

# The Monroe Vos Consulting Group

## Review & Outlook

2nd Quarter 2006

### THE MARKET

The stock market had a rough time in the second quarter giving back some of the return generated in the first quarter. The DOW ended up 5.2%, the S&P 500 up 2.7%, and the NASDAQ down 1.5% for the first half of the year. Telecommunications and energy sector lead the way on the upside with returns of 13.8% and 13.7%, respectively. Technology and healthcare were negative for the first half of the year. International stocks were up 10.2% in the first half. Bonds were down as the Fed continued to raise interest rates.

### INTEREST RATES & THE ECONOMY

Treasury yields rose across the board in the first six months of 2006. Two, five, ten, and thirty year Treasuries posted results of 0.7%, -2.0%, -3.9%, and -7.6%, respectively. The Federal funds rate, adjusted higher four times in 25 basis point increments the first half of the year, was the cause for the sell-off.

Van Hoisington of Hoisington Investment Management (a rate anticipator) thinks interest rates will move noticeably lower in the second half of 2006 in response to a rapidly deteriorating U.S. economic environment. He says that the cumulative impact of a tightening Fed policy, rising interest rates, elevated energy costs and modest job growth, in concert with the structural problems of an over-leveraged consumer sector and international wage competition, has created the risk of a sharp and/or elongated slump in economic activity.

### FIRST HALF SELL-OFF

The question of whether an economic slowdown will occur is moot since it has arrived. Coincident indicators of economic activity, such as job growth, are decelerating rapidly.

Over the past three months, private sector job gains averaged a paltry 86,000 per month, some 44% less than the average monthly increase in 2005. Real consumer spending, which accounts for nearly 70% of total GDP, is slated to expand less than 2% in the second quarter, compared with the 3.5% gain in 2005. Construction spending (residential, commercial, industrial, and public) is also on track to display no growth in the second quarter. Thus, 80% of GDP is presently expanding at only half the rate registered last year.

The sharp loss of momentum in this expansion has been well signaled by the leading economic indicators. The Leading Economic Index (LEI), as computed by the Conference Board, has now contracted over the past six months. This is a significant development since a decline of that duration has only occurred thirteen times since the end of the Korean War. Outright recessions followed nine of those episodes, and severe slowdowns were registered in the other four episodes. It is important for investors to note that short and long term interest rates fell in the aftermath of all the previous thirteen slumps in the LEI.

### YIELD CURVE INVERSION

In late June, the Federal funds rate rose above the ten year Treasury note yield. This was a result of the Fed forcing the Fed funds rate higher while the ten year did not follow suit. Sometimes this is referred to as a "frontdoor" inversion. According to Expectation Theory, market investors, on average, held the view that the economy was already slowing, creating the likelihood of interest rate declines at a later date, and this fact was more important to investors than the Fed's hike in the Federal funds rate. Over the prior 55 years, the Federal funds rate has exceeded the ten year note yield only eight times. Six of the inversions were followed by recessions.

### MONETARY INDICATORS

Today's yield curve inversion gains more significance when it is corroborated by key monetary indicators. For instance, real M2, one of the most reliable of all leading indicators, has declined from an 9% growth rate in December of 2001 to a miniscule 1.1% expansion in the twelve months ending in June, 2006. Further, total reserves of the banking system have fallen over the past twelve months by 0.5%. Since 1945, the growth in the total reserves slowed prior to all ten recessions.

### LOWER BOND YIELDS AHEAD

Long term interest rates rose in the second quarter, following increases in the first quarter, as the Fed pushed the Federal funds rate to 5.25%. Investors may be worried that further tightening is to come, but any such actions would serve to limit money and credit growth, while increasing the negative slope in the yield curve. Any additional monetary stringency would risk a downward money/price/wage spiral.

In 1990 and 2000, the Fed failed to properly account for the lags in monetary policy and carried restraint too far. If the Fed targets inflation, a lagging indicator, with changes in the money supply, a

leading indicator, they will tend to overshoot regardless of whether they are tightening or easing. Now the immediate economic risk is for overshooting on the downside. A hopeful sign is that Donald Kohn, the Fed's Vice Chairman, said that they are "aware of those risks."

With the economy already in a slowdown, recession risks rising, and inflation contained, the bond market setback in the first half of this year is temporary. Should a further hike in the Federal funds rate be initiated, it should not be viewed unfavorably by long term investors. This would only insure that the present economic slowdown would deteriorate into recession, causing all yields to decline precipitously.

### THE STOCK MARKET

The valuation of the stock market is becoming more and more compelling. For 11 straight quarters during this stock market recovery, corporate earnings have risen faster than stock prices. Currently on 2007 mean earnings estimates, the S&P 500 sells at only 14.4 times. In the second quarter, corporate profits again probably grew at an annualized pace which is more than twice the current level of interest rates. If there is a correction in the stock market it should not be devastating.



