A Change in Strategy

Is it time to climb out of the bunker and get more aggressive?

In the third quarter of 2006, the Federal Reserve finally got the message and one of the longest cycles of interest rate increases came to an end. Yes, the Fed is still pretending they might raise rates again if inflation doesn't go away. However, with an election approaching, inflation behaving, and the housing market slumping, no one believes them.

Another reason the next move in interest rates will probably be down is that oil prices finally dropped. There was an outbreak of sanity in the Middle East that undoubtedly won't last, but the easing of tensions helped to calm the oil market. In addition, there was good news in the Gulf of Mexico. A huge new discovery coupled with a hurricane season that was a non-event also helped to push oil prices lower. Finally, people reacted to higher gasoline prices by driving less. The result was that oil prices approached $60 per barrel at the end of the quarter, which should help take some pressure off inflation.

In spite of expectations of a slowdown, economic growth remains stubbornly strong. The housing market may have cooled, but the Goldilocks economy keeps chugging along as industrial production and real GDP growth showed few signs of a slowdown in the third quarter. Among investors, the betting seems to be that, with oil prices declining, consumers will have more money to spend on discretionary items. However, a look at industry and sector performance in the third quarter shows that investors are also still concerned about future prospects for the economy.

Real Estate Investment Trusts (REITs) have had one of the most extraordinary multi-year runs ever, and that streak continued in the third quarter as even a slowing housing cycle hasn't had much impact. We've given up trying to predict when REITs will roll over and are pretty much watching in amazement at this point. In the quarter, large companies finally got some attention as investors clearly preferred big companies over small. Value outperformed growth, and stable industries and those tied to consumer spending generally did better than resource companies or anything else tied to the economy. For reference, here's the equity market segment scorecard for the second quarter of 2006:

	Symbol	6/30/06	9/29/06	% Change
REITs	VNQ	67.92	71.89	5.85%
Large Cap. Value	IVE	68.85	71.81	4.30%
Large Cap.	IVV	130.13	133.75	2.78%
Large Cap. Growth	IVW	61.09	61.70	1.00%
MidCap Value	IJJ	76.69	74.00	-3.51%
Small Cap. Value	IJS	72.59	69.75	-3.91%
MidCap	IJH	79.23	75.44	-4.78%
Small Cap.	IJR	65.00	61.29	-5.71%
MidCap Growth	IJK	80.49	75.39	-6.34%
Small Cap. Growth	IJT	128.70	119.50	-7.15%
Microcap	IWC	58.10	53.40	-8.09%

Source: Thomson One Financial

In addition, here's the stock market index and industry group scorecard for the same period:

	Symbol	6/30/06	9/29/06	% Change
Dow Industrials	INDU	11,150.22	11,679.07	4.74%
Nasdaq Composite	COMPQ	2,172.09	2,258.43	3.97%
S&P 500 Index	SPX	1,270.20	1,335.85	5.17%
Health Care	HCX			9.77%

		350.69	384.94	
Technology	SPHTI	310.54	336.28	8.29%
Financials	SPFN	434.14	465.83	7.30%
Utilities	SPUT	163.80	172.33	5.21%
Consumer Staples	SPCNS	248.12	260.75	5.09%
Consumer Services	SPCCS	263.42	275.86	4.72%
Biotech	BTK	663.91	669.64	0.86%
Services	SICSS	189.53	188.53	-0.53%
Basic Industries	SPIN	308.10	306.29	-0.59%
Capital Goods	IXI	338.61	333.93	-1.38%
Energy	SPENS	420.35	411.38	-2.13%
Transportation	TRAN	4,928.89	4,453.46	-9.65%
Clean Energy	ECO	201.25	176.32	-12.39%

Source: Thomson One Financial

In the fixed income market, yields finally dropped across the board and produced a rally in bond prices. The inflation rate came down during the quarter, the Fed finally decided that overshooting the mark on short term interest rates by nearly 1% was enough, and bond investors also appeared to buy into the idea that the economy was likely to slow. The result was a strong rally on longer maturity bonds and a more modest rally in shorter bonds.

Current Yield	6/30/06	9/29/06	% Change
90 day Treasury Bills	5.01%	4.89%	-2.4%
5 Year Treasury Bonds	5.10%	4.59%	-10.0%
10 Year Treasury Bonds	5.15%	4.64%	-9.9%

Source: Bloomberg LP

As you can see, we currently have a yield curve that's a tribute to bureaucratic meddling as the short end is clearly out of line with everything else.

Source: Bloomberg LP

We expect the next move in interest rates by the Federal Reserve to be down, but don't expect that until 2007. In the meantime, concern over the strength of the economy and better inflation news should create a favorable environment for bonds. Corporate and Government Agency bonds remain our sectors of choice at present and we did lengthen bond maturities during the quarter in anticipation of a Fed pause. Now that municipal bonds are yielding more that 80% of Treasuries for shorter maturities, they are also becoming more attractive.

As you know, we've been cautious on the outlook for stocks for the last two years. However, we now feel it's time to climb out of the bunker and smell the flowers. At present, stocks are significantly undervalued relative to current interest rates, earnings growth is likely to continue, and lower bond yields should lead to higher equity market valuations. The combination of rising earnings and rising valuations should make investing in the equity market a more rewarding experience in the next two years.

For investors, seasonal and cyclical factors are also lining up. We're approaching a seasonal period (November-January) that typically produces about half the return in stocks over time. In addition, next year will be the year before a Presidential election when double digit returns in stocks are the norm. By overshooting the mark on short term interest rates, the Federal Reserve has left itself plenty of room to cut them. As it typically takes about a year for a drop in interest rates to stimulate the economy, we expect the Federal Reserve to find an excuse to begin cutting interest rates in the first half of 2007 to produce the usual improving economy and higher stock prices that are typical of election years.

In the meantime, please feel free to contact us if you have any questions or if we can be of any service.

Best regards,

Paul