December 28, 2005

2006 – THE YEAR AHEAD

2006 looks to be a most interesting year for the financial markets. It has been setup as follows: The bursting stock market and technology bubbles at the start of the decade put the economy at serious risk of a deflationary spiral. As the U.S. experienced in the 1930s, and Japan more recently, deflation can become self-perpetuating and quite destructive. So in response to that risk, the Federal Reserve Board pursued an aggressive reflationary effort. Money supply was expanded rapidly, and short-term interest rates were brought down to their lowest level in more than forty years.

Fortunately, the Fed's reflationary efforts were successful, but as the economic upturn persisted, the risk of deflation began to give way instead to nascent signs of inflation. Consequently in June 2004, the Federal Open Market Committee (FOMC) began to raise short-term interest rates once again. Now, some thirteen one-quarter point increases later, the FOMC is approaching yet another critical juncture. How much longer should it continue to tighten? In other words, at what Federal funds target interest rate will the risk of rising inflation be sufficiently dampened, without being so high as to severely damage the continuing economic expansion?

The impending retirement of Alan Greenspan heightens the importance of these questions. On January 31, 2006, Dr. Greenspan will preside over his last FOMC meeting, thereby ending an extraordinary eighteen-year reign as Federal Reserve Board chairman. His successor, Dr. Ben Bernanke, is a well known and highly respected economist, who is generally trusted by the investment community. But his leadership skills at the Fed are untested, and regardless of who is Fed chairman, the FOMC's path is anything but clear. The accuracy and timeliness of its economic indicators are limited at best, leaving the FOMC little choice but to steer this nation's economic supertanker by looking in the rear-view mirror.

So our focus is on the Fed. But in our attempt to divine the future, we are once again inclined to cite the late Niels Bohr's proclamation as a strong disclaimer: "Prediction is very difficult, especially about the future." Our continued success as investment managers will depend much more on our ability to interpret and adjust to trends and events as new information becomes available. With that in mind, what follows is our outlook for 2006 – the year ahead.

The Economy

The current thrust of Fed policy has been underway for approximately eighteen months. The desired end game is that elusive, neutral level of interest rates which would be neither overly accommodative nor too restrictive. Complicating matters late last summer were two of the worst natural disasters in this country's history – hurricanes Katrina and Rita. As a result of the significant storm damage to our oil and natural gas infrastructure, energy prices soared. But while the hurricanes' economic effects were then unknown, Federal Reserve Board members continued to talk tough on inflation and further raised interest rates.

Thus far, the U.S. economy has shown amazing resilience, but we have some concerns. For one thing, we are already expecting the economy to slow, even in the absence of further Fed tightening. For another, the Federal Reserve Board has a long history of overshooting its policy goals by maintaining its accommodative or restrictive postures for too long. To continue raising short-term interest rates with the current yield curve (spanning short-, intermediate-, and long-term interest rates) so flat is dangerous at best. In the past, inverted yield curves (where short-term rates are higher than long-term rates) have nearly always signaled future economic weakness.

Historically, incoming Fed chairmen have tended to follow the lead of their predecessors. So if Alan Greenspan finishes his term by continuing to talk and act tough on inflation, Dr. Bernanke may feel the need to begin his term by also proving his mettle as an inflation fighter. At the recently held December 13 FOMC meeting, however, Chairman Greenspan may have left the door open to future change by very slightly softening the Fed's anti-inflation rhetoric.

In the years since World War II, the average economic expansion has lasted 57 months. With the current expansion now 48 months old, we see little evidence that would lead us to believe it is nearing an end. The U.S. economy is robust. Jobs, incomes, and profits continue to climb, and the U.S. corporate sector remains in excellent financial condition. The global economy appears to be strengthening, as well. Profits are up in Japan, businesses are restructuring in Europe, and growth continues to surge in China.

On the other hand, we think that the ever-resilient American consumer may be tested in coming months, as a result of rising interest rates, higher home heating costs, stagnating housing prices, and ongoing compensation pressures in certain sectors. In addition, we would note that other central banks around the world have also begun to raise short-term interest rates. Further movement in that direction could serve to slow global growth. So we wonder, will the Fed stop raising rates in time?

Inflation, Interest Rates, and the Bond Market

In the aftermath of hurricanes Katrina and Rita, the Federal Reserve Board actually stepped up its anti-inflation rhetoric. Commodities prices, which were already high due to rising emerging-nation demand, were expected to rise even further as a result of the hurricane rebuilding effort. But more than that, Fed members were worried that the high energy-price backdrop might become longer lasting. Rising fuel costs had already begun to feed through into the likes of bus fares, delivery prices, and other everyday products and services. The concern was that inflationary expectations would begin to rise as well, raising the prospect of a new wage/price inflationary spiral.

Our view is that today's world remains more deflationary than inflationary. Global competitive pressures are intense, and there seems to be an excess of productive capacity for almost all finished goods. In such an environment, it is the low cost provider that will win. So we believe that the continuing drive for productivity gains and labor-cost advantages will keep inflation well contained, despite high energy and commodities prices. While there will almost certainly be periods of cyclical inflationary pressure, our contention is that any such episodes will prove to be temporary.

Interest rates are a function of the supply of funds, the demand for funds, inflationary expectations, and risk. Within this simplistic framework, one can find a reasonable explanation as to why the current level of long-term interest rates is more than two percentage points lower than its historic norm. As noted above, inflation and inflationary expectations remain low. The demand for funds is low as well, as Corporate America is practically awash in cash. Large numbers of U.S. companies have outsourced their manufacturing abroad in recent years. As a result, these companies have been able to refrain from undertaking significant capital investments. If the Fed tightens too much, the economy will soften and the demand for funds will decline even further.

On the supply of funds side, there has been an abundance of Asian and OPEC-nation lenders. But if our nation continues to follow its current path of ever-increasing indebtedness, these and other buyers of U.S. debt instruments could well demand higher interest rates. We are also concerned that if the very high energy-price environment persists, the U.S. could become increasingly dependent upon the excess savings of the rich oil-producing nations to fund our deficits. That would be an uncomfortable position, at best.

We are expecting a temporary rise in inflationary expectations in coming months as higher energy prices continue to work through the system. The likely result is somewhat higher long-term interest rates, but our belief is that the 5 to 5½% level on the ten-year U.S. Treasury note should represent the high point. And, absent adverse developments, that would appear to be an attractive level at which to extend fixed income maturities.

The Stock Market

The stock market showed modest progress in 2005. Corporate profits rose quite handsomely, but valuations trended lower. In many ways, last year followed the typical post-presidential election-year pattern of mediocre stock market returns. While this administration has uncharacteristically continued to stimulate the post-election economy, we think the election-related stock market cycle remains intact. If that reasoning is correct, the next four-year cycle low should occur in 2006, implying that some sort of stock market decline lies ahead. Note, however, that during the past fourteen presidential administrations, stocks have closed the second year higher eight times, while producing a positive 5.4% stock market change, on average.

On the fundamental side, much of the current evidence is positive. Corporate America is well positioned to participate in an increasingly attractive global economy. So our expectation is that corporate profits, which provide the underlying value of stock prices, will continue to grow nicely. In addition, the stock market is currently quite reasonably valued, particularly when one factors in the strong likelihood of an ongoing low-inflation, low-interest rate environment. Furthermore, global liquidity levels are still very high, indicating that there is plenty of potential buying power for stocks. On the less bullish side is the fact that higher short-term interest rates are now providing competition for equities. And of course, there are always the unpredictable external risks, such as the possibilities of a difficult unwinding of the substantially overcapitalized hedge fund industry, adverse tax legislation, terrorism, and a Federal Reserve Board interest rate overshoot.

Also, while it may seem counterintuitive, the stock market has actually declined on most previous occasions following the end of Fed tightening. There is no definitive explanation for this behavior, but we believe it is because the Fed has frequently maintained its restrictive stance for too long, and thereby choked off economic growth. Since the stock market typically anticipates economic change, it reacted accordingly. We hope the Fed will get it right this time, and if it does, there would seem to be little fundamental reason for negative stock-market performance.

The bottom line is that we remain in a transition type of stock market, much like the one which occurred during the second half of the 1970s. As such, we are somewhere in between the post-bubble secular bear market which ended in 2002, and the beginning of the next secular bull market. While we are expecting a cyclical stock market correction, we are far from being bearish and would view any correction as an opportunity to buy attractive stocks at favorable prices. Furthermore, it is our belief that 2006 is likely to end on a positive note, and will possibly mark the beginning of a lasting bull market phase. Our plan of action is to remain opportunistic, utilizing near-term periods of strength to strategically pare portfolio positions, and the expected future weakness to purchase desired holdings in companies whose shares we currently consider too highly priced.

Concluding Thoughts

We believe that the U.S. and global economies are in the midst of two major long-cycle transitions. The first one is a huge global power shift that is already well underway. Looking back to the 1800s, it was Britain that led the world, both economically and militarily. The U.S. was then but an emerging economy. While America rose to dominance in the 20th century, we think it is likely that the current century belongs to China. In fact, China's emergence quite closely parallels that of the U.S. in the 1800s and early 1900s. While it was our destiny to develop this nation's great natural resources as we expanded from ocean to ocean (sea to shining sea), China's primary resources are its demographics and low cost of capital.

If history is a guide, as nations such as China and India emerge as industrial powers, still others will lose global influence – western European countries in particular, we think. If the U.S. is to avoid the same fate, we must fully embrace globalization. And we must go forward with the ingenuity and creative enthusiasm that has so marked our past. To date, this nation has stuck with a low-tax/high-growth economic model that has provided us with the flexibility to remain dynamic and productive. Hopefully our politicians and the voting public will have the wisdom to continue on the current path of openness and flexibility.

As the developing countries of the world have embraced capitalism, there has been a corresponding increase in global productivity and a steady downward pressure on inflation. We believe that we are in an environment in which it will be possible to generate a prolonged period of global growth. Furthermore, we are convinced that Corporate America is very well positioned to participate in that growth.

The second major transition has to do with the Information Technology revolution and long-wave economic cycle. In the past, major breakthrough technologies have provided enormous long-lasting boosts to economic growth. In the U.S., one can look at the advent of automobiles and railroads as examples of such breakthroughs. The resulting positive economic effects spanned decades.

According to Peter Druker's book, *Post Capitalist Society*, we are currently undergoing a major transformation to a knowledge-based society, where knowledge becomes the "means of production." The implications are many. Global investment spending should remain strong for years to come, as should productivity growth. *BCA Research* writes that "the pace of technological innovation remains rapid and there is promise of major breakthrough advances" in the years ahead, in fields such as biotechnology and nanotechnology. Furthermore, these and other analysts place the I.T. revolution in a still early stage.

To summarize, there is a very healthy engine of growth in the world economy. As a result, global companies and investors, based both in the U.S. and elsewhere, should be well-positioned to prosper in future years. We expect the coming months to provide an excellent opportunity for investors to position their portfolios for long-term growth. Our expectations are high.

Finally, we wish all of our friends and clients, peace, joy, health, happiness, and prosperity in this new year, and for many years to come.

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