October 25, 2006

To: Our Friends and Clients

From: Robert Bingham, CFA
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Re: Third Quarter 2006 - Review and Outlook

The Individualistic Capitalism of today, precisely because it entrusts saving to the individual investor and production to the individual employer, presumes a stable measuring-rod of value, and cannot be efficient – perhaps cannot survive – without one…

John Maynard Keynes, A Tract on Monetary Reform (London: Macmillan, 1924)

Third Quarter Review

Early in the twentieth century, Keynes observed that inflation could threaten the viability of capitalist societies. This insight was made from his "front row seat" of the hyperinflation that ultimately brought the Weimar Republic of Germany to its knees. Today, central banks worldwide are working to rein in the excessive monetary growth of recent years and the escalation of inflation which has resulted.

The U.S. Federal Reserve's attempts to slow the economy and quell inflation began to take hold during the third quarter, leading interest rates to stabilize and stock prices to rise. The S&P 500 advanced 5.7% during the quarter, bringing total return, including dividends, to +8.5% through September 30th. Bonds were pressured and then recovered as the Fed signaled it was pausing after 17 consecutive rate increases. Bonds ended the quarter up 3.2% as measured by the Lehman Brothers Intermediate Government Corporate Index, bringing year-to-date returns to +3.0%.

Investors continued to focus on large-cap stocks. Economic growth is slowing as the Fed's rate hikes take effect, so investors are becoming more defensive. Consistent with this, sectors which led performance for the quarter were healthcare, technology and telecommunications. Sectors which lagged for the quarter were energy, materials and industrials.

The U.S. Dollar continued to be stable but weak. This has been a boon to domestic exporters like United Technologies whose products become more affordable to overseas buyers as the U.S. Dollar weakens. It has also helped the earnings results of companies who do a large portion of their business overseas like Coca-Cola ($44.91 10/19/06) and Procter & Gamble ($62.50 10/19/06).

Outlook

The stock market has continued its strength into the 4th quarter. The S&P 500 tacked on an additional 2.3% through Friday, October 13th, bringing year-to-date returns to 11.0%. We expect the market's current strength to hold through year-end. Investors generally discount the coming year's earnings expectations in stock prices during the final quarter of the year. As a result, the 4th quarter tends to have an upward bias. We think this pattern will be repeated again this year. We suspect that many investors missed the rally this summer and will reposition portfolios to take advantage of future gains. This should help to extend the rally through the end of the 4th quarter, assuming there are no major surprises on the global political stage.

Mid-Term elections are unlikely to change the investment climate…

One major event for the quarter will be the November mid-term elections. While it wouldn't be a surprise if the Democrats picked up seats in the House and Senate, perhaps even gaining control, we doubt it will materially change the investment climate. That being said, several stocks like Fannie Mae ($59.00 10/19/06) and Freddie Mac ($68.90 10/19/06) have been strengthening lately. Both companies have been targets of the Republican majority for years, and any increase in seats held by the Democrats will probably derail the administration's efforts to pass a Government Sponsored Enterprise reform bill.

…and rising global interest rates should help to quell inflation.

Central banks worldwide are raising interest rates. This takes some of the pressure off of the U.S. Federal Reserve in their quest to contain inflation. In a global economy, there is only so much the U.S. Fed can do without help from our major trading partners. It remains possible that the Fed will need to raise rates a few more times. However, as long as central banks elsewhere continue to reduce global liquidity and raise their rates, it seems probable that we are pretty near U.S. interest rate stability and perhaps a reduction in 2007.

As a result of rising rates, the housing market has finally slowed. Prices have declined and the pace of new and existing home sales has fallen. Consumer indebtedness is high relative to historical levels, so with home prices falling, investors have become concerned about the future pace of consumer spending. This is probably already reflected in the low valuations of many consumer discretionary stocks, but Wall Street remains cautious on this group. U.S. consumers have been surprising economists for years with their capacity for spending. We expect that once again consumer spending will surprise investors on the upside, and consumer discretionary stocks like Target ($57.42 10/19/06) and CBS ($32.00 10/19/06) will regain favor in 2007.

Softness in the U.S housing market is probably good for stocks. If housing speculation is eclipsed by rekindled interest in financial investments, it would help to underpin the current strength in U.S. equities. We expect that the "baby boomers" will at some point begin to focus on building replacement income for their retirement years. That process could be accelerated if other investment opportunities like the second home market become less compelling.

Oil and gas prices appear to have settled into a new range…

While global oil prices have weakened in the last month, we expect that the range of oil prices has permanently shifted to a new higher level. Since the early 1980s, oil has traded in a range between $12 and $36 per barrel. Now, with former global excess capacity being consumed by China and India, and their consumption growing at a rapid clip, it appears that a new higher range is being established. Given the massive free cash flow being generated by the oil industry, the new demand being created, and the new higher range of prices, we expect spending on exploration and field development to persist for some years. We recently added Halliburton ($29.38 10/19/06) to portfolios to take advantage of this expected increase in spending. We also expect Halliburton's margins to expand as they execute on their restructuring plan early next year

…so corporate earnings should continue to grow, albeit at a slower pace, leading stock prices modestly higher in 2007.

Corporate earnings should grow more slowly in 2007 than 2006 as the effects of higher interest rates, higher oil prices and a softer housing market take their toll. Also, the economy is operating at close to full capacity, so faster growth will be difficult. This should lead investors to favor larger companies with a well-developed international footprint. At present, growth is faster and opportunities to expand are more prevalent overseas.

Closing Remarks

One final comment…companies are carrying a lot of cash on their balance sheets. We expect to see more acquisitions and heavier capital spending by companies. Acquisition announcements such as those recently made by Freescale Semiconductor ($39.10 10/19/06) and Columbia Healthcare should continue as long as interest rates are low and valuations remain depressed. The current pace of merger and acquisition activity supports our thesis that high quality, domestic equities are presently among the cheapest major asset classes in the world.

As always, we welcome your questions and comments.

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