

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Second Quarter, 2006 Investment Outlook April 1, 2006

March Madness!

In the spring a young man's fancy lightly turns to thoughts of love, or basketball, or rioting, or internecine political warfare, or trading stocks.

Amidst the steady drumbeat of impending doom, the saga of the George Mason University men's basketball team stands out as a much needed "feel good" story for the whole country. While my beloved Hoyas were knocked out of the NCAA Division I Men's Basketball Tournament in the Sweet Sixteen, the George Mason Patriots advanced to the Final Four for the first time ever. They are the first 11th seed to make it to the finals in 20 years, having won four games in a row to get to Indianapolis. In their previous three NCAA appearances, the Patriots went 0-3. A relatively new, largely commuter school in the D.C. suburbs with a team made up of mostly local talent, Mason has long played in the shadows of Georgetown, Maryland, and George Washington. These über underdogs have been adopted by virtually everyone except Florida Gator, UCLA Bruin, and LSU Tiger fans. While their bandwagon is crowded,... Go, George Mason!

Meanwhile if it's spring, 'ze French must be rioting. Faced with a possible dose of global economic reality, French labor unions and Sorbonne students took to the streets to trash businesses, burn tires, and scare off tourists. Whenever a politician tries to take back a social goody or "entitlement" (in this case lifetime job security), those people who might have their entitlement goodies taken away are going to be bummed. Lest you think it can't happen here, witness the political backbone currently being exhibited by US politicians in the face of our runaway entitlement spending. The recent vote to curtail \$39 billion in increases in social spending over the next five years (that's \$39 billion out of over \$10 trillion) just went down to a crushing bipartisan defeat. Should we all start eating brie and wearing berets?

Who'd have thought that the sale of a British company to a company in Dubai might sink a US presidency? It seems that the Dubai Port World "deal" may ultimately scuttle the George Bush ship of state. Republicans are abandoning the president like rats leaving a sinking ship. (Should we call them Rat-publicans?) In an every-man-for-himself display of reelection fever, the Dubai Port issue was demagogued by the press *and* politicians like few in recent memory. The "debate" smacked of xenophobia, nationalism, and protectionism. The outcome serves no good purpose and potentially aggravates many bad trends. The United States increasingly

depends on foreigners to fund our trade deficit, and we depend on foreigners to provide us with cheap labor and goods. It's a two-way street on which DO NOT ENTER signs are being erected. Are Smoot and Hawly back in Congress?

This low point in recent politics was capped by some Bush administration spring cleaning when the chief of staff, Andy Card, was made to walk the plank. George Bush immediately replaced Tweedle-Dee with Tweedle-Dum, in what increasingly looks like rearranging the deck chairs on the Titanic. (That is the last maritime analogy. Promise.)

While all this would be little more than political theater, the increasingly lame-duck nature of the Bush Presidency could have economic and investment fallout. Montgomery Brothers is worried that the 15% capital gains and dividend tax rates will not get renewed. Any return to higher tax rates on capital will hurt economic growth, reduce tax revenue, and lessen the attractiveness of investing in the United States. Investment money goes where it's treated well. Higher taxes and xenophobic protectionism are not positives for the economic or investment outlooks.

Economic Outlook

Are they mad? In the face of bird flu, the Iraq War, Bush's plummeting popularity, terrorism, income inequality, record trade and budget deficits, and the woes of the auto companies and airline industry, consumer confidence hit a near four-year high in March. What are these people thinking? Don't they know how worried they're supposed to be?

As Montgomery Brothers suspected, 4Q'05 GDP has been revised up, but unfortunately not as much as we thought likely. Fortunately, however, 1Q'06 GDP looks to be coming in gangbusters, and we would not be at all surprised to see 4%+ growth. Employment and income are growing nicely, leading to improving personal consumption; profits are at record highs, leading to increases in corporate spending (both for inventories and capital spending); and government spending is back to being expansionary. (Even housing is hanging in, at least so far.) Much of 1Q'06 economic growth represents a rebound from the hurricane related economic weakness witnessed during 4Q'05. We think that averaging these two quarters is a decent indicator of the underlying trend in economic growth, of around 3%. This is just below the National Association of Business Economist consensus forecast of 3.3% growth for 2006 as a whole. The NABE is, however, looking for quite a sharp deceleration in growth during 2006—from 4.5% in 1Q'06 to 3.0% in 4Q'06. We have no good reason to disagree with the consensus.

Inflation continues to be worrisome but it is not as worrisome as many fear. We're back to reading that the nominal or "headline" inflation rate understates inflation. (Wasn't it just last week that it overstated inflation?) The fact is that no one inflation number fits all. If you own your home, the higher price of a home ups your net worth but also increases your taxes. If you're younger, you have more education costs but hopefully not too much in health care expenditures. If you're older, the opposite. Different things increase (or decrease) at different rates in different areas. Products and services improve. Consumers substitute. Besides, inflation is a monetary phenomenon more likely caused by too much money being printed which results in

money buying less. Inflation is not caused by economic growth, or high employment, or even rising prices.

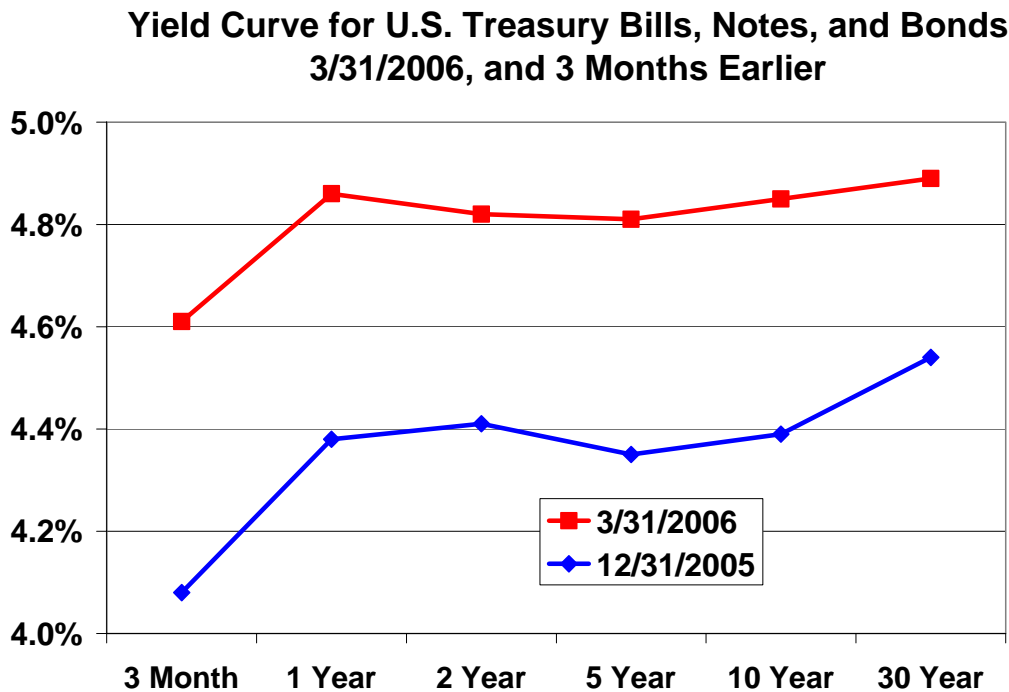
After 3+ years of economic growth of nearly 4% and 15 consecutive increases in the Fed Funds rate, an economic slowdown should not come as a complete surprise. While MBI sees little on the economic horizon to give us great concern, we are worried about potential monetary policy errors over the shorter term.

Interest Rate Outlook

This time it's different... again! For 18 years people hoped for clarification of, and tried to figure out how, Alan Greenspan and the Fed was intending to run monetary policy, with no success. So there were great expectations that new Fed Chairman, Ben Bernanke, who talks a good transparency game, would eliminate or at least reduce the Greenspan Fed's uncertainty.

The problem is not that the Fed wants to be vague. The problem is that the Fed, like everyone else, doesn't know exactly what the future holds. In spite of having 350+ PhDs in Economics on its staff, the Fed has little more success forecasting the economy than, say, you or I! Fed officials have recently been giving speeches saying that monetary policy will increasingly be dependent on the flow of economic data. Seems kind of obvious.

In a recent address, Bernanke stated, "I would not interpret the currently very flat yield curve [see yield curve shown below] as indicating a significant economic slowdown to come."



This in spite of the fact that, far more often than not, flat (and certainly inverted) yield curves precede economic slowdowns, or worse. If Bernanke is wrong and this time is not different, the

Fed will have overshot, tightened too much, and helped tip the economy over. Whoops! History shows that the Fed usually does overshoot, so why should we be surprised if it does again?

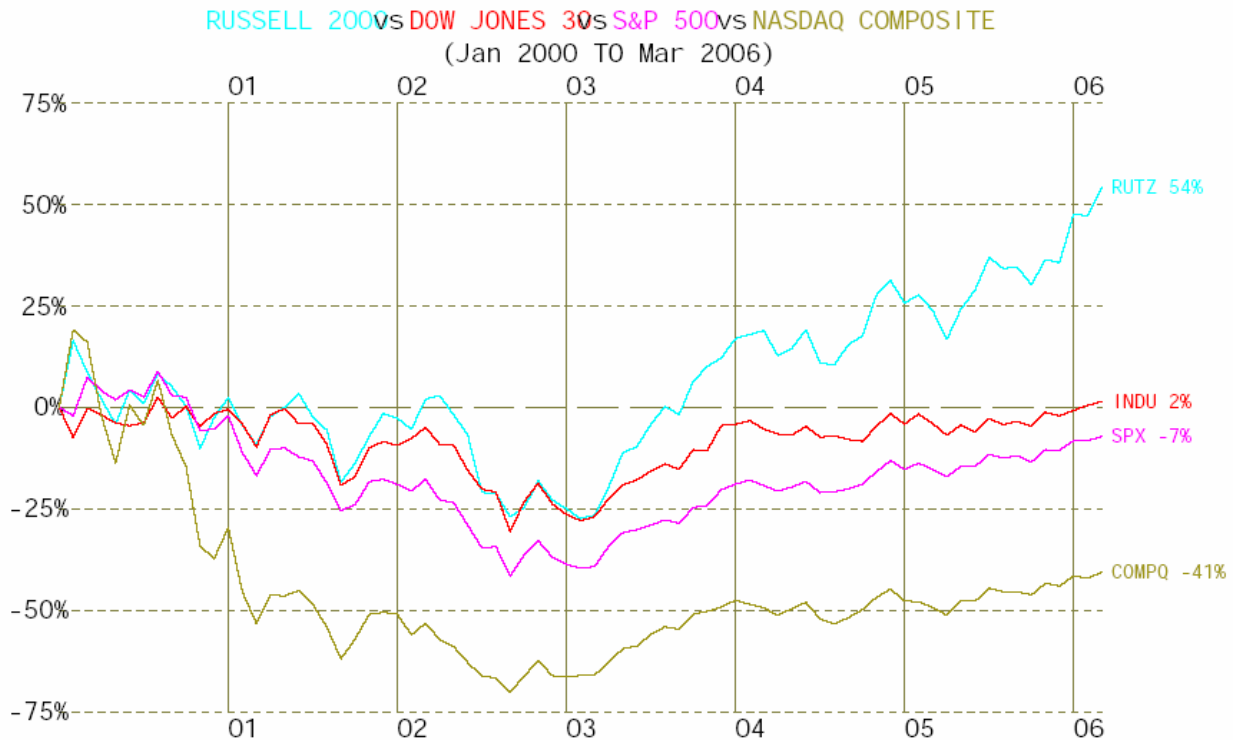
Economic expansions do not get killed off by the cost of capital, they get killed off by the lack of availability of capital. The system is awash in liquidity which was at least partially a result of the Fed's previously expansionary policies. Bernanke himself has pointed to the flat yield curve as a sign of excess savings in the global financial markets. We view this excess savings as symbolic of ample liquidity and credit availability. This is part of the reason we expect the economy to continue to expand. That and the fact that it usually does.

Montgomery Brothers guesses that the Fed is farther from being done than most believe. With the yield curve flat, quality spreads very narrow, the Fed raising rates, and plenty of liquidity in the system, we believe that interest rates are headed higher—not to double digits—but higher.

As Greenspan was doing his farewell tour, he constantly warned investors that they were underestimating the risks that they were taking. Call us mad but MBI would rather take risk in the stock market where we might get rewarded fairly for the risk taken than in the bond market where you earn almost as much in interest for lending money for thirty days as for thirty years.

Stock Market Outlook

The first quarter was the best quarter for stocks since the first quarter of 1999, or so we're constantly being told. Every time the market rallied during March, the talking heads of Wall Street informed us that we were at five-year highs. And, so we were. However, as you can see from the chart below, little progress (or money) has been made in the stock market since the turn of the century, unless, of course, you were invested in small caps, which had greatly underperformed during the decade of the 1990s.

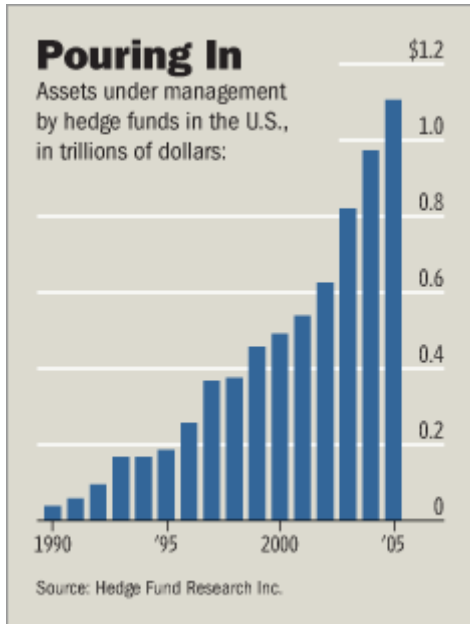


The first quarter was the same old story: small cap beat large, value beat growth, low quality beat high. Among sectors: Telecom and Energy did the best while Consumer Staples, Health Care, and Utilities did the worst. Like last year, Energy remains in the penthouse while Consumer Staples stayed in the doghouse. Otherwise, sectors are in transition.

Corporate profits continue to grow with the Commerce Department reporting that 4Q'05 net corporate profits rose 14.4%, in line with the 4Q'05 earnings increase of 13.7% reported by the S&P 500. Expectations for the earnings-per-share of the S&P 500 for 2006 are \$81.21—a 6.5% increase. Such earnings growth would lower the S&P's price-to-earnings multiple to around 16 x, which is below recent averages, especially considering how low interest rates are.

If you don't think capital gains taxes matter, please note that the capitalization of the US equity market has increased by \$3.3b (or about 1/3) since the 2003 tax cut. CRAZY! The demand for equities continues to grow with individual ownership up 5.2% since 2002 and up 14.4% since 1999. Additionally, foreign investors and companies are buying American and there are billions of dollars in private equity funds. Is it any wonder the IPO window is wide open even while corporations buy back stock?

Why is it that even though overall market volatility has decreased over the past several years, risk seems higher? Maybe this chart has something to do with it!



It shows the growth in assets under management invested in US Hedge Funds. While not all of this money is run by short-term-oriented, performance-crazed wild people, too much is. More and more money will be pouring into these funds since they *have* done well and they make lots of fees for Wall Street. We recon that at least part of the reason large cap stocks have underperformed is that a good portion of the money institutions have placed into hedge funds came from the proceeds of the sales of underperforming large cap stocks. Sell low, buy high. Gotta chase performance, don't you know?

In spite of having done well for quite some time, MBI continues to like the Energy sector. Domestic oil and gas exploration and the Oil Drilling and Service stocks currently look good to us. Technology also looks

good but we would avoid many of the big winners of the last cycle and concentrate on newer names. Big pharma seems to have bottomed and smaller bio-tech stocks look to be taking the leadership role that the larger cap bio-techs witnessed last year.

The path of least resistance for the stock market seems to be a continuation of its gradual upward track. Stay diversified and equity oriented. Above all, don't get caught up in the madness of crowds.

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P.S. Unfortunately, George Mason was defeated by the University of Florida on April 1st, as, at least for Patriot fans, March Madness gave way to April Sadness.

Some charts courtesy of Baseline and WSJ.com