

MONTGOMERY BROTHERS WEALTH MANAGEMENT

2006 Investment Outlook January 1, 2006

2005, Good-Bye and Good Riddance!

My son Buck, a sophomore at Georgetown University, just chose political economics as his major. Now, I get a lot of grief about harping on politics as it relates to economics and investments, but it is important, especially from a long-term point of view. After the German and Japanese elections, Robert Samuelson, my favorite political/economic analyst, penned a column for *Newsweek* and *The Washington Post* titled “Capitalism vs. Democracy” (<http://www.washingtonpost.com/wp-dyn/content/article/2005/09/27/AR2005092701526.html>). The second paragraph reads as follows:

“Capitalism (by which I mean an economic system that relies heavily on markets and private ownerships) and democracy need each other. The one generates rising living standards; the other cushions capitalism’s injustices and thereby anchors public support. But the mutual dependence is tricky, because if democratic prerogatives are overused, they may strangle capitalism.”

Winston Churchill once quipped, “Democracy is the worst form of government except for all the others.” He may well have also said that capitalism is the worst structure for an economy except for any other.

Montgomery Brothers monitors three factors in the interplay between capitalism and democracy. They are the political commitments to issues that we believe are necessary to maintain the balance:

- Open Financial Markets
- Free Trade
- Limited Government

This first is most easily monitored. While the United States has periodically flirted with regulated financial markets, the trend towards deregulated financial markets (both domestically and internationally), which started in the early 1980s, is now nearly universal. Politicians really don’t like free markets since free markets tend to reign in the basic tendencies of politicians to tax and spend. The financial markets react to fiscal and monetary

policy rapidly and cause a level of discipline that the voters and certainly the politicians are unlikely to impose on themselves or even to readily accept.

Government commitment to free trade is somewhat trickier. In spite of the growth of international trade and its obvious wide-spread benefits, many groups and individuals are hurt by free trade. Politicians try to protect their constituents and special interest supporters. Farmers, manufacturers, and economic groups of every stripe want to be “protected” from “unfair trade”; witness the auto industry right now. It’s hard enough for politicians to fend off protectionist pressures when things are good, let alone when they’re not.

Limited government is the most difficult of the three to be optimistic about. Difficult indeed when the government just published 120 pages of regulations for commercial human space travel. Politicians never tire of trying to buy our vote with our money or protecting us from ourselves. The sorry state of the German and Japanese economies is testimony to how high taxes, generous social spending, and over regulation stifle economic growth. MBI fears that policy mistakes (such as higher taxes, misguided energy policies, and anti-Chinese protectionism) are the biggest threats to the current expansion and the economy in general, for that matter.

Politics will play a large role in the 2006 Investment Outlook since it’s an election year. (Even though it seems like every year is an election year!) Given President Bush’s approval ratings and the increasing disarray in the Republican ranks, the Democrats have been infused with hopes of regaining the House, and maybe even the Senate. Fat chance! Given all of the gerrymandering and incumbent friendly campaign reform, congressional incumbency is pretty bullet proof. The Abramoff scandal could become a wild card in this year’s elections. This is *not* your father’s political scandal; it’s more! However, it is likely that the Dems will pick up ground in the Governor and State Legislature races—the kind of grassroots shifts that precede more seismic political shifts at the national level.

The electorate seems to be increasingly frustrated with *both* parties. But since the Republicans are in charge and have squandered their small government mandate, there’s a growing sense that it might be time to throw the bums out. Unfortunately, there seems to be a limitless supply of new bums to replace the old ones.

Economic Outlook

When Hurricane Katrina hit, economists and pundits were quick to forecast that the economy would slow, if not go into recession. The fallout from Katrina is proving more long lasting for Bush and the Republican party than for the economy. As was the case with 9/11, the US economy seems fairly immune to outside shocks.

But as Roseanne Rosannadanna used to say, “If it’s not one thing, it’s another.” In spite of the constant drumbeat to “worry, **WORRY, WORRY,**” the US economy in general, and the US consumer in particular, seem to be in pretty good shape. Even after years of above-average economic growth, this economy can’t get no respect. The flotsam from the late 1990s tech bubble has mostly cleared and, at long last, even *real* hourly

earnings have surpassed previous peaks. The net worth of US households is at record levels and has been increasing faster than household debt. (Who'd of thunk it, given the constant media barrage that only the rich are doing better!) The unemployment rate is back down to 5%, over 1.5 million payroll jobs were "created" in 2005, wages and salaries were up 4.2% year over year in November, and consumer confidence is almost back to pre-Katrina highs. Surely the end is near!

Jesse Eisinger recently wrote in *The Wall Street Journal*, "Gloom aficionados—and I count myself among them—have worried about the health of the American consumer for years and years. And we have always been wrong... But there are some early warning signals about problems." Early warning signals about problems? After years and years of being wrong? Where is the press's adult supervision? Is it any wonder why so many feel the economy is in trouble in spite of clear evidence to the contrary?

Certainly, it is possible that the US consumer will throttle back spending a bit in 2006, but corporate spending (for inventory and capital expansion) is likely to pick up most of the slack. Corporate profits have been terrific, balance sheets have been rebuilt and are brimming with cash, and order books and backlogs are bulging.

Additionally, global expansion has been above its historic average growth rate even with Germany and Japan still showing very lackluster growth. Virtually everyone worries about the US trade deficit. Without trying to sound like Bobby McFerrin, we'd point out that the export of goods and services is near record levels and growing almost as fast as imports, which have been impacted by the 45% year-over-year increase in the price of a barrel of crude oil during 2005. (Much like the housing bubble and budget deficit, the trade deficit disaster has been looming large for some time.) We do hope that the budget deficit continues to shrink but not from increased taxes. The Bush tax cuts helped grease the economic wheels and led to well above expected tax revenue *growth*. Hell! The budget deficit is the only reason federal spending and the deficit aren't even higher.

What makes MBI worry? Well, the flattening (and recent quasi-inversion) of the yield curve is a cause for concern. While everyone is now an expert on yield curve inversion, opinions on the significance of this are varied. Regardless, it still makes us nervous. The recent declines in the ratio of coincident to lagging economic indicators similarly gives us pause. A better forecaster of the economic outlook than the Leading Economic Indicators, the C/L turned down a while ago and the decline has recently accelerated, albeit only slightly. The general complacency of investors is also disconcerting since complacency can quickly turn into panic for almost any reason. But above all, MBI worries about fiscal policy mistakes on the part of politicians desperate to get reelected and/or the Fed falling too far behind (or getting too far ahead) of the curve. Most economic expansions do not die of natural causes.

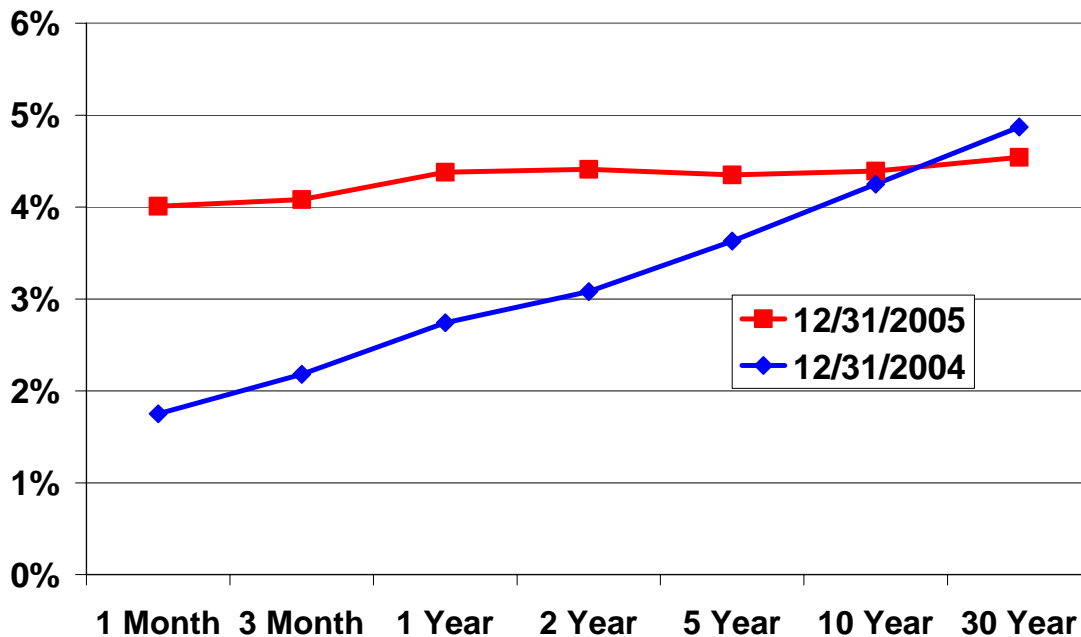
Forever, or at least for quite a while, MBI has been forecasting above-average economic growth and below-average inflation. Since it's always easiest to forecast a continuation of the most recent past, we'll stick with this forecast. *However*—and isn't there

always a qualifier—we'll not be surprised if the U.S. experiences slower economic growth, if inflation continues to be worrisome, and if, of course, there is hysteric coverage of it *all!*

Interest Rate Outlook

In our opinion, the biggest financial surprise of the year was the flattening of the yield curve. (See below.)

**Yield Curve for U.S. Treasury Bills, Notes, and Bonds
12/31/2005, and 12 Months Earlier**



I don't recall many forecasting flat or declining longer-term interest rates but the markets do what's necessary to frustrate the majority. How soon-to-be Fed Chairman Ben Bernanke deals with the monetary mantle being passed to him by semi-deity Alan Greenspan is an omnipresent bond market concern. In an effort to address the Y2K crises (remember that chestnut?) and subsequently to soften the blow from the bursting of the "tech bubble" (the mother of all bubbles) and the resultant recession, the Fed flooded the system with liquidity. While the immediate missions were accomplished, the global financial system remains awash in liquidity. In addition, what is increasingly referred to as a "global savings glut" adds to this liquidity—all of which is sloshing around the global financial system looking for decent returns.

Gallons of ink have been spilled speculating on what new policies Bernanke will bring to the Fed. Will he continue to fly monetary policy by the seat of the pants? Will he target inflation and/or economic growth to steer monetary policy? We know Bernanke is a bright guy and a student of (monetary policy during) The Great Depression. While he may not be as Delphic as the great and powerful Oz, he seems to be starting out pretty vague on what he'll do as an encore to the departing Greenspan. Supposedly the Fed has become more

forthright (the new buzz-word being “transparent”) but many remain confused. Entire careers revolve around interpreting the minutes of Fed meetings. As usual, monetary policy will loom large in the investment outlook.

In spite of being awash in cash, US corporations continue to borrow, but more often they buy back stock and increase dividends rather than fund expansion. Yield spreads are historically narrow and interest rates historically low, so corporations borrow even though the money isn’t really needed. In the aforementioned search for returns, many “investors” leverage up in an effort to increase their returns. The flattening of the yield curve has played hob with the so-called “carry trade.” Additionally, private equity firms borrow liberally to buy public companies using those companies’ cash flows to pay down the borrowed debt before, hopefully, taking those companies public again. All of this increases the demand for money but also shows a callous disregard for risk. The supposed “Greenspan put”—the belief the Fed will bail out the over leveraged, à la LTCM in 1999—continues to be assumed. For too many, it’s all about return unless things get ugly. Then, and only then, does it become all about risk again. MBI believes that most of our investors prefer to take their risks in the equities market and avoid risk in the bond market. With a relatively flat yield curve, historically low interest rates, and narrow quality spreads, we see little reason to reach for extra yield; the risk is just too high. Better to live with the low yields on short-term, high-quality debt instruments and floating rate debt than to pick up (minimal) additional income at the longer end of the debt markets—and a whole lot of risk in the process. For taxable investors in higher brackets, municipal bonds do offer some attractive alternatives but in general the pickups seem meager in the bond market. At least to us!

Stock Market Outlook

The year 2005 was lackluster for stock market returns in general and for the returns from larger capitalization and higher quality stocks in particular. Shown below is a chart of returns from various stock market indices for last year.

Dow Jones 30 (INDU), S&P 500 (SPX), Russell Top 200 (RUPZ),
 Russell Midcap Index (RUMZ), Russell 2000 (RUTZ)
 (Dec 31, 2004 TO Dec 30, 2005)



Mid caps (RUMZ) led the parade with small (RUTZ) and large caps (RUPZ and SPX) in the middle and Blue Chips (INDU) bringing up the rear. Volatility was also low. Since 1926, the S&P 500 has shown an average return of 10.4% with a standard deviation (the generally accepted academic measure of risk) ranging from plus or minus 20.4%. This means that two-thirds of the time investors should expect annual stock returns to range between -10.0% and 30.8%. In 2005, the S&P 500 returned 4.9% and for the entire year was never much more than 6% above or below where it started the year.

Montgomery Brothers feels that stocks are fairly valued. In fact, since earnings in 2005 went up more than stock prices, price divided by earnings multiples are actually lower than they were at this time last year. In fact, based on the so-called “Fed Model,” P/Es are a little low compared with 10-year US Treasury yields of 4.4%. Corporate profits are likely to continue to grow although not at the double-digit rates witnessed over the past several years. As the economic expansion slows and since corporations have done about as much as possible to reign in costs, profits will be more dependent on growth in revenues and increases in labor productivity. With returns on equity and profit margins at record highs, with profit growth slowing (along with the economy), and with interest rates near multi-decade lows, the returns from stocks are likely to remain lackluster. Additionally, 2006 is the second year of the presidential cycle, which historically have the lowest returns of the four-year presidential cycle.

But this does not mean that 2006 will be bereft of excitement since there are many new cross-currents to deal with. The largest factor is the emergence of hedge and private equity funds. These “investors” are likely to accelerate the trend of shareholder activism in

demanding corporate restructuring, mergers and acquisitions, and the return of cash to shareholders (through increased dividends and/or share buy-backs) in an effort to boost their own returns. Wall Street investment bankers will be only too happy to aid and abet these funds since there are huge fees to be garnered from such activities. While bordering on extortion, this form of corporate activism is a trend to be reckoned with. MBI is not at all sure that these are favorable long-term trends but so what?

How are we planning to invest your money? Given our ho-hum forecasts for the returns from stocks and bonds, MBI is holding larger than normal amounts of cash. We are less convinced than many that the Fed is done raising short-term rates. This indicates that, like 2005, 2006 will witness increasing returns from cash equivalents, at least early in the year. Additionally, the chances for a monetary policy error seem high given the Fed's track record and its new chairman. (Do you recall October 1987, two months after Alan Greenspan took over from Paul Volker?) Lastly, it's an election year which increases the possibility of stupid fiscal policy moves such as tax increases or special legislation aimed at the health care and/or energy sectors.

Coincidentally, these sectors are attractive to us. Health care demographics are positive; companies that can provide services that help contain costs appear positively positioned for growth, and large pharmaceuticals are flat out cheap. Energy stocks are in many cases statistically cheaper than before energy prices started their run and remain considerably cheaper than the stock market in general. The entire energy complex looks good to us, but we'd emphasize domestic exploration and production companies as well as the service and equipment industrials for new commitments.

Smaller capitalization stocks have outperformed larger caps for the past six years; value has outperformed growth since the top of the tech bubble; and international has outperformed domestic for the past half a decade. We lean toward domestic, large cap growth stocks, but we did at this time last year also, which explains MBI's underperformance. As you know, even a broken clock tells the right time twice a day.

As we flip the calendar to 2006, we remain impressed by the US economy and the outlook for US companies. MBI is plenty glad to be looking at 2005 in the rear view mirror and looking forward to 2006. Bring it on!

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JOHN E. MONTGOMERY
1730 RHODE ISLAND AVE. NW, SUITE 206
WASHINGTON, DC 20036
202-861-2380 PHONE
202-861-6036 FAX
888-293-6668 TOLL FREE

Some charts courtesy of Baseline.