



# INVESTMENT STRATEGY UPDATE

June 26, 2006

## **CORRECTION – OR SOMETHING MORE?**

The stock market has rallied over the last several days, breaking the momentum of the six week decline, at least for now. But prior to the rally, the number of questions from clients had begun to increase. For the most part, they were the same questions that are asked almost every time the stock market trends lower. Is this a correction within a continuing bull market, or will it end up turning into something more damaging? If it is a correction, how long will it last and how deep will it go? Before we render our opinion, we should first consider where we are.

We have believed for some time that stocks were due for a correction. Prior to the pullback, the stock market had risen for 795 trading days without having suffered at least a 10% correction. It was the third-longest such period in S&P 500 history. In addition, speculative excesses had developed in the prices of commodity, energy, and emerging-market stocks, and in the past, rising speculation has been a typical sign that a market upcycle was nearing an end. Furthermore, as we have previously written, 2006 is the second year of the well-publicized four-year presidential/stock market cycle – a year during which stock market corrections have consistently tended to occur.

We have been impressed by the stock market's persistent strength, particularly over the past year or so, as stocks rose in the face of so much bad news. In retrospect, we wonder how investors would have positioned portfolios a year ago, had they fully foreseen the unfolding of events.

### **Picture This**

Imagine yourself back in mid-May of 2005. The Dow stands at 10,140 and the S&P at 1,150. You are a stock market investor and have just won a contest granting you a private interview with a well known seer – an unusually accurate predictor of the future. Although he is not allowed to provide you with stock or bond market advice, he does tell you the following:

*Over the next twelve months, from now until mid-May 2006, the following will occur: In the late summer of 2005, the city of New Orleans will be flooded and almost totally destroyed by a hurricane named Katrina. The rebuilding expense will be enormous. Soon after Katrina, another storm, Hurricane Rita, will strike the Gulf Coast, significantly disrupting Gulf of Mexico oil production. In Rita's aftermath, oil prices will soar, rising to more than \$70 per barrel. With the exception of a short-term pullback, oil prices will stay at very high levels for the remainder of the twelve month period. By early 2006, the average price of regular gasoline will be close to \$3.00 a gallon, at the pump. Other commodity prices will soar as well during the coming year, largely as a result of rising demand from the emerging industrial nations. Fearing the potential for a rise in inflation, the Federal Reserve Board will continue to raise short-term interest rates. In fact, by May 2006, there will have been sixteen straight one quarter-point increases in the Fed Funds Rate.*

*In May 2006, the U.S. will still be fully engaged in Iraq. The death toll there will continue to rise amidst growing internal hostility between the Sunnis and Shiites. Some will fear that civil war is breaking out. Also in the Middle East, Palestinian general elections will result in a disturbing victory by the militant Hamas faction. And despite widespread global opposition, Iran will announce its decision to move forward with its nuclear development program. On the home front, the budget deficit, trade deficit, and financing gap will all remain quite negative, and President Bush's approval rating will have plunged to new lows.*

Given this prognosis, what would you have done? How would you have structured your securities investments if you had possessed accurate foreknowledge of what was going to occur? The probable answer is, "quite defensively." And yet in the year that followed, stocks rose sharply. By May 10, 2006, before the onset of the recent pullback, the Dow Jones and S&P 500 stock market averages had each risen some 15% over the previous twelve months. In hindsight, the global economy and corporate profits had both grown strongly, and perhaps more importantly, a significant amount of excess liquidity had remained in the system.

### **A Question of Time Horizon**

So what has changed? The primary difference now, as we see it, is in the liquidity environment, both domestic and global. In the days that followed the bursting of the technology and stock market bubbles, central banks around the world injected substantial amounts of liquidity into their economies in order to counteract the rising deflationary risk. Those funds not utilized by businesses and consumers spilled over into the investment markets. It was this excess liquidity that fueled the worldwide price appreciation in real estate, commodities, collectibles, and equities.

By and large, the reflation strategy worked and the global risk of deflation has been substantially lessened. But with all of the stimulus, the threat of inflation has resurfaced and now, inflation is once again being viewed as the greater risk. So central banks around the world are withdrawing excess liquidity, and that could lead to a slower rate of global economic growth and additional financial market weakness. On the domestic front, the Federal Reserve Board has raised short-term interest rates to a level that we believe constitutes a neutral policy stance. Further interest rate increases would likely prove restrictive, in our opinion. Among the biggest concerns for investors is the fact that the Federal Reserve Board has a long history of overcorrecting its interest rate policy. And if the Fed raises short-term interest rates by too much, the U.S. economy would correspondingly slow too much, perhaps even falling into recession.

Here's what we believe: The pace of economic growth will slow somewhat, but we will not slide into an outright recession. Fed Chairman Bernanke is a very bright and seemingly reasonable person. While Dr. Bernanke does need to assure the financial markets of his commitment to fight inflation, we also believe that inflation is unlikely to become a significant problem. Global productivity gains, continuing growth of emerging-market trade, and an exceptionally competitive business environment will keep a damper on corporate pricing power. So we think it is unlikely that the Fed will see the need to raise interest rates much higher. What we anticipate is a mid-cycle economic slowdown.

From a longer-term point of view, the economies of the newly industrialized emerging nations will continue to expand. As they do, tens or even hundreds of millions of people will become new entrants into the middle classes. It is a self reinforcing process. Greater prosperity results in increased consumption of goods and services, higher levels of education, and increased opportunity for ownership. With those factors will come a much larger political base, supportive of fair and open markets. U.S. companies are well positioned to participate in a continuing global expansion.

During the past few weeks, stock markets around the world have been declining, most notably those sectors which were previously subject to excessive speculation. Yet, trading at less than 15 times forward earnings, current stock market valuations are quite reasonable, overall. Furthermore, the fundamental environment is sound. Inflation is likely to remain contained, the global economy will continue to expand, and Corporate America is in excellent position to grow earnings. Remember that corporate earnings represent the underlying value of the stock market. As earnings grow, stocks become worth more.

We are closely monitoring the actions of the Federal Reserve Board and our new Fed Chairman, but for now we view the current pullback as a correction within an ongoing bull market. Our stock market position is a compromise based upon time horizon. We cannot know how low the market will go or how long the correction will last. We

expect volatility in the months ahead, and are fully aware that in the short-term, investor psychology can sometimes overpower the fundamentals. The corrective process is probably not over, and may even seem scary at times, but we remember from past experience that the best values and, therefore, the best opportunities tend to come during those times when the stock market outlook appears most bleak.

At BTR we have positioned our portfolios in line with our positive long-term outlook. But for now, we have also chosen to retain a modest amount of cash and other short-term reserves so that we may have some buying power available as opportunities arise.

*Previous Investment Strategy Updates are available online – [www.btrcap.com](http://www.btrcap.com)*

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