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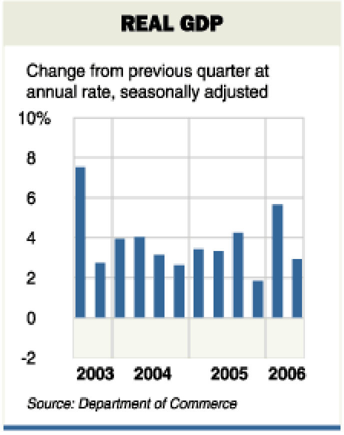
# Investment Outlook Fourth Quarter 2006

In this quarterly outlook, we attempt to convey our current views on economic conditions, the state of the financial markets, the most likely scenario for what's ahead for both, as well as the greatest risks to our outlook.

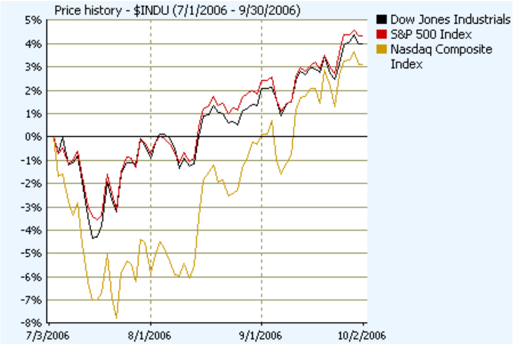
## The Economy



Source: Department of Commerce

GDP growth decelerated to 2.9% in the second quarter from the rapid 5.6% pace generated in the year's first quarter. Third quarter estimates range between 3% and 3.25%. Although the fear of inflation has been well advertised, actual inflation appears to be well contained, especially in light of the recent pullback in energy and precious metals prices. And while deterioration in the housing market is now unquestioned, much of the impact has been felt in the most overheated markets where prices had reached unsustainably high levels. Employment trends, while not totally impressive, have been indicative of a healthy, growing economy. Consumer spending has held up far better than most expectations in light of the slowdown in economic activity. The recent decline in interest rates and energy prices has certainly been a positive influence on consumer confidence and retail sales. Energy prices in particular have endured a sudden correction with oil prices down 25%, gasoline prices 33% lower than during the peak summer driving season and natural gas prices tumbling by two-thirds from January's highs. A slowing US economy, relatively calm hurricane season and the perception of reduced tensions with Iran have been mentioned as reasons for the drop in prices. In fact, the Fed has cited declines in energy prices and the housing market as reasons for holding the Fed Funds rate steady at the past two FOMC meetings. With investors now convinced that the Fed is unlikely to raise rates anytime soon, yields on longer-term bonds have declined, creating a steep inversion in the yield curve from 3 months to 2 years and then a flat curve beyond 2 years. Recent news that the Federal budget deficit has shrunk to $248 billion representing 1.9% of GDP is also good news for the bond market.

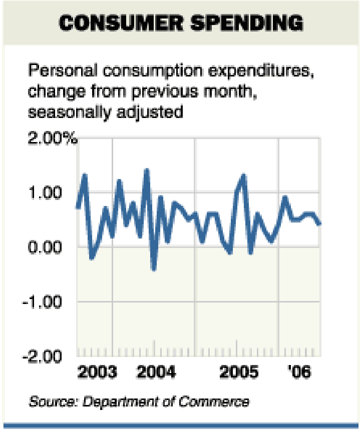
## The Financial Markets



Stock prices staged an impressive turnaround in the third quarter as the likelihood of a pause in interest rates hikes by the Fed and increased probability for a soft-landing for the U.S. economy became evident. The Dow Jones Industrials rose 4.7%, the S&P 500 5.2% and the Nasdaq advanced 3.9% during the period. As has been the case all year, growth stocks continued to lag the market's advances as the Lipper Large Cap Growth Index rose only 1.9%. Financial companies, retailers and technology stocks led the market's climb in the quarter while most energy related stocks retreated. The bond market's surge was equally impressive with the 10 year US Treasury Note yield falling from 5.15% to 4.64% from beginning to end of quarter. Corporate earnings growth is poised for a 15th consecutive quarter of double digit gains. And with a weak residential real estate market and sharp declines in many commodities prices, momentum traders appear to have found a renewed interest in stocks as an avenue for growth.

## Market Outlook

The strong performance for financial markets during the third quarter is somewhat unusual as September and October tend to be amongst the worst months historically. While we are still of the mind that stock indices will realize a normal year-end rally, it is certainly possible that they are short-term over-bought (trader's jargon meaning they've advance quickly without a sufficient pullback or pause). It is also possible that the positive third quarter results may steal some from the forth quarter, muting gains. Count us amongst those predicting a soft landing for the U.S. economy. We firmly believe that recent declines in interest rates and energy prices have resulted in a re-acceleration in consumer demand. Back-to-school retail sales were generally strong, typically a good sign for retailers that Christmas spending will be healthy. The recent slump in energy and precious metals prices is likely to take the pressure off inflation concerns for now. And although the commodity cycle has experienced its first significant correction after four strong years, we believe the long cycle will resume within the next 12 months and extend for at least another 5 years.


CONSUMER SPENDING

Personal consumption expenditures, change from previous month, seasonally adjusted

Source: Department of Commerce

## Risks

In highlighting the risks to the scenario we've outlined, some are obvious and some not as much. While geopolitical risks remain elevated, world financial markets seem to accept these risks as ones they are willing to assume in search of higher investment returns, or have concluded that it is too difficult to predict when the next financially disruptive terrorist attack may occur. Iraq, Iran, North Korea, Afghanistan and others remain security hot-spots and create headline risk, but none appear to poise immediate threat to our financial markets. A renewed surge in energy and/or commodity prices which causes a slowdown in consumer spending would clearly be negative for both stock and bond prices. Another more subtle risk to financial markets is the outcome of mid-term congressional elections next month. With expectations running high of a Democratic takeover of one or perhaps both houses of Congress, investors may become concerned about the implications of this change. Historically, the stock market has performed well during times of divided government. Expectations are low for an outbreak of bipartisanship regardless of the composition of the next Congress, resulting in more legislative gridlock. From an investment vantage point, gridlock is a good thing since no disruptive legislative changes are likely and more certainty allows for higher confidence when creating financial models or assumptions.

## Strategy

For several years now, we have been advocating increased diversification amongst asset classes and investment styles as a means to reduce risk. Risk reduction of this nature won't necessarily generate higher long-term returns, but it will almost certainly reduce the volatility of yearly returns. By way of example, growth stocks were strong performers last year, exceeding stock market returns by a large margin. Fortunes have been completely reversed this year as growth stocks have lagged all other indices in a big way. Even Bill Miller, the legendary growth stock manager from Legg Mason is trailing the return of the S&P 500 by over 10 percentage points at this time. His unprecedented streak of outperforming the S&P 500 16 consecutive years will almost certainly be broken this year. While we have long advocated the merits of growth stock investing and still believe it to be the best strategy for long-term after-tax stock market returns, many of our clients have requested a strategy which encompasses less volatility, albeit with somewhat lower expected long-term returns (our clients didn't necessarily desire the lower return part, but there is the unfortunate principle of a trade-off between risk and reward). Earlier this year, we created an Equity Income Stock Model utilizing some of the philosophy in our growth stock model, but overlaying a dividend yield and dividend growth rate criteria to our analysis. I'm pleased to report that the results have been quite favorable thus far. And while fewer clients have requested a more aggressive approach to the market, we've recently constructed an Aggressive Growth Equity Model to accommodate the objectives of those who do have a higher risk tolerance for some portion of their financial assets. As many of you are aware, we continue to support direct investment in individual bonds as opposed to bond mutual funds. For other asset classes that fall beyond our area of expertise we recommend the use of no-load mutual funds, exchange-traded funds (ETFs) or principal protected securities to gain participation in a particular area. These include commodities, precious metals, developed and emerging market foreign investments, real estate (REITs), and small cap stocks. We would be pleased to discuss the desirability of including any of these asset classes or instruments in your portfolio and welcome any comments or questions you may have.