

# **C** *Economic & Market* Commentary

## **GROUNDHOG DAY**

The U.S. economy has put in yet another impressive year. The Gross Domestic Product (GDP) grew at a rate of 3.8% in the four quarters ended September 30, 2005, and looks to have come in at close to 4% for 2005. Therefore, economic growth will have exceeded the 20-year average of 3% for 10 straight quarters.

Factory orders grew throughout the year, and are at all-time highs. Order growth outpaced inventory growth, which pushed the inventory-to-sales ratio to record lows. The Federal Reserve ("Fed") pushed the Fed Funds rate 88% higher to a level of 4.25%, and the price of a barrel of crude oil, while down from its \$70 high, jumped roughly 40% during the year. Corporate capital spending is growing, banks are lending to finance this growth, and - with inventories not bloating GDP growth - reported GDP growth looks all the healthier.

There will be a changing of the guard at the Fed at the end of January when Dr. Ben Bernanke becomes Chairman of the Fed, succeeding the retiring Alan Greenspan. The 52-year-old Bernanke has been a professor at Stanford University, chaired the economics department at Princeton University, and was a Fed Governor from August 2002 to June 2005, prior to being appointed Chairman of the President's Council of Economic Advisers. He is arguably one of the best people for the job. The single biggest difference we see between Bernanke and Greenspan is Bernanke's interest in setting an explicit inflation target, rather than an open-ended goal of "price stability." He spelled out this concept in his July 23, 2003 talk at the University of California, San Diego where he said "inflation risks are no longer one-sided." Our take is that the Bernanke Fed will avoid opening Pandora's Box (deflation) and will be less of an inflation vigilante than his predecessor. The text of the November Fed meeting indicated that the Fed could be nearing the end of its "measured" tightening, and the December text confirmed our view. At this point, the Fed should be viewed as having a neutral stance, willing to make changes only as they are needed to correct current or projected future imbalances in the economy.

We have previously discussed the mismatch between earnings and valuation over the last year, and believe this mismatch continues. In general, public companies have done a masterful job of balancing investment and earnings. Even after they have produced nice operating profit gains for 14 straight quarters, some observers find fault in the percentage of profit growth attributable to stock buyback programs. A good example of this mismatch is seen in the declining price/earnings ratio (P/E) of the S&P 500 index over the last year. At the start of 2005 its P/E was 20.99, but at the end of the year its P/E stood at 18.7, which was an 11% decline in the valuation of a dollar of earnings. We believe the markets will

ultimately recognize earnings growth, but it may not be at the speed we, as investors, would like. Cash-rich companies buying their own stock (\$456 billion announced in 2005), or cash takeovers of other companies (\$277 billion announced in 2005) may well signal that valuation levels for quality companies are attractive.

For the year, the markets were essentially flat, as earnings growth offset the decline in P/E; and energy was the swing factor in most market indexes. The price of the “energy-light” Dow Jones Industrial Average was modestly lower on the year, and the price of the “energy-heavy” S&P 500 index was modestly higher on the year. Cash did about as well as bonds and stocks. In a lumpy and one-sided year in the stock markets, energy stocks were responsible for 50% of the gains in the S&P 500.

Looking ahead, a few things should be different in 2006. Oil is not predicted to jump another 40% to \$84 per barrel. The Fed Funds rate is not predicted to almost double again to 8%, as the Fed is expected to be neutral. However, we entered the year with a slightly inverted yield curve (short-term rates were higher than longer-term rates), which has often been a harbinger of recessions.

The situation surrounding the U.S. Treasury yield curve is a little different than in the past: there are no new 30-year bonds being issued, and that is pushing demand to the 10-year bond (helping to create the inversion); the still-healthy consumer continues to drive import demand higher thereby sending more dollars overseas, which tend to be invested back into our Treasury bonds...of course, focused on the 10-year bond. Also, the inversion has happened at much lower interest rates than in the past. The combination of the first two factors could be keeping an artificial lid on mid and long-term interest rates, and with rates still relatively low, the inversion of the yield curve will have to become more pronounced for us to believe that a recession is right around the corner. The last thirteen inversions and/or near-inversions in the yield curve since World War II preceded six recessions, so the predictive powers of an inverted yield curve are about as good as the ability of Punxsutawney Phil when it comes to predicting the end of winter on Groundhog Day. Recent history shows that the U.S. Treasury yield curve was inverted in 2000 just before the most recent recession, and was briefly inverted in the summer of 1998 during the Asian financial crisis just prior to the massive market boom in 1999.

We enter 2006 as both optimists and realists in that what we see at present looks good for the economy, good for the equity markets, and neutral for the bond markets. It is not necessarily a requirement that the economy break all growth records for the markets to do well. Rather, it is a question of the when investment capital will recognize the decent valuations available in the highly-liquid equity markets. At that point, quality will perform.

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