

The Monroe Vos Consulting Group

Review & Outlook

1st Quarter 2006

THE STOCK MARKET

The stock market rallied in the first quarter on stronger than expected economic data. The Dow was up 4.2%, the S&P up 4.2%, and the NASDAQ up 6.1%. Telecommunications, energy, materials and industrials led the way. Small cap stocks performed the best compared to mid and large cap stocks. Bonds lost money in the quarter as interest rates rose.

INTEREST RATES & THE ECONOMY

The yield curve (measured by the difference between the ten year treasury note yield and the federal funds rate) continues to be flat. The Federal Reserve Board will most certainly raise the Fed Funds rate to 5% when it meets in May. Some noted economists think that the Fed will stop there and others think it will take higher rates to slow the economy down. Lehman Brothers thinks that the Fed will raise the rate to 6.25% before it stops. Whether its 5% or 6.25% the flat yield curve makes it difficult to make better than coupon returns in bonds. Van Hoisington of Hoisington Investment Management (a rate anticipator) thinks that the Fed will stop raising rates at 5%, the economy will slow in the second half of 2006, and the Fed will start lowering rates as the economy slows. He says, "The economic evidence in early 2006 reveals a distinct weakening in the forward looking economic indicators. This presages a noticeable slowing in economic growth as the year progresses. The cumulative impact of tighter Federal Reserve policy is taking its toll on domestic economic conditions, and international competition continues to place downward pressure on the prices of manufactured goods and services. With inflation quiescent, and economic growth slowing, a substantial decline in long rates will occur over the remainder of 2006." He continues, "The Federal Reserve appears content to raise rates until GDP slows. This approach is equivalent to driving while looking in a rear view mirror since GDP is a coincident indicator of economic activity. Monetary policy and interest rates work on the economy with long and variable lags, and it is apparent that a two year time span and 375 basis points of tightening have already tilted the economy toward a negative trajectory. How do we know that? We don't for certain. But great efforts by statisticians have been made over the years to arrive at a set of impartial, non-judgmental economic statistics which forecast future economic developments. These are known as leading economic indicators. The Conference Board and the Economic Cycle Research Institute have developed thirteen different leading indicators which provide a glimpse of future economic developments. At the present time, despite Federal Reserve opinions to the contrary, all but two are signaling a noticeable slowdown, if not a recession, in the quarters ahead.

Despite the weakening of eleven indicators, two indicators are still rising, disputing the call for an outright recession. These widely viewed factors are stock prices and commodity prices. Here, however, the recent record of these key financial indicators has been poor in signaling economic turning points. The S&P 500 and the New York Stock Exchange Price Index peaked in August and

September 2000, which was the kickoff to the last recession. Similarly, industrial commodity prices, as measured by the *Journal of Commerce*, peaked in September of 2000, providing no advance warning for the impending recession."

HOUSING SECTOR

Real disposable income (DPI) expanded by 1.5% in 2005, compared with a spending increase of 3.5% in the same period. The difference, of course, has to be additional borrowing or money taken out of savings. The primary source of funding in 2005 appears to have been the withdrawal of home equity, as, according to Freddie Mac, nearly \$250 billion was added to consumer pocketbooks with the cashing in of home values. That process will be less easily repeated in 2006. First, federal regulators have finally begun to scrutinize the quality of zero interest and other non-traditional loans. While the specific guidelines are scheduled to be issued this month, the impact of regulatory changes can be dramatic. In May of last year, regulators issued guidelines regarding home equity loans. Consequently, the six month change fell from over \$130 billion to minus \$10 billion currently.

Second, home values are now beginning to fall (down about 5% since October 2005), and new home sales are 21% off last year's peak levels. Since the new regulations are targeting zero down loans which represented 43% of new home sales last year, further declines appear to be in store. With home sales down, inventories of unsold homes are up 23% from a year ago. Mortgage purchase applications are down 12% from a year ago, and refinancings are down 20%.

It would appear that speculation was an important component of the housing buoyancy of 2005. New regulations, combined with the higher interest rates, have stopped that speculation and will make home equitization exceedingly difficult in 2006, suggesting that consumers will be able to spend only what they make. This is quite a change since in eight of the last ten years income has trailed spending.

INFLATION

The "open" global market continues with China and India thriving with low manufacturing and service costs that are keeping a lid on inflation in spite of rising energy and commodity prices. From 1871-1940, an open economy, bond yields averaged below 3%, inflation averaged negative 0.4% and GDP averaged 3.2%. We are in this type of economic environment where inflation should not be a problem.

CONCLUSION

The flat yield curve, rising Federal Fund rates, rising energy and commodity prices are slowing the economy and this should continue on the second half of 2006. Inflation should not be a problem because of the "open" market. Opportunities continue to lie in alternatives like energy, commodities, real estate, and emerging market debt. Portfolios should be well diversified.

