

# The Oarsman Outlook

## Fourth Quarter 2005

Global financial markets posted positive returns in the October-December quarter, capping a solid 2005. While major U.S. stock-market benchmarks notched 12-month returns in the low single-digits, your portfolio's performance was boosted by exposure to complementary assets classes (e.g., small-company and non-U.S. stocks, real estate securities), as well as by above-benchmark results from your core domestic stocks. Yields on short- and intermediate-maturity bonds generally rose during the year, resulting in subdued, albeit positive, returns from the portfolio's fixed-income holdings.

### Market Performance

Among U.S. stocks, those in the Energy, Basic Materials, Utilities and Capital Goods sectors fared best in 2005. Technology, Financial Services and Health Care issues generally lagged. Small-company stocks, as a group, marginally outpaced blue chips, while real estate securities posted double-digit gains. Outside the U.S., results varied but nearly all were strongly positive; Japan paced large-country markets with a 12-month return of 40%, while numerous Latin American and Asian emerging markets posted returns in the range of 30% to 50%.

### Benchmark Performance – Equities

	<u>Fourth Quarter 2005</u>	<u>Last Twelve Months</u>
S&P 500 Index	+2.1%	+4.9%
Dow Jones Industrial Avg.	+2.1%	+1.7%
NASDAQ Composite	+2.5%	+1.6%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+2.2%	+4.9%
Small-Cap Stocks (Russell 2000)	+1.1%	+4.6%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+4.9%	+17.1%

### Benchmark Performance – Fixed Income

	<u>Fourth Quarter 2005</u>	<u>Last Twelve Months</u>
Intermediate-Term Taxable Fund Avg. (Lipper)	+0.4%	+1.8%
Intermediate-Term Muni Fund Avg. (Lipper)	+0.4%	+1.5%

### Review of 2005

A range of potentially troublesome events failed to roil the U.S. markets in 2005: the Federal Reserve hiked short-term interest rates eight times; energy prices skyrocketed; hurricanes battered the Gulf Coast; the American auto industry lurched toward insolvency; and seemingly everyone fretted about a real estate “bubble.” Yet underlying economic growth, propelled by unstinting consumer spending, was surprisingly robust; consumer-price inflation remained tame; and corporate profits notched a third-straight year of double-digit gains. Through it all, bond yields were practically unchanged (10-year Treasury yields began

the year at 4.22% and ended it at 4.39%) and major stock benchmarks edged higher and closed at their best quarter-end levels since June 2001.



Outside the U.S., 2005 was quite different, being characterized by sluggish economies (with the important exception of China) yet buoyant stock markets. Attempting to revive long-dormant demand, central banks in Europe and Japan maintained super-accommodative monetary policies. Depreciating currencies boosted export-oriented industries, while consumers remained reluctant to spend. Despite an abundance of tepid economic data and the mid-year terror bombings in London, investors apparently discerned better times ahead: nearly every major overseas stock market posted strong gains for the year. Meanwhile, the Chinese economy continued to steam ahead, recording 9%+ growth for a third-straight year and pulling much of Asia with it. (Following a recent statistical revision, China's is now estimated to be the sixth largest national economy, eclipsing G-8 members Russia, Canada and Italy and likely within a year of overtaking the U.K. and France.)

## Outlook

We believe the major pieces are in place for another good year for the U.S. economy and financial markets. We expect domestic growth to moderate but not stall, as slowing consumer spending is mostly offset by rising corporate investment. Importantly, we do not believe inflation will take hold either here or abroad – the deflationary forces of globalization and digitization are simply too powerful. Accordingly, we suspect the Federal Reserve is nearing the end of its rate-hiking phase, and longer-term interest rates should remain near current, low levels. Corporate profit gains seem likely to decelerate from the recent torrid pace, given slowing economic growth and near-record margins. But low bond yields and a change in the monetary-policy cycle could allow U.S. stock market valuation (i.e., how much investors are willing to pay for expected profits) to expand from currently low levels, boosting returns.

The most compelling financial-market drama of 2006 is likely to be U.S. monetary policy. The Federal Reserve faces the imminent retirement of all-but-beatified Alan Greenspan and the ascendance of its first new chairman in almost 20 years. In addition, the central bank's 18-month policy of "measured" increases in short-term rates seems to be nearing an inflection point. Accordingly, day-to-day economic news will begin to have an increasing impact on investors' perceptions of likely Fed moves, which have essentially been on auto-pilot for the past year. We believe the key indicators to watch will concern inflation

and the housing market. Inflation, following a mid-2005 scare, seems to have receded from the forefront of investors' worries. Recent statistics reveal scant evidence that soaring energy costs are feeding through into consumer-price inflation, while the yield differential between normal and inflation-protected Treasury securities has registered a decline in longer-term inflation expectations.

If the inflation outlook remains benign, the Federal Reserve could stop raising short-term interest rates as early as the spring. And depending on the tenor of forthcoming growth-related statistics, the central bank could be hinting at or even delivering rate *cuts* by yearend. In this regard, the housing market will be key: any hint of serious weakness in previously red-hot markets would grab the Fed's attention, given the important role played by housing-wealth gains in supporting consumer confidence and spending during the current economic expansion.

Although we expect a low-interest rate environment will avert a housing meltdown, evidence from past real estate bubbles in Australia and the U.K. suggests that even a leveling-off of home prices could have a negative impact on consumer confidence and spending. At a minimum, the repeated waves of mortgage-refinancing of the past five years – which have put hundreds of billions of disposable dollars into American pockets – seem likely to have come to an end. A 50% year-over-year increase in energy prices and higher borrowing costs associated with variable-rate loans will put further pressure on consumers in 2006.

If America's consumers seem squeezed, its corporations are flush with cash, having focused during most of the current economic expansion on cutting costs and bolstering balance sheets. Persistent lack of pricing power and intense, global competition are, however, beginning to convince managements to spend more freely on productivity-enhancing capital equipment, computer software and information-technology and telecommunications services. We expect this trend to become more pronounced in 2006.

While this projected shift in spending from consumers to businesses will help sustain overall economic growth in 2006, it also suggests certain changes be made to our clients' investment portfolios. At the margin, we are deemphasizing the stocks of "consumer-cyclical" companies (e.g., retail chain stores, restaurants) and consumer-oriented financial firms. In their place, we are favoring industrial, information-technology and business-services providers that would benefit directly from increased business spending, as well as consumer-oriented companies in the health care, food & beverage and household products areas whose businesses are relatively less sensitive to changes in consumer spending.

Although U.S. corporate profit growth seems set to slow this year, we are encouraged by the currently reasonable valuation of large-company U.S. stocks. At yearend 2005, the S&P 500 Index was valued at just 16 times estimated 2005 earnings. This compares to a figure of nearly 30 in 2001 and, on an absolute basis, is as cheap as the index has been since early 1996. Moreover, according to research published by the *Bank Credit Analyst*, when adjusted for today's low bond yields, valuation is as low as at any time since the beginning of the epochal 1980s-1990s bull market. Such reasonable valuation would likely limit stocks' downside in the event of an unexpected economic or profits downturn. In addition, it sets the stage for a possibly meaningful expansion of price/earnings multiples if inflation worries continue to recede, bond yields remain low and monetary policy turns more accommodative.