The Oarsman Outlook

Second Quarter 2006

After a strong April, global financial markets struggled through May and June, bedeviled by uncertainty regarding the outlook for inflation, Federal Reserve policy, and the future course of economic growth and corporate profits. Most U.S. stock market benchmarks declined on the quarter, although among high-quality, large-company stocks the damage was fairly modest. Higher-risk asset classes generally underperformed, with small-company U.S. stocks and emerging overseas markets taking the worst beating. Bond yields drifted higher, as investors discounted further Federal Reserve policy tightening, resulting in meager returns from all but the shortest fixed-income securities.

Within the U.S. stock market, the best-performing sectors were Utilities, Energy, Capital Goods, and Financial Services; poor results came from the Consumer Cyclicals, Communication Services, Technology and Health Care sectors. Non-U.S. stock performance varied widely, with major European markets and Hong-Kong-traded Chinese shares up, while Japan and most emerging markets were down.

Benchmark Performance – Equities

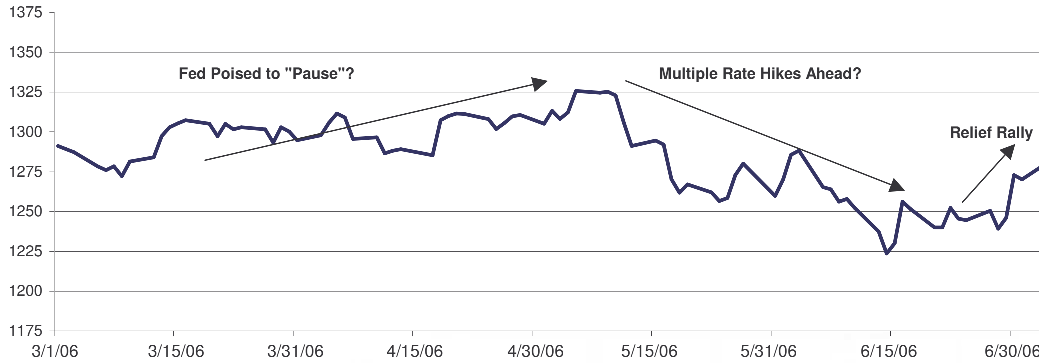
	Second Quarter 2006	Last Twelve Months
S&P 500 Index	-1.4%	+8.6%
Dow Jones Industrial Avg.	+0.9%	+11.1%
NASDAQ Composite	-7.1%	+5.8%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-2.5%	+7.5%
Small-Cap Stocks (Russell 2000)	-5.0%	+14.6%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-0.0%	+28.1%

Benchmark Performance – Fixed Income

	Second Quarter 2006	Last Twelve Months
Lehman Aggregate Bond Index (taxable)	-0.1%	-0.8%
Lehman Municipal Bond Index (tax-exempt)	+0.0%	+0.9%

Review

Financial market participants spent the April-June quarter seemingly mesmerized by inflation statistics and public (and sometimes non-public) commentary by Federal Reserve officials. During the first five weeks of the period, stocks rose smartly, buoyed by Fed chairman Bernanke’s hints of a possible “pause” in the U.S. central bank’s two-year campaign of interest-rate hikes. Meanwhile, Treasury yields began to creep higher, suggesting bond investors feared the new Fed chief might be “soft” on inflation.



As April (and later, May) inflation statistics came in worryingly high, Chairman Bernanke and his colleagues sought to reassert their inflation-fighting credentials with tough words regarding the imperative of preserving price stability. In a dramatic shift in sentiment, investors interpreted the new party line as indicating the likelihood of several additional rate hikes, causing stocks – especially economy-sensitive issues – to swoon, but apparently soothing bond-market fears, as both yields and implied-inflation measures stabilized.

Finally, the Fed's June 29th post-meeting policy announcement seemed to suggest a middle-course: the Fed's actions to date were indeed slowing the economy and inflation, while worrisome, did not seem to be spiraling out of control. In a dramatic "relief rally," U.S. stocks posted their best one-day performance in over three years, while bond yields moved sharply lower.

Recent market behavior clearly indicated that investors fear runaway inflation less than they do the possibility that the Federal Reserve ("under new management") may err by raising rates too much. There was scant evidence in the hyper-inflation-sensitive bond market that investors sensed the start of an inflationary spiral like those experienced in the 1970s and early 1980s. The stock market's gyrations, however, surely reflected investor anxiety regarding the potential for aggressive Fed action to quash the four-year-old economic and corporate-profit expansion: economy-sensitive groups (e.g., energy and basic-materials companies, capital goods manufacturers, retail stores) were both hardest hit as the market declined and came back strongest in the late-June rally.

The May-June stock-market dip was also a text-book response to the uncertainty that naturally attends inflexion points (real or perceived) in the courses of monetary policy and economic cycles. Although mild by historical standards (at its worst, the S&P 500 had fallen less than 8%), the six-week swoon did represent the worst "correction" in more than three years. However, as of early July, large-company U.S. stocks continue to enjoy their second-longest recorded run without a 10% decline, stretching back to March 2003 (the longest such stretch occurred between early 1995 and late 1998).

Outlook

Economic growth in the U.S. is clearly moderating under the lagged influence of rising interest rates and higher energy prices. The slow-down is most prominent in the housing sector, where sales, mortgage applications and price gains have all decelerated, while unsold inventories are at multi-year highs. In addition, surveys of corporate purchasing

managers as well as the index of leading economic indicators are well off their peaks. Barring a more alarming deterioration in the housing market – whose decline to date has been very orderly – we believe the trajectory of the U.S. economy over the next several quarters will resemble the much-sought "soft landing" rather than something worse. After a super-strong first quarter (+5.6%), aggregate growth seems bound to slow, as a deceleration in the housing-fueled consumer sector is only partially offset by solid corporate investment and a pick-up in the export sector due to strengthening demand in major overseas markets and possibly a falling dollar.

Outside the U.S., we continue to see widespread signs of economic vigor. China and emerging Asia seem to be slowing only modestly, while all signs continue to indicate that both Japan and Germany are clearly on the upswing. The global economy appears to be entering a period in which growth will be more broadly balanced among the major economic centers, rather than being reliant primarily on the U.S. and China. This shift has been reflected in the strong performance of overseas financial markets over the past two years, and – in conjunction with the prospect of a weaker dollar – continues to argue in favor of maintaining substantial investment exposure outside the U.S.

Most important, we continue to believe that inflation will not become a problem. Core inflation remains below 2% in nearly every major global economy. Even in the U.S., where the rate is somewhat higher, prices have risen, but wages have not: strong productivity growth has kept unit labor costs flat over the past five years. Without rising wages, it is difficult to see how a self-reinforcing wage-price spiral could take hold. Moreover, prices of goods (and, to a growing extent, services) imported from countries like India and China continue to drop, helping keep a lid on the overall price level. Finally, moderating economic growth in the U.S. will take some pressure off industrial commodity and energy prices, which seem more likely to fall than rise in the months ahead.

If our views are validated, the Federal Reserve will likely soon step to the sidelines, and longer-term interest rates are unlikely to rise much further and may even decline modestly. However, as noted above, economic inflexion points tend to be wrought with volatility-inducing uncertainty. While the strong market rebound of late June tempts us to sound the "all-clear," additional turbulence seems likely until investors become convinced the Fed has finished raising rates without inflicting major damage on the economy. Geopolitical bug-bears (North Korean missile diplomacy, Iranian nuclear posturing) also continue to hold the potential to spoil the summer.

Even if the road ahead proves bumpy, a number of factors should moderate the U.S. stock market's downside risk. Trading at less than 15 times consensus projections of 2006 earnings, the S&P 500 Index is as cheap as at any time since the early 1990s, and high-quality large-company stocks are particularly attractive. In addition to raising dividends in increasing numbers, American companies are also using their mountains of cash to buy back more of their stock – 100 billion dollars' worth in the first quarter of 2006, a year-over-year increase of 22%. Meanwhile, corporate insiders have recently stepped up purchases of their companies' stock, suggesting confidence regarding the future. Finally, investor sentiment – usually a good *contrary* indicator – is close to lows recorded in late 2002 and early 2003, indicating a substantial "wall of worry" for the three-year-old bull market to continue to climb.