of the Federal Reserve's statement at the conclusion of the September 20 FOMC meeting. The Fed's decision to raise the fed funds rate to 3.75% and to signal additional rate increases in the months ahead have unsettled the financial markets over the past few weeks. The Fed now appears more willing to risk a slowdown in economic growth brought on by raising rates too much, rather than risk letting inflation rise further by raising rates too little. Investors have become uncertain as to whether the Fed is accurately assessing the inflation landscape or whether they may overshoot and push the economy into recession.

In the weeks since the FOMC meeting, Fed officials have sounded increasingly hawkish when speaking about inflation and the outlook for interest rates. These monetary policymakers have apparently concluded that the Gulf Coast hurricanes' impact on inflation is more worrisome that their effects on economic growth. Up until recently, the Fed's official communications cited strong productivity growth as helping inflation remain well contained. U.S. productivity rates, defined as hourly output per worker, have eased to around 2.5 percent from as much as 4 percent to 5 percent in recent years. In addition, unit labor costs are rising at about a 4 percent rate, the highest it's been since year 2000; causing Fed policymakers to become concerned that some wage pressures look to be entering the economy. Couple that with energy, gold and other commodity prices attaining levels not seen in nearly twenty years along with surveys now suggesting rising inflation expectations, and it is clear the monetary authorities have begun to take notice. Although we are still of the belief that core inflation (CPI - excluding food and energy) remains under control due to globalization, the internet and still strong productivity gains, it is only the Fed's opinion that investors are concerned about.

Another obvious worry on the minds and pocketbooks of investors is high energy prices. The recent rise above $3.00 per gallon of gasoline prices shocked many motorists and has begun to influence consumer behavior. Some retailers, restaurants and travel-related enterprises have experienced slowing demand and auto manufacturers have seen a surge in orders for cars with high fuel efficiency and away from gas guzzlers, including large SUVs. The next shoe to drop in this area will be in the winter months when consumers are forced to pay up to sixty percent more than last year to heat their homes. This could have a "chilling effect" on consumer spending during the first half of 2006. Unfortunately, with supply constrained due to lack of excess refining capacity and gulf coast energy infrastructure damage combined with continued strong demand from China and India, high energy prices are unlikely to reverse anytime soon.

While experts have been calling for the end of the housing boom for a number of years, conditions now appear right for a weaker market. The average U.S. home price is roughly 3.1 times average household income - the highest in history and up from an average of 2.6 times since 1960. The National Association of Realtors' national measure of home affordability fell in August to its lowest level since late 1991. Inventories of unsold homes are rising, buyers are turning cautious, and, analysts and real estate agents have been reporting, that in some cases, prices are slipping after a period of explosive gains. Housing prices and demand have been driven by a combination of demographic and immigration trends and historically low mortgage rates. But as suggested above, a growing inflation threat will likely keep the Fed on the path for higher interest rates, with the Fed funds rate, which now stands at 3.75%, likely to be boosted to 4.5% to 5% by next spring. The casualty in this will likely be the housing and mortgage market. While house prices are unlikely to fall across the board, the nation's most overheated markets, particularly those in California, Florida, the Northeast and many metropolitan areas could be subjected to some declines. Also, Wall Street may be underestimating the potential of a major tax overhaul. While President Bush has suffered a recent string of setbacks, Democrats are eager to repeal the alternative minimum tax, or AMT, which threatens a growing number of middle-class taxpayers each year, particularly in Democratic-leaning "blue states." As a result, lawmakers may end up embracing a plan that could include a proposal to limit the mortgage interest deduction, another straw that may finally help break the back of the housing market.

Much has been made about the economic dangers of the US federal budget deficit and foreign trade deficit. While our preference would be for the government to maintain a policy of fiscal restraint, the size of the current deficit is only average when measured historically. Due to the strength of the US economy, tax revenues have come in well above expectations helping to drive the deficit down toward $300 billion, almost $100 billion less than expected at the start of the last fiscal year. However, the cost of reconstructing the hurricane damaged Gulf Coast combined with our continued involvement in Iraq and the costs associated with the new Medicare prescription drug program increase the likelihood of a higher deficit next year.

As far as the foreign trade deficit is concerned, the sheer size of the number, approaching a trillion dollars annually, is alarming but is more likely related to rising oil import prices and the strength of the US economy in relation to our trading partners. Should the US consumer’s propensity to spend diminish, as we expect, the trade deficit should begin to shrink. And the strength of the US dollar this year versus the euro and the yen can largely be attributed to rising US interest rates. With rates expected to rise further, we would anticipate dollar stabilization to continue.

US employment trends this year can be characterized as solid with the economy on track to create better than 2 million new jobs in 2005 and the unemployment rate dropping to 5%. Corporate profit growth has been impressive and is poised to extend a string of double digit profit EPS growth to an unprecedented 14 consecutive quarters. Profitability measures remain at historically high levels and corporate balance sheets are in their best shape since the 1960s.

After accounting for the drag on growth from the Gulf Coast devastation, our expectations are for second half GDP growth of around 3%. Stimulus from the reconstruction of this region could add half of a percentage point to GDP growth in the first half of next year. With the Fed determined to keep a lid on inflation and the economy still growing at a respectable pace, it is probable that intermediate and long-term interest rates will rise is parallel with the rise in short-term rates. This could bring the yield on the ten-year US Treasury Note to 5.0%-5.5% by the spring, up from the current level of 4.5%.

The implications for stock prices are less clear. Positive growth and profitability characteristics are offset by the headwinds of high energy prices and aggressive Fed policy. In a rising interest rate environment, it is reasonable to assume that valuation levels will contract further. Simply put, this means that stock prices are likely to appreciate at a slower rate than corporate earnings. Amid these signs, we are taking a cautious approach to both bonds and stocks. We would expect a modest year-end rally to begin soon, but rising interest rates, high energy prices and the possibility of a slowdown in consumer spending cause us too much anxiety to be overly optimistic at this juncture. It is our expectation that a healthy rally in stocks will begin a few months before investors are convinced the Fed will end its rate hikes. Although our investment performance has been relatively strong this year, primarily due to some timely stock purchases, we continue to advocate diversification beyond US stocks and bonds as the best way to reduce risk and deliver respectable returns in a low-return environment. As always, we would be please to discuss our investment expectations with you and how they may relate to your individual needs and objectives.