

The Oarsman Outlook

Third Quarter 2005

Despite battering hurricanes and a persistently hawkish Federal Reserve, the third quarter of 2005 turned out to be a good one for investors, especially those with exposure to non-U.S. markets. All major U.S. equity benchmarks advanced solidly, while both major and emerging overseas markets produced double-digit returns. The yield on the benchmark 10-year Treasury Note rose from 3.94% to 4.33%, resulting in modest gains or slight losses from bonds, depending on maturity and issuer. Real estate securities notched gains approximately in-line with U.S. stock market averages.

Market and Sector Review

Within the U.S. stock market, smaller-company and other higher-risk categories slightly outperformed “blue chips.” Stocks in the Energy, Basic Materials, Capital Goods, Technology and Utilities sectors provided the strongest results, while those in the Financial Services, Consumer Staples and Consumer Cyclical sectors lagged.

Benchmark Performance – Equities

	<u>Third Quarter 2005</u>	<u>Last Twelve Months</u>
S&P 500 Index	+3.6%	+12.3%
Dow Jones Industrial Avg.	+3.4%	+7.2%
NASDAQ Composite	+4.8%	+14.0%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+3.7%	+11.6%
Small-Cap Stocks (Russell 2000)	+4.7%	+18.0%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+11.7%	+28.8%

Benchmark Performance – Fixed Income

	<u>Third Quarter 2005</u>	<u>Last Twelve Months</u>
Intermediate-Term Taxable Fund Avg. (Lipper)	-0.6%	+2.4%
Intermediate-Term Muni Fund Avg. (Lipper)	-0.3%	+1.7%

Economic Impact of Hurricanes Katrina and Rita

The Gulf Coast hurricanes, which will go down as the worst natural disaster in U.S. history, were undoubtedly the quarter’s big story. While the loss of life, property and social cohesion were tragic, the storms’ biggest economic impacts were to damage the nation’s energy infrastructure and fiscal balance. Although myriad disruptions and dislocations will depress economic activity in the short-term, the torrent of federal dollars pouring into the region will begin to act as an offset fairly quickly and will likely add at least 0.5% to aggregate economic growth (GDP) in 2006. Meanwhile, however, some 15% of the nation’s oil refining capacity remains out of commission, and damage to undersea pipelines and offshore drilling assets is still being tallied. The eventual cost to the Federal government is

likely to be measured in the hundreds of billions, adding to the sizeable deficits accumulated in recent years. Clearly, we will be assessing (and living with) the legacy of these storms for some time.

In the immediate aftermath of Katrina, many prognosticators opined that the Federal Reserve might take a “wait and see” approach and leave short-term interest rates unchanged at its September meeting. But as the meeting approached, available data indicated the economy had good momentum and, more important, suggested the storms’ most worrisome economic effect would be to boost already sky-high energy prices. In hiking short-term rates for the eleventh time, the Fed sent a clear signal that it was more concerned about incipient inflation than what it called a temporary slowdown in growth. Market-based indicators seemed – at the time – to justify this stance: implied inflation expectations had risen noticeably (measured by the yield differential between inflation-protected “TIPS” notes and regular Treasury notes), the general level of bond yields had drifted higher, and both stock and corporate bond prices were surprisingly resilient. The early-October slippage in the stock market (as well as falling bond yields and narrowing inflation-spreads), casts some doubt as to the Fed’s wisdom, however.

Growth is Set to Cool A Bit

As we look ahead, we suspect the balance of macroeconomic concerns will revert to the pattern that has prevailed – with intermittent reversals – since 2001: that growth is fragile and more likely to disappoint than surge ahead.¹ Despite reconstruction-related stimulus, the growth-rate of the U.S. economy seems set to slow in 2006, under the weight of rising interest rates and stubbornly high-energy prices. Slowing growth would likely take some pressure off commodity prices, including energy, possibly allowing inflation fears to subside. In such an environment, the Federal Reserve would likely stop raising short-term interest rates, perhaps at a level not much above 4.0% (the current target is 3.75%). Bond yields could retreat somewhat from recent highs, leading to solid returns from fixed-income investments.

Meanwhile, cooling demand, combined with higher costs and slowing productivity growth, seems likely to prevent corporate profits from exceeding fairly lofty expectations: after consistently *underestimating* profit growth the past two years, Wall Street may now be too optimistic in projecting another 10%+ gain in 2006. This would not be a particularly conducive environment for stocks, but because valuation is reasonable, any setback seems likely to be modest. In fact, an early end to Fed tightening and a possible drop in bond yields could be more than sufficient to offset disappointing, but still-growing earnings. On the other hand, if the Fed stays hawkish too long, leading investors to believe the impending slowdown will lead to recession (and a substantial *decline* in earnings), a more meaningful pullback could occur. We continue to monitor internal stock market indicators and, importantly, the behavior of the corporate and high-yield bond markets for early signs that things are taking this path.

¹ Growth was actually *stronger* than expected during most of this period; prevailing concerns about the economy, however, tended to be more about perceived *fragility/weakness* than inflation.

Housing Market

The biggest wild-card for the U.S. economy remains the housing market, which is widely viewed as being in a speculative “bubble.” The increasing value of residential real estate has been a huge engine for robust consumer spending over the past several years. A sudden decline in home values would likely have a substantial, negative impact on consumers, which account for more than two-thirds of U.S. economic activity. However, for any speculative bubble to “burst” at a time when many observers are predicting just that would be quite unusual. (The real estate bubble has been featured in both popular and scholarly magazines as well as countless television programs; even the chief economist for the national realtors’ association has acknowledged that the market may be nearing a peak.) Moreover, the real estate market is not nearly as liquid or transparent as most financial markets, suggesting that a slow, drawn-out “leak” may be the bubble’s more likely fate. Unfortunately, recent experience in the U.K. and Australia, where housing bubbles deflated slowly rather than bursting, suggests that even an end to predictable appreciation, rather than an outright decline in prices, can be quite hard on a consumer-driven economy.

International Markets Outperforming the U.S.

An interesting development this year has been the substantial performance divergence between U.S. and overseas stock markets. Through September 28th (the last date reported by *The Economist*), every developed-country market outside the U.S. had advanced at least 12%, compared to a rise of just 0.4% for the S&P 500. Gains ranged from 12.8% (Italy) to 40.8% (Austria); the largest markets – the U.K., Japan, Germany and France – were up, respectively, 14.1%, 16.9%, 18.6% and 20.4%. Although more variable from country to country, emerging-market returns, as a group, have been even stronger. All of this happily suggests that global economic and financial-market conditions are quite sound. Worryingly, however, the underperformance of U.S. stocks suggests that investors are less than comfortable with the situation here. As the *Bank Credit Analyst* enumerated in September, the U.S. economy is laboring against five major “imbalances”: soaring energy prices; a humongous trade deficit; a real estate bubble; record-high corporate profits that seem likely to contract; and record-low personal savings that seems likely to expand, thus subtracting from growth. Although their corporations may be less efficient and their economies may grow more slowly, most overseas markets are simply confronted by fewer big worries. We suspect this pattern will persist for some time, and continue to advocate meaningful exposure to non-U.S. equity markets.

Emphasis Growth Over Value

Finally, another piece of relative-performance analysis recently caught our eyes. In its October report, the *Bank Credit Analyst* highlights the relative performance of “value-” and “growth-” oriented stocks over the past several years and its implications for future results. Since the 2000-2001 collapse of the growth-driven technology-stock bubble, value stocks across all capitalization ranges have substantially outperformed their growth counterparts. The *BCA* analysis contends that this outperformance has reached statistical extremes in terms of both magnitude and duration. More important, the returns of growth and value have historically been both highly cyclical and what is known as “mean-reverting” (i.e., periods of massive outperformance by one style are reversed in subsequent periods), suggesting that the

U.S. market could soon enter a period of strong relative performance for growth stocks. This statistical inference is supported by our fundamental outlook for slower economic growth, decelerating gains in corporate profits and the prospect of a depreciating U.S. currency, all of which would tend to favor large, multinational growth companies like Johnson & Johnson, Medtronic, PepsiCo, Colgate, and Microsoft.

