Monthly View - September 2005

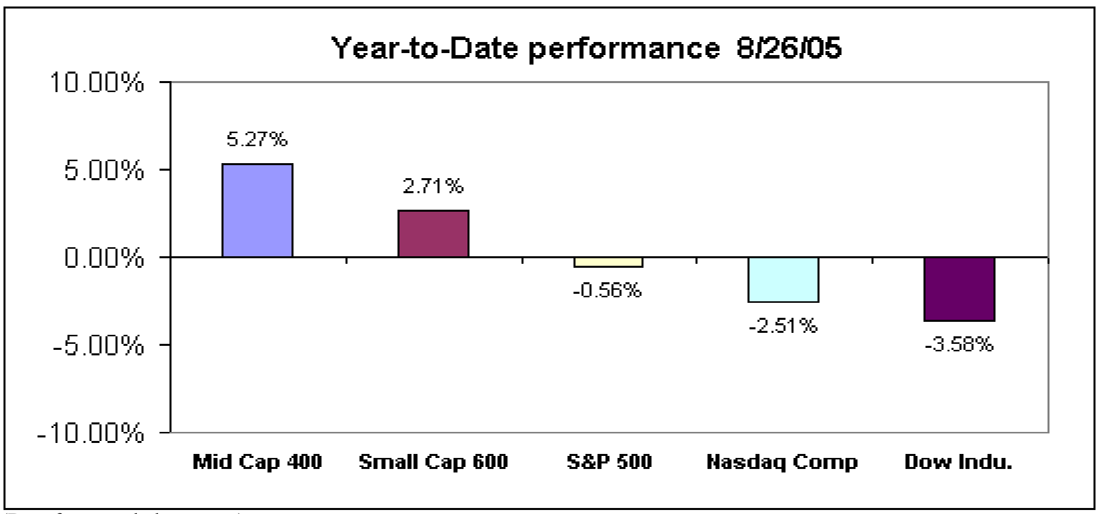
August 29, 2005 Opinion and Commentary

Outline:

- Year to date equity market performance
- Investor Sentiment
- Seasonality of returns
- Economy Outlook: 3 concerns, 3 positives
- The U.S. Dollar, Globalization, and the 'China Effect'

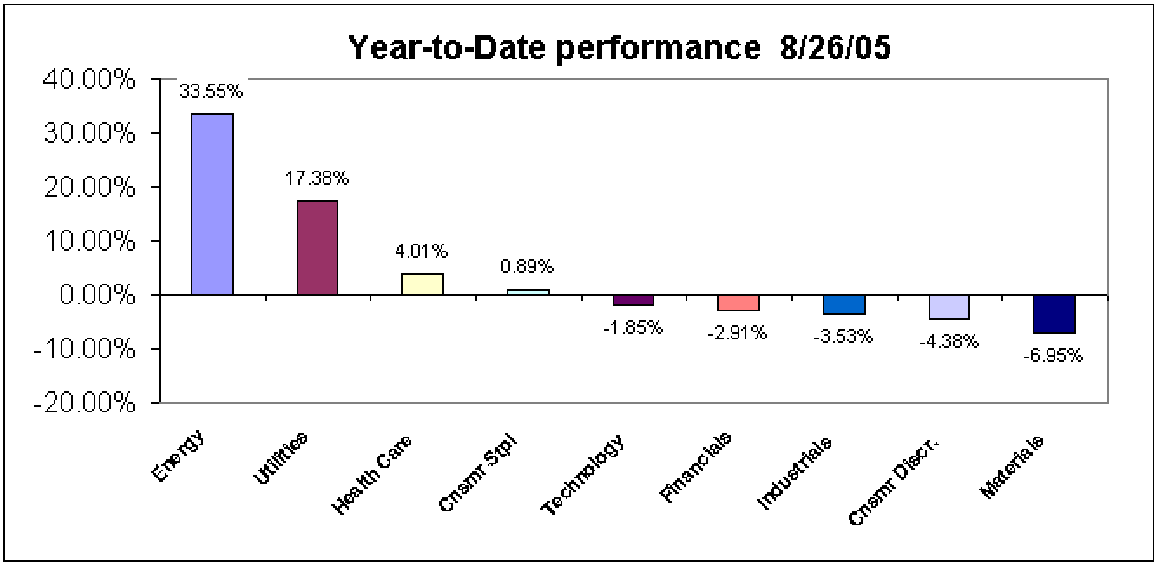
Year to Date Equity Market Performance:

With the exceptions of a few sectors: **Energy, Utilities, and Healthcare**, 2005 has been a lackluster year so far for equity investors. The S&P 500 index, the most commonly used benchmark for equities has returned -0.56% so far for investors. After inflation through 8/26/05 (using the Bureau of Labor Statistics recent annual CPI of 3.2%) that would roughly equate to a -2.76% return for the S&P 500 index overall.



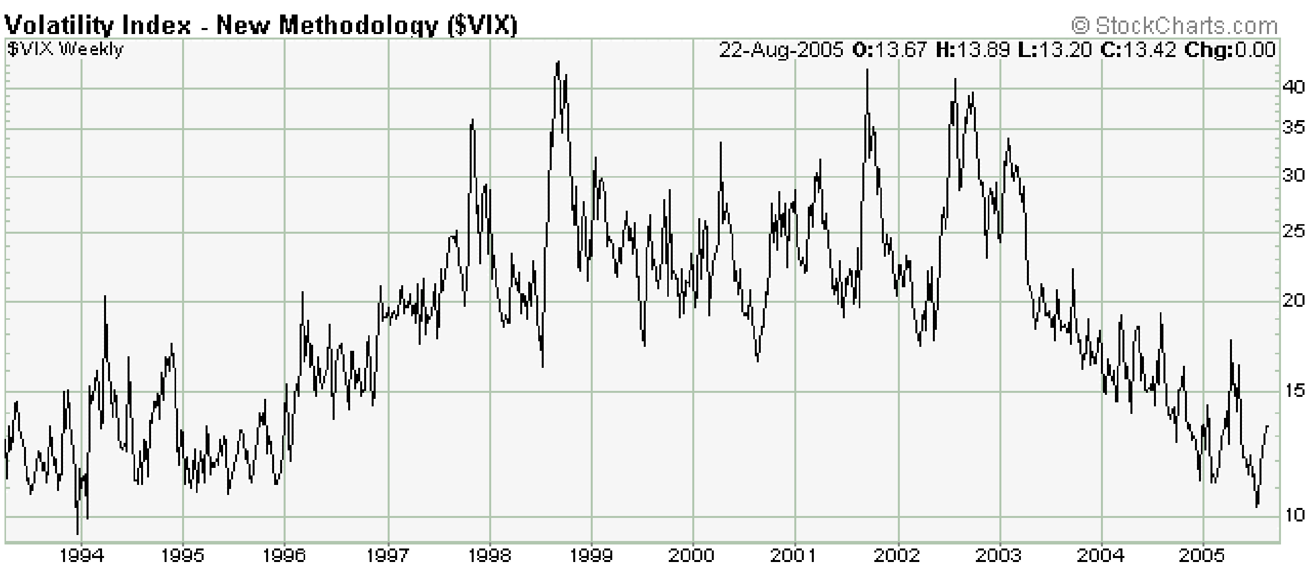
(Data from stockcharts.com)

While mid and small cap indexes have fared better with 5.27% and 2.71% ytd nominal returns as of 8/26, the overall market's gains have been concentrated in a small handful of sectors. Energy in particular has been the best performing sector as oil prices have hit record highs this year. ***In fact, if one were to remove the Energy component of the S&P 500, which amounts to only 7% of the weighting of the total S&P 500 index, the index would show a net decline since the end of 2003.*** Not only are the bulk of the gains in the S&P 500 coming from the energy sector, but the bulk of the profit growth for the index is from the energy. Despite the fact that the energy weighting within the S&P 500 is only 7% of the total index, it currently contributes over 17% of the profits of the index. In addition to the energy sector, Utilities have returned 17.38% so far this year as long-term interest rates remain at multi-decade lows. In a low interest rate environment, not only are borrowing costs beneficial to utilities, but their dividends hold strong appeal to investors in a 15% capital gains rate framework. The performance of various S&P sectors can be seen in the chart on page 2.

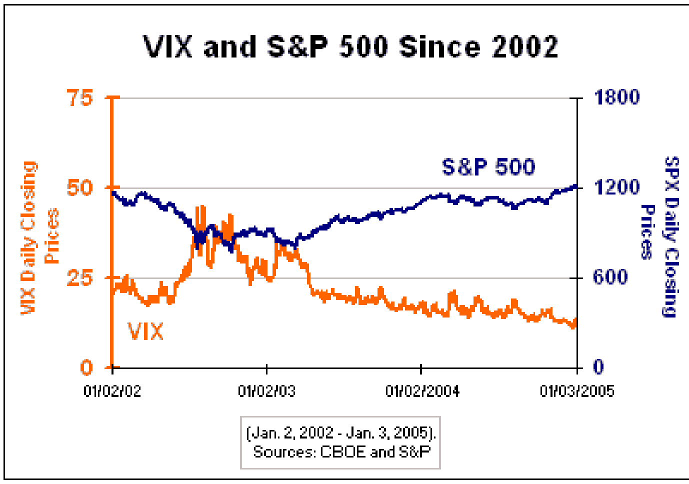


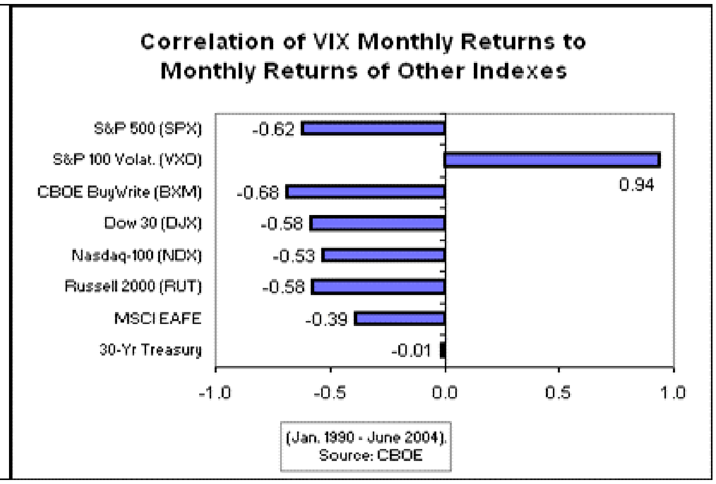
(Data from stockcharts.com)

<u>Investor Sentiment</u>:
As the charts below show, investors appear to be showing a strong appetite for risk. Or put another way, many indicators show investors are particularly complacent about the risks inherent in the equities markets. Three good indicators of investor sentiment are the VIX (S&P100 options volatility index), corporate bond spreads, and investor sentiment polls. Currently the VIX, which measures the prices paid on options used to hedge equity positions is priced at decade lows. When the VIX is high it shows investors are worried about protecting their downside exposure, while conversely, when the VIX is at low levels it shows investors are not worried about downside protection. The VIX recently hit 10.00 in July 2005, a low not seen since 1995 showing a remarkable lack of fear in investor attitudes.



In addition, corporate high-yield (aka junk bond) spreads are at multi year lows, and well known investor sentiment polls are showing very high levels of bullish sentiment. Consensus Inc. shows 65% bulls, Investors Intelligence survey shows 71% bulls, and Market Vane shows 64% bulls. These are all relatively high levels of bullish sentiment. While 60-70% readings are not considered extreme, they are typically indicative of an overly complacent investing attitude toward risk and are short term caution signs. Investors who are thinking about putting assets to work in the equity market may want to wait to see signs of ***less*** risk taking in the market, such as higher VIX levels, and some sort of pullback in the broader indices before making buying decisions. This is especially true as we make our way into months that are seasonally more difficult for investors.

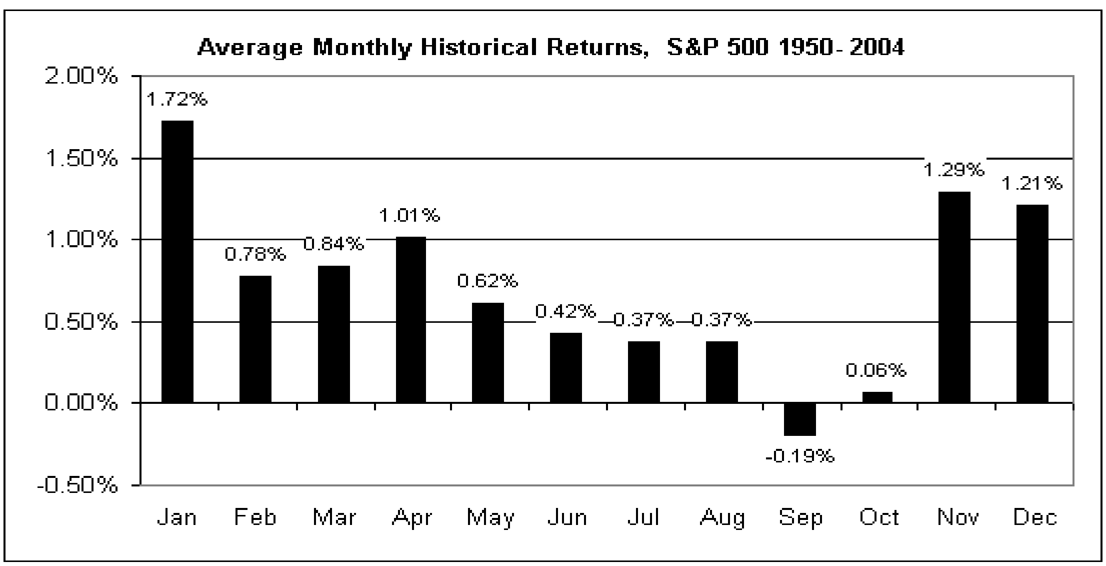




(chart source: cboe.com)

<u>Seasonality</u>:

We are heading into the toughest part of the calendar year in terms of seasonality now. Historically August and September have been difficult months for the stock market. Looking at the data from 1950 to 2004, September has been the worst month of the year, and the only month that has had a ***negative*** average monthly return. For long term investors this isn't important. But for investors looking to put assets to work in the next several months this can be a relevant consideration. The good news is that while the August to October time frame is a difficult period, the following three months are the best months of the year for equity returns. November to January has historically been the best period of the calendar year for equity investors. Should the seasonal pattern play out, we may see an opportunity to put assets to work after a corrective period in September for what is commonly termed the "year end rally". What one can also see from the chart below is that since 1950, 49.5% of the average annual return was gained between November and January.



(monthly S&P500 data from Robert J. Shiller, Yale Univ.)

Economic Outlook, 3 positives and 3 concerns:

Positives:

1) Low long term interest rates
2) Wealth effect from the housing boom
3) Stable, moderate to low inflation

Concerns:

1) Oil Prices
2) Contractionary Monetary Policy
3) Consumer debt levels/ housing cycle

It would be an understatement to say that a lot rides on long term interest rates in the next 18 months. With borrowing costs to consumers, home buyers, and corporations at multi decade lows, the U.S. economy has enjoyed a solid rebound from the 2001 recession. In part this was the combined effect of record economic stimulus by president Bush, and in part it was the effect of record stimulus by the Federal Reserve in the form of low interest rates. The key question now is: "what next?"

The Bush tax cuts have worked their way through the system and the Fed has now raised short term interest rates 10 consecutive times toward the stated goal of a "neutral fed funds rate". Occasionally, as is the case today, a *rise* in short term rates can be accompanied by a *fall* in long term rates. This is currently the situation, and what Fed chairman Greenspan has referred to as a "conundrum." On the one hand, a higher fed funds rate restricts credit growth, and discourages bank lending, on the other hand lower long term rates stimulate the economy and foster the perpetuation of a strong housing market and the continued extraction of home equity in the form of home equity loans and home equity lines of credit. In fact, I would argue that today, given the importance of the housing market to the overall economy that long term interest rates are far more important than the fed funds rate. For example, in 2004 40% of the job creation was related in some way to the housing boom. The U.S. economy has never been more leveraged to the growth of mortgage debt and the housing sector. Therefore it is crucial to the short term outlook that long term interest rates and in particular mortgage rates remain at or below current levels to avoid a slowdown in the broader economy.

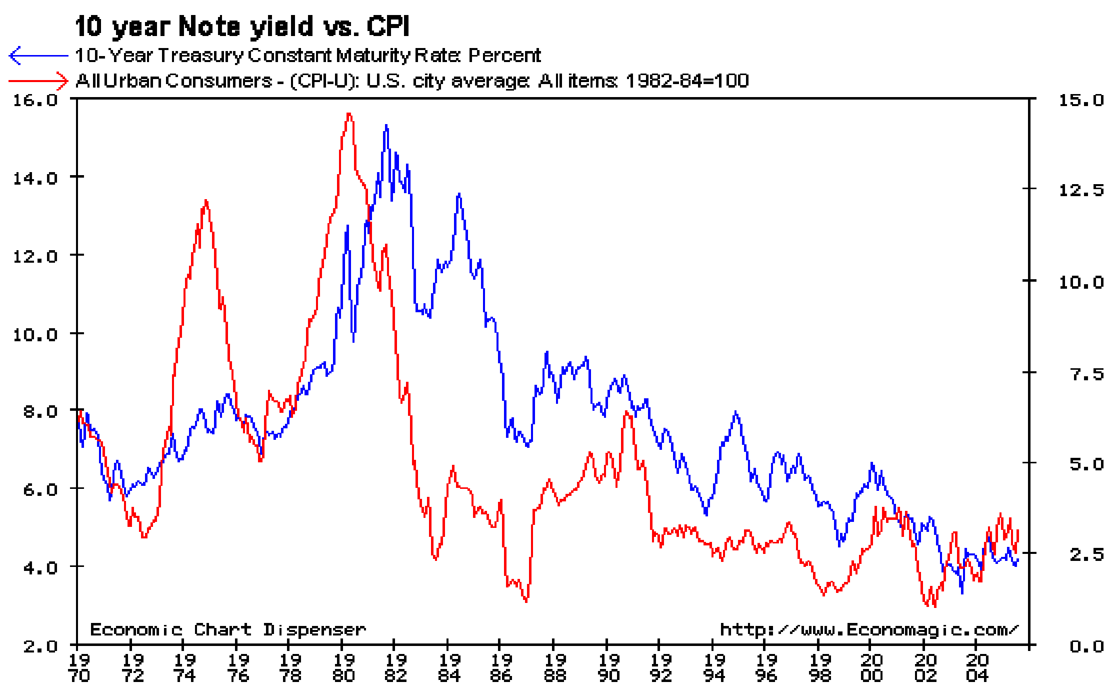
The first positive is that **long term interest rates have remained near 40 year lows** despite rising oil prices, and despite a multi year increase in commodity prices, which normally would be associated with inflation. We owe this partially to the central banks around the world who are recycling our trade deficit back into U.S. treasury and Agency (mortgage related) bonds. Central banks collectively are buying around 40-50% of our treasury debt at every auction. In addition OPEC nations have begun recycling the huge wave of petrodollars we send them back into U.S. securities as well. This helps to suppress our long term interest rates, and in turn support our housing boom and keep revolving debt payments like credit cards low. In addition, stocks as an asset class are cheap relative to bonds at current levels. And as long as bonds yield low rates of return investors will show a marginal preference for equities.

The second positive is that the **wealth effect from the housing boom** has bolstered consumer confidence and bridged the gap left from the bear market in equity markets between 2000 and 2003. The combination of low interest rates and rising home prices allowed homeowners to extract an extraordinary amount of equity from their homes and maintain spending patterns. This has been crucial, since some 60% of our annual GDP is related to consumer spending. According to Alan Greenspan, approximately 40% of the growth of new mortgage debt over the past 5 years has been solely for the purpose of extracting home equity. To illustrate the importance of this financing in bridging the wealth gap left from the stock market decline, Canadian Imperial bank of Commerce estimated that as much as 1/3 of total U.S. consumer spending in 2002 was financed by home equity withdrawals. It is clear that low interest rates and rising home values have been a linchpin of the current U.S. economic expansion. The FDIC notes in its 2004 winter regional outlook that an estimated $300 Billion in Home Equity Lines of Credit have yet to be spent. So the consumer still has a large store of spending power to draw from.

The third positive is that we continue to enjoy a stable and low inflation environment overall. Low inflation allows interest rates to remain low, contributes to a predictable pricing environment for businesses, and plays an important role in equity market returns. Studies by Ed Easterling, professor at SMU and head of Crestmont Research, have demonstrated that stocks perform best in a stable, low interest rate climate. Too much *inflation* or too much *deflation* tends to result in poor stock market returns. With that in mind, The Bureau of Labor Statistics' Consumer Price Index shows that despite a 34% increase in the costs of petroleum related products over the last year, overall consumer inflation remains a subdued 3.2%. This has been a pleasant surprise for the stock and bond markets as many economists feared a stronger inflationary trend from the recent spike in oil prices. In fact the CPI without the energy component rose only 2.2% over the 12 months ending in July, an ideal environment for consumer spending and for interest rates. Naturally all eyes will continue to watch these numbers closely. But As long as inflation remains tame, and interest rates low, we can continue to enjoy a solid economic expansion and in all likelihood higher prices for the equity markets.

And now, onto the three concerns…

The first Concern is obviously **oil prices**. Oil closed Friday's NYMEX session at $66.13, and as Hurricane Katrina moves into the southern gulf states where a large amount of oil production platforms and refineries reside, its likely we'll see new record highs in the coming week. It is important to note first, that while nominal oil prices are at all time record highs, that adjusted for inflation we would have to see $86/ barrel light sweet crude to match the highs seen during the OPEC embargo in the late 70's. In addition our economy is less leveraged to the price of oil than it was in the 70's when it took 15,000 btu of energy to produce $1 of real GDP, and today it takes only 9,000 btu of energy. That said, it's estimated by economists that at $66/barrel and a national average gas price of $2.60 energy spending for the consumer is now up to 6% of disposable income from 3.9% in 1999. Gasoline alone has risen from 1.8% of disposable income to over 3% acting as a tax on the consumer and a drag on the overall economy since consumer spending amounts to over 60% of annual GDP. The key question however is whether or not this spike in oil prices will be converted to higher overall consumer prices and therefore higher inflation.

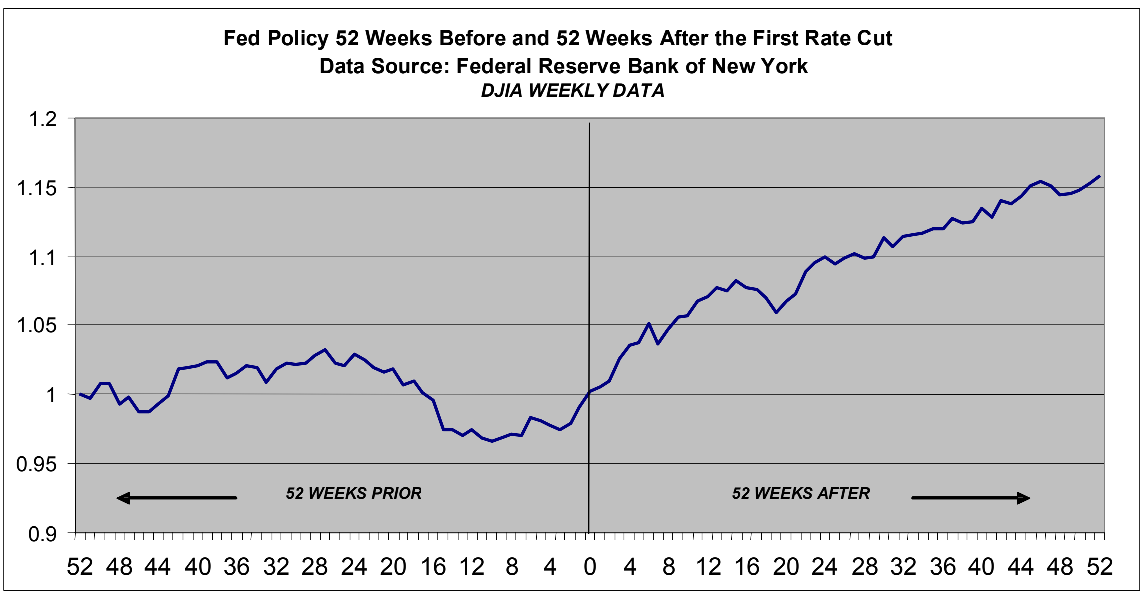


As we can see in the chart above, which shows the yield on the 10 year Treasury note with the Consumer Price Index Interest Rates are highly correlated to the consumer price index as a measure of inflation. So far the CPI has remained low and stable despite the rise in oil prices.

With our economy currently depending on low interest rates for stability, any jump in core inflation would move interest rates higher and threaten the current economic expansion. So far the Consumer Price Index has yet to show any real signs of inflation, but the bond market will be watching these numbers ***very*** closely to see if oil is beginning to have an effect. Fed Governor Moskow voiced concerns over building inflation pressures last week, saying:

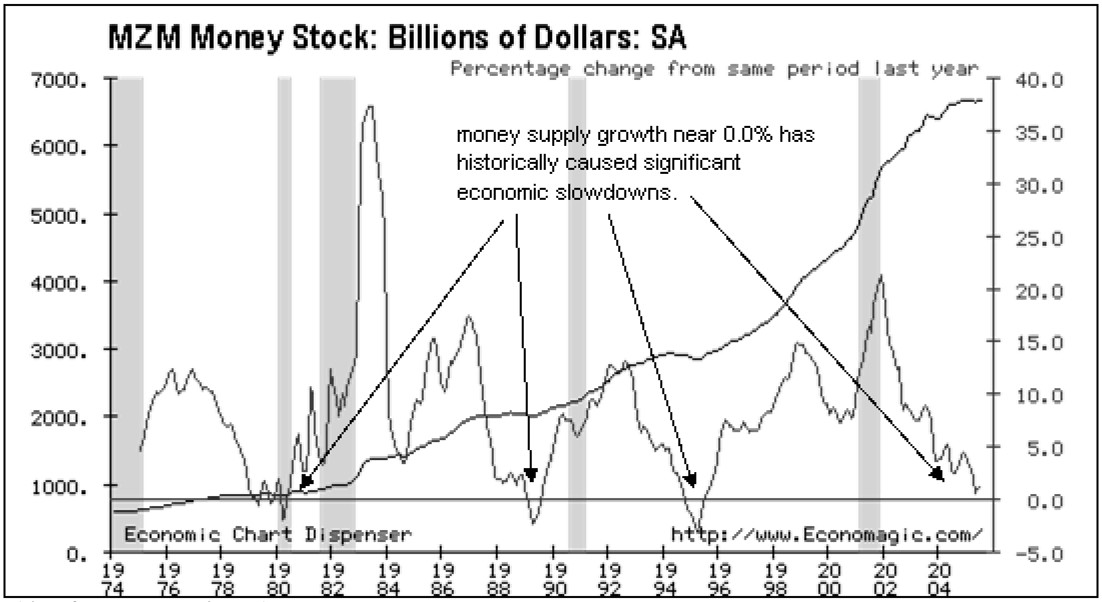
> Because the economy is running nearer to potential, unfavorable cost developments are more likely to pass through to core inflation. And core inflation is now at the upper end of the range that I feel is consistent with price stability… If we indeed start to see a string of higher inflation numbers, people may begin to expect permanently higher inflation. Such expectations could become self-fulfilling if they become built into the behavior of households and businesses, And this would have adverse effects on longer term economic performance.
>
> -Fed Governor Moskow, 8/24/05, Rosemont, IL

The Second Concern for the economic outlook is the current **contractionary monetary policy** initiative at the Federal Reserve Bank. The Fed has now raised rates 10 consecutive times on its way to a theoretical "neutral Fed Funds rate" which would be a rate at which it neither is accommodative nor restrictive to economic growth. Historically the stock market has not faired well during rising rate cycles. The effect of rising rates is to slow money supply growth and restrict lending. In a recent poll by Merrill Lynch of global money managers, this neutral fed funds rate was thought by the majority to be between 4 – 4.25%, implying at least 2 or 3 more .25 point hikes. The bad news is stocks typically perform poorly during the last stages of a tightening cycle, but the good news is that stocks tend to do well once the tightening cycle has ended and reversed into an easing cycle. This tendency can be seen clearly in the excellent chart below by Matt Klocke, CMT of Raymond James & Associates.



The X (horizontal) axis represents time prior to and after the first rate hike. The Y (vertical) axis represents the performance of the growth of $1 invested 52 weeks prior and after the first rate cut.

One of the reasons that stocks may continue to be sluggish during the rate hike cycle is that the financial sector tends to perform poorly with a flat yield curve. For banks the Fed Funds rate is the rate at which they can borrow money, while the 10-30 yr bond rate is the rate range where they will lend out funds. As the Fed funds rate has risen, the spread between the 10 yr note and Fed Funds rate has narrowed to only 0.67%. That means that for many banks their profit margins are being squeezed dramatically here. Since over 40% of the S&P500 is comprised of financial sector companies, this helps to explain the near term poor performance of that index. Banks should continue to underperform as long as the yield curve remains flat and expectations remain for higher short term rates. However the bright side is that once this tightening cycle has ended banks, financials, and equities in general tend to perform well.



(chart from Economagic.com)

The Third Concern would be if we were to see a marked slowdown in the housing boom (or bubble if you prefer). As we all know the media has focused on the housing boom for a long time now as a major risk to the economy. And many media pundits and economists have predicted the demise of housing only to be shown to be completely wrong. No one knows whether housing will slow substantially this year or in 5 years. However, for the first time, Fed chairman Greenspan on Friday weighed in on the topic and let us all know that as far as he is concerned there are inflated asset prices in housing which inevitably have to cool down.

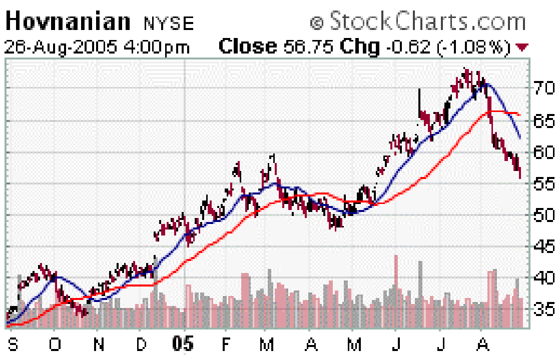
> Nearer term, the housing boom will inevitably simmer down. As part of that process, house turnover will decline from currently historic levels, while home price increases will slow and prices could even decrease. As a consequence, home equity extraction will ease and with it some of the strength in personal consumption expenditures. The estimates of how much differ widely…Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher prices
>
> -Fed Chairman Greenspan, 8/26/05, Jackson Hole, WY

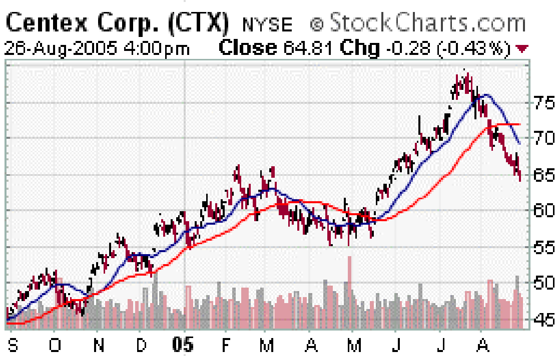
It is rare that Chairman Greenspan has come out and openly called asset prices inflated. The last time this occurred was his famous speech in 1996 referring to equity market investors as "irrationally exuberant". I would note that it was another 4 years of tremendous price gains before the equity market finally topped.

The risk in a slowdown in housing having a deep impact on the economy is very real, however. According to the New York Times 40% of new jobs created in 2004 were a result of the housing boom. In 2002, 1/3 of consumer spending was from home equity draw-downs. The wealth effect of housing price gains has given consumers the confidence to spend at high rates since housing values as a percentage of overall household net-worth have risen from 33% to 45% just in the last 3 years.

The consumer has become reliant on higher housing values and the ability to draw down home equity in case of income shortfalls. Should the housing gains reverse we could see damage to consumer confidence and spending, as well as higher unemployment rates. This month I have noticed a few anecdotal reasons to believe that the housing sector may in fact be peaking this year. I'll briefly list a few:

1) insider selling in the homebuilders' stocks in 2005 hit all time historic records with Toll Brothers' insiders selling $441 million in stock just through June '05. And across the homebuilders' sector over 5.1 million shares have been sold this year by insiders. That is highly unusual in ***any*** industry.
2) despite record profits homebuilders' shares have fallen between 15-20% in the last 2 months.
3) Lumber prices, a leading indicator for home building demand have fallen 40% since last summer.





Whether or not Greenspan's last speech will serve to mark the top of the housing boom remains to be seen. Anecdotal evidence aside, we won't know for some time whether housing will really slowdown this year or not. But if it were to slow or perhaps contract, one of the primary drivers of consumer spending and confidence would be removed. It's also becoming clear that regulators *would like to see* a cooling in housing and mortgage lending. The Office of the Comptroller of the Currency recently issued guidance for banks in the area of mortgage and home equity lending, noting their alarm at the growth of high risk interest-only, and sub-prime lending. I would surmise that between the OCC restrictions on lending and the fact that required minimum payments on outstanding credit card balances are mandated to ***double*** by year end, that we will see some form of moderating in the housing related finance area.

Interest-Only Loans as Share of Total

	2003	**2004**
Prime Jumbo	36.1	52.5
Subprime	9.1	23.5
Alt-A	25.1	50.9

Fannie Mae.

Could a slowdown in real estate be a positive for equities?
Now here is an interesting question. Most of the financial media has come to the conclusion that the housing bubble is bad, any drop in housing is bad for the economy, and anything bad for the economy is bad for stocks. But hold on here. One of the interesting trends over the last 4 years has been the shift in investment assets from equities into real estate. There is now a very large amount of short term oriented investors parked in real estate investments which may get frustrated in a flat real estate market. Those investors might soon look again to equities as a better investment should real estate run flat the 2nd half of the year. That possible shift in investor preference could help underpin equities going into 2006.

Are current crude oil prices also in a bubble?
The interesting thing to note is that even as crude oil prices have hit record levels, the U.S. inventories of crude oil are running at 2 year **highs.** In fact many market analysts believe that we have **plenty** of oil in inventory today. So why the inflated oil price? The answer is two-fold. First, refining capacity is at historic lows. The U.S. hasn't built any new refineries since the 1970's. The premium for gasoline is a result of the tight refining situation in this country. Second, a 15-20 dollar risk premium has been incorporated into crude oil prices. $65-70 oil prices are not representative of the real supply demand situation. Those prices reflect fears of supply disruption in the Middle East, Venezuela, Nigeria etc. Those prices also reflect a large amount of speculation by investors within the oil complex. I believe we could see a substantial price correction down to the $50 level later this year in oil after the hurricane season subsides. ***And that would go a long way to help boost equities into year end.***

Overall conclusions:
What direction should investors take with all of these crosscurrents in the economic landscape?
The best investments this year so far have been in defensive areas. I continue to believe that a portfolio with a moderately defensive weighting in energy and healthcare and a focus on dividends is the best way to be positioned currently. It's difficult to make any reasonable forecasts about the economy these days with so many global cross currents. However I feel confident in 3 things going forward: energy is in a structural long term bull market. Healthcare is also in a structural bull market for several decades as the demographics shift in the U.S. to a larger concentration of elderly population. And China will continue to experience a super industrial revolution that will changing the global economy. We can reasonably assume that China's demand will continue to power a variety of industries to record profits. Investors can take advantage of these trends without undue risk. While energy is due for a substantial correction, possibly later this year, any such correction will represent a great buying opportunity for investors.

As I mentioned above, September is typically a down month for the equity market, but November to January is a very strong period. This year should be no different, and any reprieve from high oil prices should help give us a nice year end rally.

The U.S. Dollar and the 'China Effect'

Looking around the world today it's clear we are in truly fascinating and unusual times. As an investor it is becoming increasingly important to be aware of what goes on outside of the U.S. borders. Globalization is altering the investment landscape rapidly as so called "emerging economies" participate in global trade with fewer barriers to trade than ever before. The entry of China into the World Trade Organization in the late nineties is having a dramatic effect on the U.S. economy. As the developed economies in the G-8 mature and slow the emergence of China and India as economic engines has spurred seismic shifts in economic trends. While the U.S. economy dwarfs that of china, with U.S. GDP of $11 Trillion per year vs. China's $1.5 Trillion per year in growth, China's GDP growth rate of 9.5% dwarfs that of the U.S. at 3%. China's industrial revolution is changing the outlook for so many industries that many U.S. businesses are finding they are either *dependent upon* Chinese demand, or are *competing with* Chinese industry. And China's ability to compete on price with 90% lower wages, and a fixed exchange rate makes it a fierce competitor.

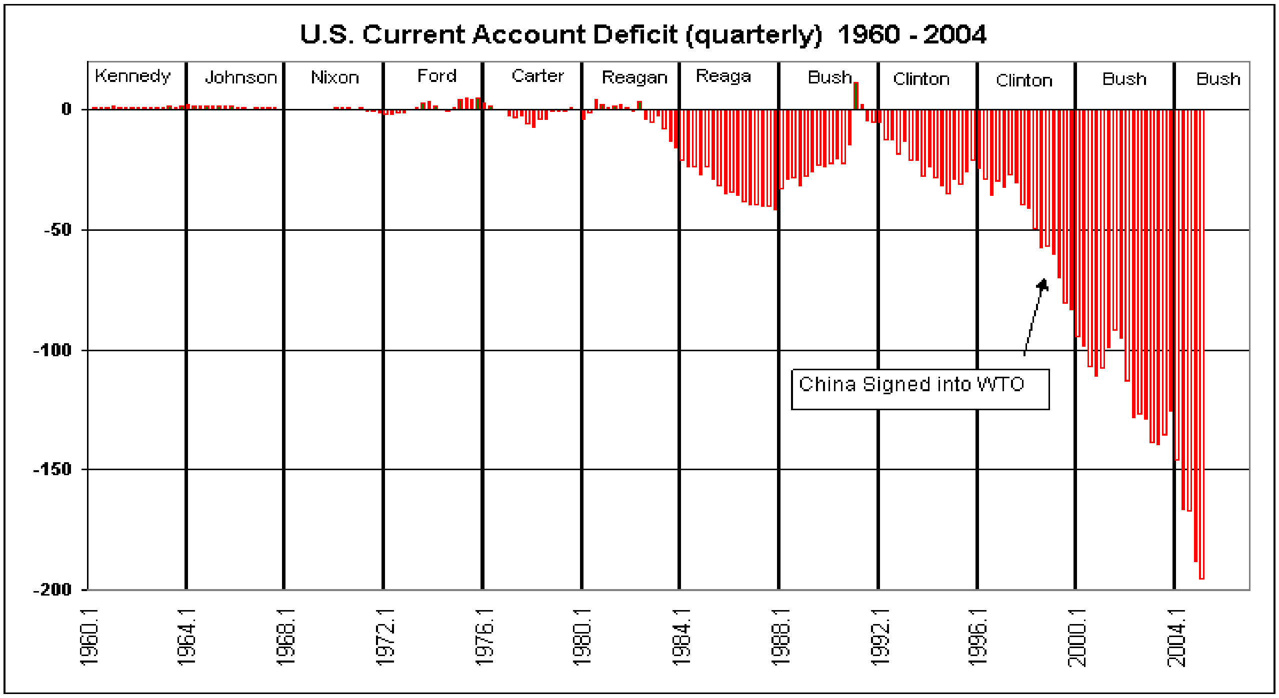
In addition, China's appetite for raw materials is so great that it is single handedly causing shortages and price spikes across a number of commodities. In the last 4-5 years Steel prices have nearly doubled, Oil prices have nearly quadrupled, copper prices have doubled. This extraordinary spike in demand has revitalized some industries like steel, and at the same time has hurt other industries which now have to pay higher prices for their inputs. Increasingly U.S. manufacturers are finding they can't compete with china while the average daily wage in a Chinese factory is close to 15$ per day. The net effect has been that U.S. manufacturers have little choice but to outsource to China or India or they simply can't compete at lower price points.

With China growing at 9.5% GDP and a population of over 1.5 billion, the country's thirst for raw materials and commodities is having a profound effect on the global supply/demand balance for almost every commodity. Consequently China demand is causing huge price increases and price swings in general. Below are a few statistics that illustrate what I term the 'China Effect':

Commodity Research Bureau Index + 72% since 2002
Crude Oil +312% since 2002
Copper +193% since 2002
Soybeans + 54% since 2002 (+150% in 2004)
Steel +160% since 2002
Coal +200%-250% since 2002

The two immediate consequences of the 'China Effect' for the U.S. economy are 1) a rapidly increasing trade deficit with China, and 2) dramatic increases in costs of raw materials, particularly oil. As can be seen in the chart below the China Effect rapidly accelerated after the Clinton administration, in the late 90's gave china PNTR (Permanent Normalized Trade Relations) and signed China into the World Trade Organization. This allowed American corporations to directly invest in China and relocate manufacturing and other facilities to China to lower costs. As a byproduct of opening the trade doors to China Americans are buying an increasing amount of Chinese goods, worsening our global trade deficit substantially to a previously unheard of 6% of GDP annual rate. In other words every year we are sending over $600 billion in dollars overseas in exchange for goods and services. This is a tremendous fundamental imbalance that will eventually have to unwind. In the meantime the primary effect is to weaken the U.S. currency relative to its trade partners.

With that in mind many U.S. investors have found above average returns by taking advantage of the China Effect by investing some portion of their portfolios in commodity producing industries, which benefit from the strength in Chinese demand, and in international funds which benefit from the rise in foreign currencies relative to the U.S. dollar. These trends should continue as trade with China expands.



(data from Federal Reserve Bank of St. Louis)

Any and all comments or questions are always welcome.
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