

The Monroe Vos Consulting Group

Review & Outlook

3rd Quarter 2006

THE MARKET

The stock market had a good third quarter with the Dow ending up 10.8%, the S&P 500 up 8.5% and the NASDAQ up 2.4% year to date. The S&P Energy Index gave back 2.0% in the quarter. Energy stocks took a breather in the quarter as oil prices and gasoline prices moved down. The AIG Commodity Index back up also. Telecommunications led the industry sectors, up 25.9% YTD, followed by energy, financials, utilities, and consumer staples.

A seemingly limited growth slowdown, lower fuel costs, and easing inflation pressures have validated investors "leap of faith" in an economic outlook favoring financial assets. Healthy gain in stocks and bonds in the third quarter have rested on a growth outlook finely tuned to accommodate both healthy earnings gains and lower interest rates. That friendly backdrop for the financial markets continues to be reinforced by still ample liquidity suppressing interest rates and cushioning economic and earnings growth from the slowdown in housing. However, that same fine balance in the economic outlook could leave the financial markets vulnerable to heightened volatility in coming months.

INTEREST RATES & THE ECONOMY

The U.S. Treasury bond market rallied sharply in the third quarter. Two, five and ten year notes returned 2%, 3.4%, and 5% respectively, while the longer-dated thirty year bond rose more than 8% for the quarter. This rally was generated by weaker economic data while the Fed funds rate remained at 5 1/4%.

Presently, the five, ten, and thirty year interest rate levels, standing at 4.6%, 4.7% and 4.8% respectively, are noticeably below the 5 1/4% funds rate. This yield curve inversion, while unusual, is not unprecedented. Similar inversions occurred prior to six post WWII recessions. In the inversions prior to the 1990 and 2000 recessions, the yield curve became more inverted until the Federal Reserve lowered the Fed funds target rate. A similar outcome should prevail in this business cycle, with the inversion process only halting when the Fed reduces rates.

Judgments regarding the course of future economic activity are as plentiful as pages in a newspaper. Current opinions range between a Fed pause and subsequent tightening to an early reduction in the funds rate. Interestingly, a body of statistical indicators exist that carry no opinion, but which proven over an extended period of time to do a superior job of forecasting the level of economic activity. This statistical series, compiled by the Conference Board since 1960, and prior to that by the U.S. Department of Commerce, is known as the Leading Economic Index (LEI). The LEI, comprised of ten different economic indicators, has declined on a six month basis thirteen times since 1952. Nine recessions and four slowdowns followed each of these contractions. This 70% batting average is measurably better than the record of most economic pundits.

One of the LEI components--the spread between the ten year Treasury note yield and the Fed funds rate--has, by itself, an outstanding record of signaling

recessionary periods since the late 1960s. Since the end of WWII, a simultaneous yield curve inversion and a six month decline in the LEI have occurred only seven times. With the exception of an inversion forty years ago, this combination has been 100% accurate in calling recessions. The average lead time between the meeting of these two conditions has been about nine months. The most recent episode occurred in June of this year, suggesting that the economy should register at least below trend growth rates in 2007. All "opinions" aside, cyclical financial history points to disinflationary, sub-par growth rates over the next several quarters. Augmenting this statistical view is the present collapse of various housing indicators.

THE TRADE DEFICIT

One of the most persistent worries concerning the bond market is the record trade deficit. As the logic goes, the deficit is so unmanageable that at any point foreign investors may dump their dollars, forcing the dollar downward and the U.S. inflation rate upward. Research from Hoisington Investment Management indicates that these concerns are entirely misplaced. First, attempting to find a correlation between the U.S. dollar and the trade deficit fails. Second, the trade deficit and its associated internal capital flows have allowed foreigners to amass a total of \$13.6 trillion in claims on U.S. assets. From the U.S. position, this could be seen as they hold \$13.6 trillion of U.S. assets. This statistic ignores the important fact that U.S. investors hold \$11.1 trillion in foreign assets. Of significance, the difference is \$2.5 trillion. Two Nobel Laureates, Milton Friedman and Edward Prescott, shed significant light on this complex problem. They maintain that any impact on the dollar comes from the difference in what is earned on the \$11.1 trillion that we own versus what foreigners earn on their \$13.6 trillion. Historically U.S. investors have achieved a higher yield than their foreign counterparts. And, this differential is much more closely correlated with movements in the dollar. With the recent rise in the Fed funds rate, yields on short dated instruments have risen, and therefore essentially evened the yield differential in this calendar year. As short term U.S. rates fall away, the spread will move back in favor of U.S. asset holders. Therefore, concerns regarding the dollar and its impact on U.S. interest rates are fundamentally unfounded if they are based on the trade deficit or massive foreign holdings of U.S. assets.

CONCLUSION

As the Federal Reserve keeps Fed funds at 5 1/4% or raises the rate, as some think, to 5 3/4% the economy should slow down in 2007. The stock market should suffer as a result of slower earnings growth. At some point the Fed will lower rates probably in the second half of 2007. This will take the yield curve back to normal resulting in excellent returns in bonds for 2007. In the meantime we think sitting in money market is the wise thing to do.

Energy stocks are taking a rest from superior returns over the last three years. Energy managers tell us that the fundamentals have not changed and they are still bullish on the energy sector. Some view this pullback as an excellent buying opportunity.



