

MONTGOMERY BROTHERS WEALTH MANAGEMENT

First Quarter 2006 Investment Outlook Update February 15, 2006

“What Does the Public Know About Economic Policy and How Does It Know It”

was the title of a seminar I recently attended at the American Enterprise Institute. Alan Blinder, head of the Princeton Economics Department and former Chairman of the President’s Council of Economic Advisors, discussed the findings of a recent survey he did which addressed this issue. The results of the survey and Blinder’s presentation were critiqued by Jeff Birnbaum of *The Washington Post*, Douglas Holtz-Eakin of the Congressional Budget Office and Steve Liesman of CNBC. The paper and round-table discussion centered on how the public reacts to economic policy initiatives and how public opinion on economic policy is formed. Areas examined included: What does the Public know? How do they learn it? Which media does the public rely on for economic information?

It was two of the most profoundly depressing hours I’ve spent on anything recently!

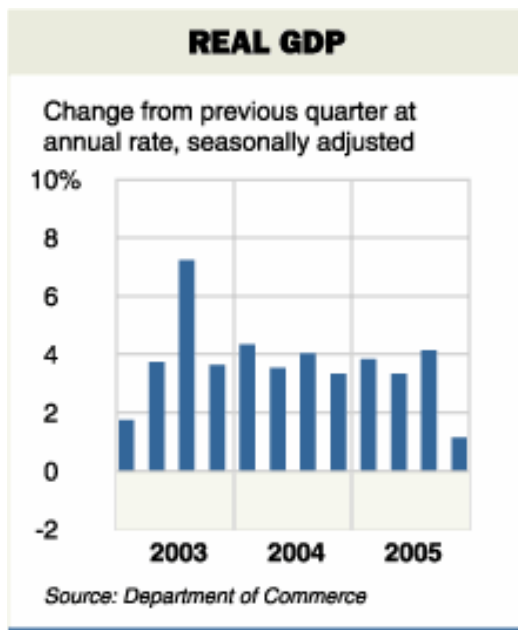
While almost three quarters of survey respondents said that it is very important to be informed about economic policy, fewer than a quarter said that economic policies affected their voting. Maybe this is because almost half claim that television, television!, is their most important information medium. The survey also tested the informational knowledge of those surveyed and found that those who relied on television were far less knowledgeable than those who relied on any other source. No, duh! Equally depressing was the propensity for ideology rather than knowledge, education or even self-interest to dictate respondents’ opinions.

During the panel discussion, there was general agreement that the press does little to try to educate the public on economic issues. Even more discouraging was the consensus that politicians put their parochial political interests far ahead of any responsibility to educate the public on economic issues. In fact, often politicians will distort economic arguments to serve their interests.

All of the above is extremely disconcerting given that important economic issues such as the budget, trade and taxes will play a key role in the upcoming elections. More importantly, individuals are increasingly being called on to make economic decisions for themselves (such as investing through 401(k)s and health insurance related issues) which used to be made for them by employers, insurers or the government. President Bush refers to this as the “ownership society.” Given the public’s lack of economic knowledge, the media’s seemingly disinterest in educating the public on economic issues and politicians’ desire to obfuscate economic reality to benefit their own agendas, is it any wonder that most of the participants at this forum left shaking their heads?

Economic Outlook

If there ever was economic data that screamed out for upward revision it was the preliminary announcement that the fourth quarter 2005 GDP grew at only a 1.1% annual rate. Hurricanes Katrina and Rita certainly hurt early 4Q growth and the preliminary GDP report mostly extrapolates October and November data. It was, however, inconsistent with most of the economic data reported for December. Shown below is a chart of the quarter-by-quarter GDP growth since the end of the last recession.



Many Americans already believed that the US was in a recession and some actually think that the government fabricates data to make the economy look better than it actually is. This announcement and the subsequent mainstream media coverage will do little to allay such uninformed and/or conspiratorial views.

The 4Q GDP data, the way it was reported, puts the economy and Federal Reserve in a bind. Slowing economic growth and rising “core” inflation is a witch’s brew which could force the Fed to raise interest rates more than expected. *If*, it’s true. But, if the 4Q GDP data is revised up, such current concerns will prove ill founded.

Even if the fourth quarter GDP is not revised up, as we expect, the data announced so far during 1Q'06 looks very strong. Employment and income continue to expand, retail sales have been surprisingly strong, state and federal tax receipts are growing, orders are way up, backlogs are bulging and corporate profits have been, once again, above expectations. Wealth, both from home values and financial assets, is at record highs and incomes are growing. A recent article by the Cleveland Federal Reserve Bank argues that the deterioration in the ability of households to service debt has been greatly overblown. The consumer, who has been left for dead more often than Dracula, lives, breathes and continues to spend.

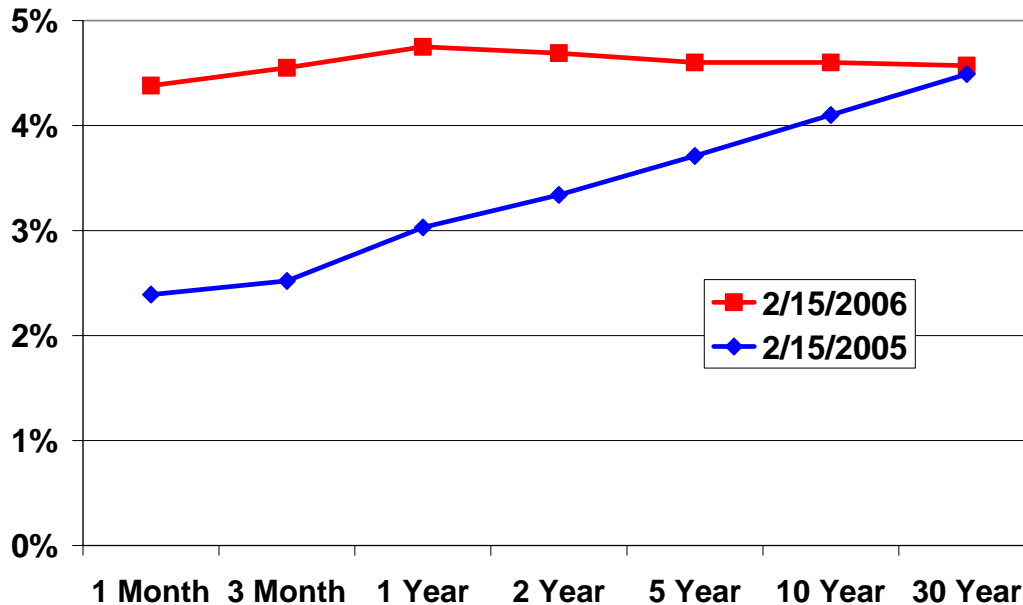
Unsurprisingly, the Economic Report of the President forecasts a pretty good 2006 with GDP growth of 3.4%, unemployment of 5% and inflation at 2.4%. (This is remarkably close to the “average” forecast of the 56 economists polled by *The Wall Street Journal* late last year. It is also quite similar to the consensus forecast from the National Association of Business Economists.) MBI has no big argument with these forecasts.

What is interesting is that most of the work done for the Economic Report of the President was completed while Ben Bernanke was the Chairman of the President’s Council of Economic Advisors. While Bernanke recused himself from this report, since he had been nominated to Chair the Fed, the report, no doubt, reflects at least some of his economic thinking. In fact, the forecasts in the Economic Report are very similar to those which Bernanke made in a speech to the National Economist Club on October 11th while he was still Chairman of the C.E.A.

Interest Rate Outlook

As stated in previous Outlooks, the thing that worries us most about the economic outlook is the yield curve which, as you can see from below, is flat to inverted.

Yield Curve for U.S. Treasury Bills, Notes, and Bonds 2/15/06, and 12 Months Earlier



We are familiar with all the “this time it’s different”’s and have even proffered some of the explanations earlier, such as the “global savings glut” argument. Nevertheless, and unfortunately, virtually every flat/inverted yield curve over for the past fifty years has led to at least a slowdown in economic growth.

Inflation remains the bogeyman of the outlook. Should the Fed perceive that inflation is accelerating (or even just worrisome), it is likely to continue to raise rates higher and for longer than the consensus currently believes. Montgomery Brothers, like everyone else, monitors headline inflation reports such as the CPI and PPI, both the total and core numbers. We also monitor productivity, which took a header during the fourth quarter, and various labor cost data. But, MBI is a follower of the Chicago monetarist school. Not only do we follow the usual monetary indicators and reserve data but we also monitor various indicators of the possible monetization of government debt by the Federal Reserve. The domestic data remains encouraging but we see a wild card. The latest data show that foreign holdings of U.S. government debt increased by \$204b or 15.2% over the past twelve months. Does this qualify as monetization of the federal budget deficit? No one seems to really know but it certainly heightens inflationary concerns, at least on our part.

Ben Bernanke has taken over as Chairman of the Federal Reserve and recently completed his initial congressional testimony in this role. Bernanke seems less Delphic than Paul Volker but more comprehensible than Alan Greenspan. He is likely to continue raising interest rates for as long as the data dictates. For the past five years, the direction of short-term interest rates has been quite predictable. Now, less so.

In general, MBI continues to favor short maturity bonds and floating rate debt instruments.

Stock Market Outlook

So far this year the major market averages are up anywhere from around 2.3% but the leadership of the small caps continues with the Russell 2000 up by 7.7% through 2/15/06. Like the proverbial broken record, we continue to feel that large cap, blue chips offer greater appreciation potential with higher current income than their smaller cap brethren...brethren...brethren... While the market averages are becoming slightly more volatile than what we've witnessed over the past two years, the wild ups and downs for individual issues continues unabated. MBI feels that the proliferation of hedge funds has led to both a more efficient overall market, as reflected in the lower volatility of the major averages, *and* greater volatility of individual assets, as "investors" try to dump losers and chase winners, in the increasingly manic focus on short-term performance.

This "bull market," if in fact this is a bull market and not a big rally in a secular bear market as some argue, is getting long in the tooth. Since the bottom, the S&P 500 is up about 60% and has been up for three consecutive years without even a 10% correction. In five of the eight previous such post WWII up moves, the fourth year failed to produce a gain. After three years the cyclical factors, that propel stock market recoveries from the preceding declines, have usually been spent. Recent history has been more encouraging and, since the fundamentals are fairly solid, we are relatively sanguine on the outlook. P/Es are generally reasonable but not cheap. Earnings are expected to continue to grow albeit at a decelerating rate. Liquidity is ample and interest rates remain relatively low.

MBI continues to like the energy stocks but cautions that the shares are subject to both the wild swings in the underlying commodities as well as the political risk of dim witted politicians doing something stupid like instituting a "wind fall profits tax." Additionally, we like large cap stocks in sectors such as media, pharmaceuticals and technology which have largely been out of favor recently. They appear to us to be cheap and under-owned.

There are an increasing litany of worries to take into consideration such as politics (it's an election year which increases the risk of the politicians making policy blunders) and the second year of the presidential cycle (usually the worst in the four year term); the Fed could continue to raise interest rates while the majority believes that the end is near; the persistency of the yield curve to be flat to invested presages a more serious slow down than most expect; foreigner investors could decide the U.S. isn't all they've cracked it up to be and head for the hills; and, the technical indicators are decidedly mixed even though the path of least resistance for the stock market is upwards.



It's a good thing stocks are reasonably priced, but everybody knows that. They learned it on T.V.

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