

The Oarsman Outlook

Third Quarter 2006

The three-month period ending September 30th was a solid one for most financial investments. A cooling housing market and falling energy prices convinced investors that inflation was contained and the Federal Reserve was at the end of its twenty-eight month campaign of interest-rate hikes. Reflecting expectations of both lower inflation and moderating economic growth, bond yields fell (bond values rose), while stock prices, buoyed by continued strong earnings growth, continued their four-year advance.

Within the U.S. stock market, large-company “blue chip” stocks posted their best three-month gain since the fourth quarter of 2004, although mid-size- and smaller-company stocks were essentially flat. The best-performing sectors were Health Care, Consumer Staples, Financial Services and Technology; relatively poor results came from Energy, Capital Goods and Basic Materials stocks. Non-U.S. equities gained, too, with emerging markets once again leading the way. Real Estate securities notched yet another stellar quarter, while Commodities-Linked investments were down modestly. With benchmark yields declining some 60 basis points (0.60 percentage points), intermediate-term bonds produced their best three-month returns since the third quarter of 2002.

Benchmark Performance – Equities

	<u>Third Quarter 2006</u>	<u>Last Twelve Months</u>
S&P 500 Index	+5.7%	+10.8%
Dow Jones Industrial Avg.	+5.3%	+13.3%
NASDAQ Composite	+4.0%	+5.1%
Large-Cap. Growth Mutual Fund Avg. (Lipper)	+2.6%	+3.6%
Small-Cap Stocks (Russell 2000)	+0.4%	+9.9%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+3.7%	+19.3%

Benchmark Performance – Fixed Income

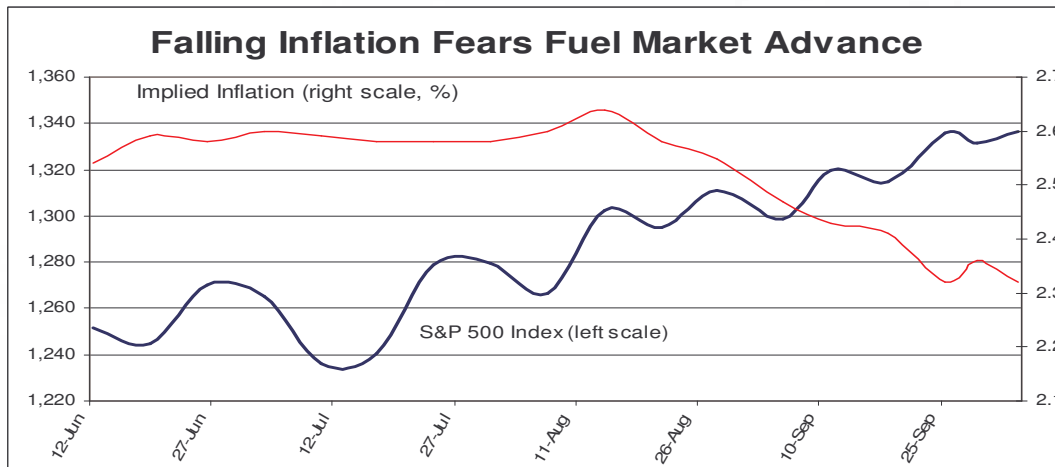
	<u>Third Quarter 2006</u>	<u>Last Twelve Months</u>
Intermediate-Term Gov't/Corp (taxable)	+3.2%	+2.0%
Intermediate-Term Municipal (tax-exempt)	+2.9%	+3.2%

Review

The July-September quarter began on a soft note, with flaring violence in the Middle East pushing energy prices to new highs, which in turn stoked fears of higher inflation and a more aggressive Federal Reserve. Bond yields edged to new 2006 highs (causing bond values to fall) and stock-market benchmarks dropped about 3% over the quarter's first three weeks.

By late July, however, another strong corporate earnings season had been recorded, while early but unmistakable signs of a cooling residential real estate market had begun to take pressure off the inflation/interest-rate outlook. As August and September passed, oil and

gasoline prices fell almost as quickly as they had risen earlier in the summer, and investors discerned mounting indications of a slowing U.S. economy. Bond investors drove yields lower, with the 10-year Treasury note falling from a late-June high of 5.24% to just 4.63% at quarter-end. Meanwhile, the inflation forecast implied by the difference between “normal” and inflation-indexed 10-year U.S. Treasury notes (the “TIPS spread”) declined precipitously. Stock investors focused on the positive story of slowing inflation and a less aggressive Federal Reserve, rather than on the potentially negative one of weakening profits amid a slowing economy: stocks grinded their way higher, with the S&P500 adding more than 8% from its mid-July low to a new five-year high reached on September 28th. (See chart)



Outlook

While falling energy prices and shrinking TIPS spreads clearly suggest that the threat of runaway inflation is receding, less certain are the prospects for real economic activity (“growth”). On one hand, prices for industrial commodities (and the stocks of resource and industrial companies) have declined. However, whether those declines mostly reflect a reversal of financial speculation rather than a decline in real demand remains unclear. The balance of recent economic statistics also suggests at least a moderating pace of growth. Nevertheless, the decline in bond yields to date seems to stem mostly from a decline in inflation expectations; “real” (i.e., inflation-adjusted) yields have so far fallen little, suggesting investors do not yet perceive a major down-shift in growth. Perhaps this helps explain the resilience of stock prices: if growth is set to slow only marginally, while inflation eases, this could be a very conducive environment for American businesses.

Integral to the economic outlook are the fortunes of the residential real estate market, which has great influence over the consumer spending that accounts for two-thirds of domestic economic activity. No doubt, the housing slowdown is for real: sales of both new and “existing” homes have sputtered, unsold inventories have ballooned, and prices have – at best – stalled, and in some “hot” markets have declined meaningfully from recent peaks. However, falling interest rates and energy prices (not just for gasoline, but also for heating oil and natural gas) are serving to cushion the impact felt by consumers. The price of gasoline is more than 25% below its July peak, while mortgage rates have fallen more than a half-percentage point since June. Importantly, refinancing activity has picked up in recent weeks, indicating the drop in rates may have come just in time to bail out thousands of home-owners

with short-term, adjustable-rate mortgages. These offsetting positives may be enough to prevent a significant slow-down in consumer spending, as the recent, strong performance of retail-store stocks suggests.

Meanwhile, the business sector of the U.S. economy has begun to show signs of slowing. Job growth has clearly decelerated, and the national purchasing-managers' (ISM) surveys released just after quarter-end indicated the weakest pace of growth since mid-2005. While export-oriented industries will be boosted by a lower foreign-exchange value of the dollar and continued strong demand from overseas markets, it seems that the corporate sector is set to join the consumer in the decelerating-growth category.

Reflecting these developments and its own econometric projections, the Fed's internal forecast is said to call for up to six quarters of below-trend growth, beginning with the April-June quarter of 2006 (which came in at +2.6%). Combined with apparently receding inflation pressures, such a projected lull would seem to guarantee that the Fed is finished raising interest rates for this cycle. Indeed, the market for interest-rate futures has begun to indicate that investors expect the Fed to start *cutting* short-term rates as early as the spring of 2007, although a surprisingly resilient consumer sector could spoil this optimistic view.

If Fed policy is likely to become more conducive to the financial markets, the same cannot be said about the likely course for corporate profits. After 17 consecutive quarters of double-digit growth, aggregate corporate profitability (profit margins as well as pre-tax profits as a share of GDP) stands at a multi-decade high. Historically, corporate profitability has been predictably mean-reverting (i.e., peak – as well as trough – levels predictably revert to the long-term average) over the course of the business cycle, as high profits beget increased competition as well as rising demands from labor. Throw in a slowing economy and profit growth seems certain to slow. The question is how much? Most Wall Street analysts and strategists are looking for profit growth to exceed 10% again in 2007, although there are some notably negative voices crying in the wilderness. We suspect that strong corporate finances and continued investments in productivity-enhancing technologies will allow corporate profits to surprise the naysayers. Nevertheless, a slowdown appears to be in the cards, a probability that many investors have yet to acknowledge.

Even if corporate profit growth is destined to slow, this may not bode ill for the stock market. Valuations remain very reasonable, with the S&P 500 Index trading at less than 15-and-a-half times projected 2006 calendar-year earnings. A passive (or possibly rate-cutting) Fed and low (or possibly falling) bond yields could be a significant positive, allowing valuations to expand even as profit growth slows. Moreover, research conducted by the *Bank Credit Analyst* indicates that periods of declining profit margins have historically been accompanied by surprisingly good stock market returns, as such periods have often coincided with falling inflation and interest rates – much like the environment today.