

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Mid-Second Quarter, 2005 Investment Outlook Update Friday, May 13, 2005

Looking Up?

An article in the April 9th Washington Post, surprisingly not April 1st, brought a new and potentially vastly superior concern to our attention. Astronomers discovered that the romantically named asteroid “2004MN4” had a one in 38 chance of hitting the earth. They even provided the date – drum roll please – Friday the 13th of April 2029! (We are *not* making this up.) Why this hasn’t been more widely reported is a great mystery to us, given the propensity of the press, politicians, and the public to constantly find ever more spectacular things to fret about. And, if the earth being hit by an asteroid is not something to worry about, we’re not sure what is. We fully expected near total panic but none followed, nada, zilch! Later, it was determined that 2004MN4 was likely to miss by 15,000 to 25,000 miles, depriving us of nearly a quarter century of a single disaster to focus on. Rats!

In spite of the fact that there probably isn’t much that could be done to prevent such a calamity, it would have been interesting to see what would have been proposed. Alas, we’re left with our more pedestrian worries of war, global warming, economic collapse, financial market meltdowns, terrorism, and all the other usual suspects.

It is probably more likely that an asteroid will hit the earth than that politicians will address, let alone solve, any of the myriad problems which they’ve had such a hand in creating. During the 1990s most of us came to believe that “gridlock is good” but this is probably no longer true. Unfortunately, gridlock is certainly a probability, if not a mortal lock. The Republicans have discovered that “It’s good to be king,” and figured out that cutting taxes while increasing spending is a great way to buy votes. They are following this formula with a slavish passion. Meanwhile the Democrats, who wonder why they didn’t figure out that formula first (they had the latter part down cold), have decided to just say “No”... to anything and everything that President Bush and the Republicans propose. Democratic proposals are, apparently, considered unnecessary.

Having won an election by beating an unelectable opponent, Bush declared a mandate to govern as he saw fit. While he got off to a fast start, his forward momentum got bogged down by Iraq, Terri Schiavo, Tom Delay, and other issues of importance and not. Oh, well! It really is more of the same, only more so.

Economic Outlook

The recent announcement that 1Q 2005 GDP expanded at a 3.1% annual rate was met with groans. Never mind that 3.1% is almost exactly the 40-year average rate of growth for the U.S. economy and that the preliminary 4Q2004 GDP was announced at that same 3.1% rate only to be revised up later to almost 4%, worry was in the air. The quarterly GDP announcement capped several weeks of concern that the economy was hitting a soft patch, or worse. Any such slowdown, it was supposed, might cause the Fed to back off from its policy of $\frac{1}{4}$ of 1% point rate increases “for as far as the eye could see.” This was 180° from earlier concerns that the economy was picking up speed and that the Fed would have to accelerate those $\frac{1}{4}$ of 1% rate increases. Then the GDP data was followed by the April employment data which was stronger than expected, and the “too fast, too slow, too much inflation, what is the Fed going to do?” debate started anew. Frankly, Montgomery Brothers finds it hard to remember from week-to-week, let alone day-to-day, what we should be worried about. Thank goodness, we have the press and the pundits to tell us the concern du jour and CNBC to give us the minute-by-minute details.

What we do know is that no one should be too surprised that growth is slowing three years into an economic recovery from one of the mildest recessions on record. Monetary and fiscal stimulus is diminishing and interest rates, at least shorter term interest rates, are rising in response to the inflationary pressures caused by the aforementioned monetary and fiscal stimulus. This is nothing new and has all been seen before. It's called the business cycle. But don't be surprised when 1Q2005 GDP is revised upwards. Most of the economic surprises have been to the upside.

While most fret about all the things that could go wrong, Montgomery Brothers is focusing on what is likely to continue to go right. For example, over the past twelve months, over two million jobs have been created and average hourly earnings have risen by almost 3%. Many worry about “real” income levels, but we'd point out that very few consumers spend inflation-adjusted dollars. Additionally, not only the two million who found new jobs but also the 138.5 million or so who already had jobs are likely to spend most, if not all, of their increasing income. While many worry about a possible real estate bubble and rising debt, we'd point out that the most recent Federal Reserve data shows the *net* worth of Americans is at record highs. The Wall Street Journal recently reported that “especially troubling was a deceleration in business capital spending,” but the 4.7% increase in 1Q2005 was a slowdown from the 4Q2004 increase of 10.5%. Not exactly a disaster and consistent with a similar slowdown in 2004's first quarter which was followed by a pickup for the rest of that year. We would also point out that much of the economic fretting is over “seasonally adjusted” economic data. The statistics wonks try to massage the data to reduce its normal volatility but have an especially tough time “norming” the results when Easter, falls in different quarters, as it did this year.

Lastly, we'd like to point out one of what MBI considers to be the best economic indicators around. This data is not seasonally adjusted, nor reported in “real” terms. We're talking about taxes. Federal taxes, state and local taxes, personal taxes, corporate taxes, FICA taxes, sales taxes. All are going up, and more than expected. No one wants to pay

more taxes than they have to and most do whatever they can to minimize the taxes they pay. But, man, does the tax data give you a good idea of what's really going on in the economy. And, right now, the tax data says that things are going well.

Interest Rate Outlook

At first, we thought that a “Conundrum” was an imported car, but it turns out that conundrum is really something hard to fathom and harder, yet, to explain. For example, low and declining long-term interest rates in the current economic environment with the Federal Reserve raising short-term interest rates is a conundrum. MBI, along with virtually every interest rate forecaster, bond investor and economist, has been surprised by the stubborn refusal of longer-term interest rates to rise. Even Maestro Greenspan is scratching his head. The best explanation we've seen/heard/read is that there is a global glut of savings relative to investments and all that savings has to go somewhere. Given the dollar's role as the global reserve currency, the U.S.'s steady economic growth, its low inflation, the U.S. financial markets, in general, and U.S. Treasury market, in particular, are excellent repositories for this excess global savings. And, given the U.S. trade deficit and developing economies' propensity to save, it does make sense to invest those savings in the U.S. Conundrum solved?

If one were to view the U.S. trade deficit as the global economic engine that it is, and if one saw investment opportunities in helping one quarter of the world's population develop economically, and if one viewed the fact that the world's savers believe that the U.S. is a good place to invest their money, maybe the U.S. wouldn't be so increasingly xenophobic and protectionist.

The next time that you hear that if we could just get the Chinese to revalue the renminbi (or is it the yuan or are they the same thing?) just remember that we've seen this movie before. In the 1930s there was Smoot Hawley, and in the 1970s we persuaded the Japanese to revalue the yen. The former was a total disaster; the latter merely a big mistake. Politicians shouldn't wish too hard, they might get what they want. But, hey, if it buys a vote or two in the short term, it's worth it to get reelected. Eh?

Montgomery Brothers remains cautious on longer maturity bonds. We point out that even after eight consecutive 25 basis point increases in interest rates by the Fed, monetary policy remains relatively expansive. The yield curve has flattened dramatically, which we *do* find worrisome for both the economic and investment outlook. The Fed has stated as clearly as the Fed ever does that it will continue to increase rates. In the past the Fed has almost always overdone it, both loosening and tightening. And it seems that every time the Fed taps on the monetary brakes, somebody somewhere goes through the economic windshield.

Stock Market Outlook

Are we having fun yet? If you answered “No,” join the club. This year’s stock market has been wildly frustrating and promises to remain so. Let’s revisit Montgomery Brothers’ current stock market backdrop.

- A) Things aren’t all that bad. The economy is expanding; interest rates and inflation remain near historical lows; corporate balance sheets are strong while corporate profits are expanding; and profit margins and returns on equity are historically high;
- B) Stocks aren’t cheap with P/Es above average and dividend yields below average (but stocks shouldn’t be cheap, given point A);
- C) Stock market returns will be below historic averages largely since A) and B) are already factored into the price of stocks;
- D) Financial markets are increasingly efficient. After 25 years of generally rising stock and bond markets, there are many more smart players controlling mountains of money who are armed with huge amounts of information and number crunching capabilities, and are trying to find a shrinking number of investment opportunities;
- E) The keys to the asylum have been given to the lunatics. Program traders and hedge funds play a larger role in the market than ever before. Friction (commissions and spreads) are low and incentives for specialists and market makers to maintain orderly markets have largely been eliminated. The general lack of volatility (until recently) in the market averages hides a great deal of volatility for individual issues, as these investment behemoths run from one side of the boat to the other;
- F) Event risk has been wildly heightened in the current environment of regulatory overkill and prosecutorial zeal and we’ve yet to see any light at the end of these tunnels.

The MBI bottom line: long periods of generally downward stock market drift will be punctuated by sharp rallies, such as the one we had during 4Q2004. See the chart below.



Our tactics remain much the same: try to buy good companies at reasonable prices; dividends (especially rising, well-covered dividends) are good; and, tax efficiency is increasingly important because of C), above. Since we are three years into the current economic expansion, we believe late cycle stocks such as energy, healthcare, and consumer non-durables make more sense than more economically sensitive stocks. (You might wait to use the current weakness of energy prices to add to positions.) Additionally, with developing economies, especially those of Asia, growing more rapidly than the U.S. economy, we believe it is important to have exposure to foreign economies and markets in your portfolios.

Many of the short-term stock market tools that we've used over the years don't work as well as they used to – if they ever really worked in the first place. Nevertheless, we feel that human nature is fairly constant and believe that when everyone is looking down, things are probably starting to look up. Besides, if you're looking up you'll be able to avoid being hit by that asteroid if it ever does strike the earth.

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Some charts courtesy of Baseline.