



INVESTMENT STRATEGY UPDATE

March 30, 2006

AS TIME GOES BY

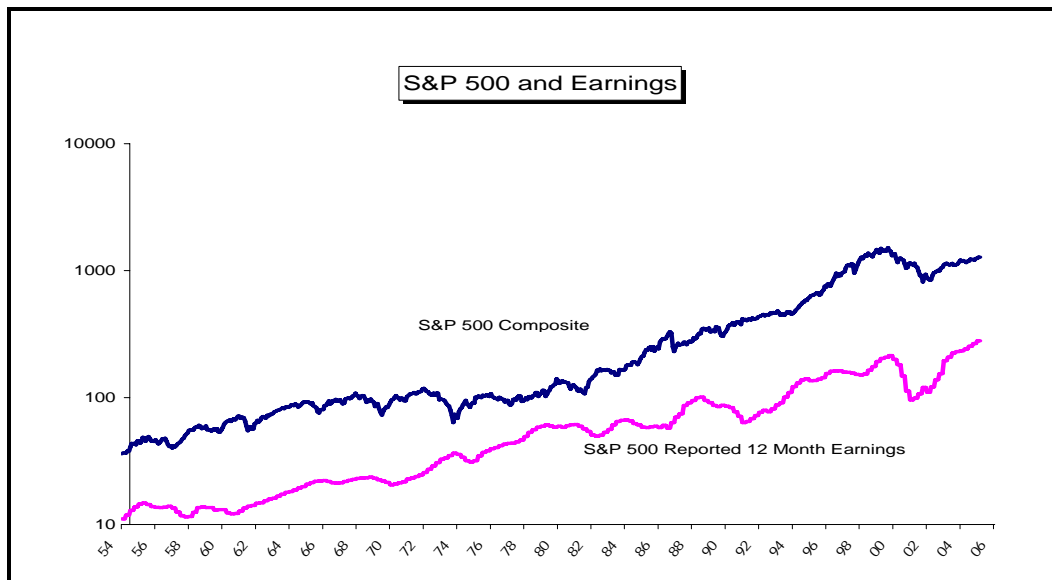
*This day and age we're living in / Gives cause for apprehension
With speed and new invention / And things like fourth dimension...*

*And no matter what the progress / Or what may yet be proved
The simple facts of life are such / They cannot be removed...*

The fundamental things apply / As time goes by...

– Herman Hupfeld, “As Time Goes By”

As we discuss the stock market with clients and colleagues, our constructive long-term outlook is frequently met with skepticism. There is much to be worried about, they say. We agree: there is always much to be worried about. But consider some of the events we have experienced over the years and then look at a long-term chart of the stock market.



Source: The Leuthold Group

During the more than fifty years covered by the chart shown above, there have been wars, inflation, recessions, an oil embargo, bursting financial bubbles, a stock market crash, and far too many corporate scandals. Yet when all was said and done, the stock market tracked a trend line of positive returns around which enormous events have simply caused variances. It is almost as if none of the disruptions had actually occurred. Why is that?

The Stock Market Tracks Earnings Growth

Stock market return consists of earnings growth, dividend yield, and change in valuation. Earnings provide the underlying value of a company's stock. Earnings growth is therefore the primary determinant of a stock's growth, and collectively of all the stocks that make up the market. Dividend yield, currently 1.7% for U.S. equities, is slowly rising. And valuation, a function of numerous internal and external factors, varies widely. At the company level, valuation is affected by earnings-growth potential, balance sheet, quality of management, and perceived risk. External to the company are the industry's competitive environment, interest rates, inflation, and investor perceptions of the sector and economic outlook. Basically, the stock market is a discounting mechanism for investors' hopes, fears, and expectations about the future.

During the 1950s, stock market valuations were very low, as investors worried about deflation and depression, which had almost always followed war before. Valuations were also very low during the 1970s, but in that case it was because investors feared a sustained period of very high inflation, which they got. During other periods, such as the late 1960s and late 1990s, investors' views of the future were far too rosy and were reflected in excessively high valuations. But over the long term, stock market valuations have tended to regress to a mean of close to 15 times reported corporate earnings. So with a long enough time frame valuation becomes a constant, and what stock market investors can reasonably expect going forward is a return consisting of dividend yield plus future earnings growth.

In the past, U.S. corporate earnings have trended to a six to seven percent rate of growth. But times have changed, and we are told that earnings cannot continue to grow at historical rates because the U.S. economy is mature and we are losing our manufacturing base to the emerging industrial powers.

We agree with the facts, but not the conclusion. It *is* a new world. China and India are indeed emerging as the future global industrial powers. As their economies continue to strengthen, other nations, including the U.S., will find it harder to grow their economies at previous rates. Be that as it may, the world economy continues to embrace capitalism, and today's global business environment is increasingly open. Our expectations for global economic growth are quite favorable. And large numbers of American companies are prospering by effectively competing in the international arena.

These days, U.S. based companies do not have to manufacture here or, for that matter, directly manufacture at all. The new global competitors are essentially design and

marketing companies. They source the products they sell wherever it is cheapest and most efficient to do so. Indeed, in this highly competitive environment, it is the low-cost producer that wins. And they sell their products (often packaged and differentiated for local taste) wherever they are profitably able to do so. Given the current environment and Corporate America's demonstrated innovation and flexibility, our expectation is that earnings will continue to grow at near historic rates.

Of Bulls and Bears

So where does this put the stock market? On an intermediate-term basis, the bullish and bearish factors seem more or less in balance. The bullish case is fairly clear cut. While U.S. economic growth may be slowing somewhat, the global economy appears to be strengthening. And, many larger U.S. companies are well positioned to participate. Corporate balance sheets are very strong. Stock market valuations are reasonable. Inflation and interest rates are still low by historical standards. And there is a lot of potential investor buying power (liquidity), with few attractive investment alternatives to stocks.

On the bearish side are investors' concerns about the repercussions of the housing bubble and an overly extended consumer. Also, we know from experience that it is unwise to "fight the Fed" when it is raising interest rates to restrictive levels. Furthermore, a yield-curve inversion will pressure financial system profits, and higher short-term interest rates are providing increasing competition for stocks. In addition, as we have mentioned in past *Investment Strategy Updates*, 2006 is the second year in the four-year stock market/presidential election cycle – a year in which the stock market almost invariably reaches some sort of a cyclical low point. The bears also express longer-term concerns about rising budget deficits, the U.S. reliance on foreign financing, possible oil supply disruptions, and the ever-present threat of terrorism.

Our belief is that some of the bearish concerns are overblown. Insofar as the Fed is concerned, the current cycle of rising short-term rates appears to be nearing an end. Our expectation is that Fed Chairman Bernanke will be reasonable and balanced in his approach to interest rates. The U.S. economy is slowing and it is obvious that the Fed has done enough to stem the rise in housing prices. And regarding the potential for a steepening yield-curve inversion, we do not believe that nominal or real (adjusted for inflation) interest rates are at high enough levels to put meaningful pressure on the economy. While it is true that previous yield curve inversions have almost always led to economic recessions or slowdowns, on those occasions interest rates were quite a bit higher and far more restrictive.

As to the housing bubble, we do not believe that the rise in housing prices has been so extreme, on a national basis, that it constitutes a bubble which needs to burst. We have no doubt that there will be some strong regional housing-market disruptions, but nationally we expect little more than a multi-year period of housing-price stagnation. Furthermore, we do not believe that the American consumer is quite as stretched as the numbers seem to indicate. Employment is strong, wages are rising, and our opinion is

that the published savings rate is generally understated. For instance, the published U.S. savings rate does not include increases in asset values, such as in equities and homes. By contrast, European savings rates do include capital gains and housing appreciation.

The bears' concerns regarding some of the macro issues bother us as well, including the growing budget deficit and our increasing reliance on foreign financing. But while those issues may cause longer-term difficulties, we do not foresee any negative near-term consequences. We also worry about the possibility of oil supply disruptions because a further increase in energy prices from current levels would almost certainly lead to economic weakness. And of course, we worry about the rise in fundamentalist religious unrest and the resulting potential for terrorism. Nonetheless, we think that the financial-market consequences of any terrorist acts will be related to the severity of those acts, and will pass over time, much like the effects of previous disruptions to the stock market.

Conclusion

So, as indicated in prior *Investment Strategy Updates*, we believe the stock market remains in a transition period, somewhere between the post-bubble secular bear market which ended in 2002 and the beginning of the next secular bull market. In our opinion, this transition is likely to continue for another year or two. In the interim, there is a definite case to be made for a four-year-cycle setback this year, possibly beginning in the next few months. But while we are expecting at least a portion of the bear case to be realized, there is little reason to believe that any pullback would be significant by historical standards. And following the low, the positive underlying fundamental environment should quickly push stocks higher once again.

While we have taken some modest defensive measures in order to protect client accounts from an expected interim decline, we believe that the more important task is to position those accounts to take advantage of the positive longer-term trends and opportunities. The S&P 500, which was valued at 25 times earnings in the year 2000, currently trades at close to 15 times expected future earnings – right about at the long-term average valuation. Earnings will continue to grow at favorable rates, in our opinion, and the longer the stock market stays in this transition period, the cheaper valuations will become. So the bottom line is that we remain long-term bulls, with a steadfast belief that “the fundamental things” will “apply as time goes by.”

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