MONTGOMERY BROTHERS WEALTH MANAGEMENT

Third Quarter, 2005 Investment Outlook

July 4, 2005

"Non" Sense

When the French voted "non" to the European Common Market constitution we initially tried to make sense of their vote. In a world where less and less seems to make much sense why should the French "non" vote make any sense? Many reasons were proffered as to why the French thumbed-down decades of (supposed) progress toward European unification, but it wasn't until we read Steve Pearlstein's column in the *Washington Post* on June 1 that we started to get it. Pearlstein wrote "President Jacques Chirac [in response to this "Non" vote] yesterday replaced his prime minister and shuffled his cabinet but never explained to his people why they can't be rich if they insist on working 35 hours a week, retiring at 55, and overtaxing those who are productive and ambitious to subsidize those who aren't." Zut alors! Plus ca change, plus c'est la meme chose.

MBI reckons that the French vote was against European unity in favor of the status quo, at best, and a regression to the protectionism and socialism of the past, at worst. It's no wonder that the Euro has been weak (vs. the dollar) since, and even before, this vote. In effect the French, and probably the majority of western Europe, has decided that global economic competitiveness just isn't worth the effort, so why bother. Ironically, most European bourses are at, or near, three-year highs. Go figure!

The United States should react with restrained glee since there will be *less* global competition for us—at least from Europe. But, wait! Just because the French do unbelievably stupid and counterproductive things, why shouldn't the United States? And, in fact, we seem to be heading down the same socialist and protectionist path that has made France, Italy, and swatches of what Donald Rumsfeld referred to as "Old Europe" the economic basket cases that they've become. Witness the U.S. political reaction to the economic developments in China and, to a lesser extent, India. Rather than view the entrance of a third of the world's population into the (relatively) free market, capitalistic economy as possibly the greatest economic opportunity in the history of the world, the United States seems to be acting like the proverbial 98-pound weakling by whining about competitiveness and demanding currency revaluations.

In 2004, we witnessed the fastest global economic growth in decades, yet too many see only threats from the integration of formerly Third World countries into the global economy. We don't disagree that China's political system leaves a lot to be desired, but economic growth tends to foster, not retard, democratic liberalization. Threats of protectionist

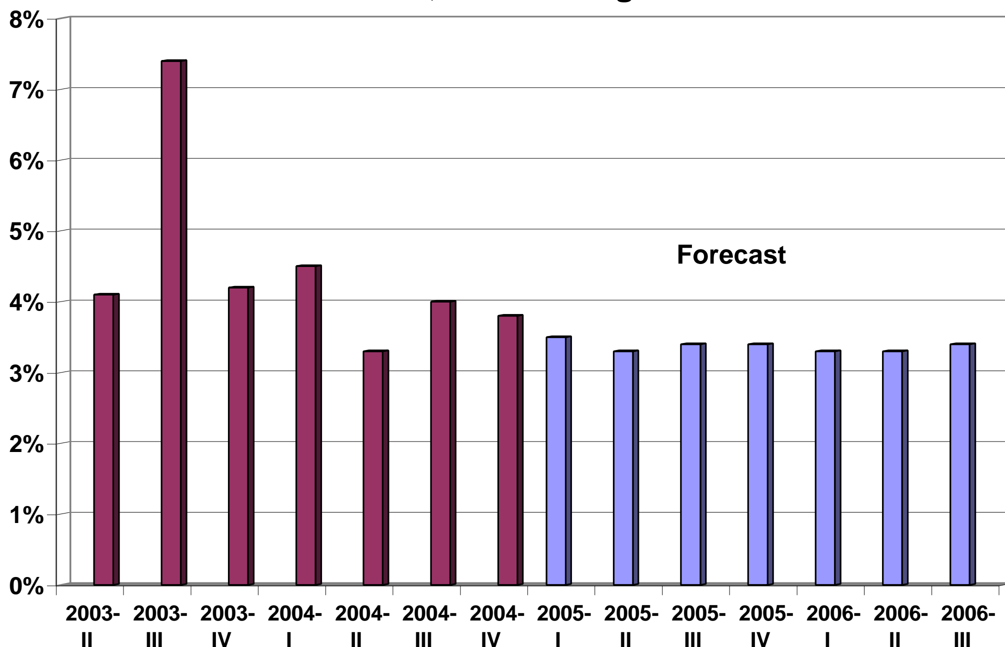
retaliation, or even worse actual protectionist legislation, are unlikely to improve the situation. The Smoot-Hawley legislation of the early 1930s turned a bad recession into the Great Depression, and similar protectionist moves against the Japanese in the early 1970s had precious few positive results. Much of the political rhetoric and protectionist legislation is supposedly aimed at stemming the tide of globalization. Such actions will lead to as much success as King Canute experienced in ordering the ocean tides to recede.

Economic Outlook

Why, when the United States has experienced all of five quarters of economic contraction in the past twenty years, is everyone constantly looking for the next recession? On June 29, the Bureau of Economic Analysis announced its (final) report on first quarter 2005 GDP, revising growth upwards to a 3.8% annualized growth rate while revising the rate of inflation downward. Similar to the fourth quarter of last year, the first quarter advance report announced *anemic* growth of 3.1% with high(er) inflation, only to have growth revised up and inflation down as data became more complete. Is this the weakening economy that we've heard so much about? Is 3.8% growth with 2.7% inflation "stagflation"?

In spite of the nonstop media hand-wringing and the political carping, the American public doesn't seem to be buying the supposedly impending economic doom which is, once again, right around the corner. The Conference Board's reading of Consumer Confidence hit a three-year high in June with rising optimism about business conditions and employment prospects. Don't these (consumer) schlubs get it?

The same day that the BEA announced first quarter 2005 GDP growth of 3.8% we received the June 1, 2005, issue of the "Blue Chip Financial Forecasts." Shown below is a chart of the quarterly growth of GDP from 2Q '03 through 4Q '04 and the consensus forecast for GDP growth from 1Q '05 through 3Q '06.



Note that the consensus was "forecasting" 3.5% growth for 1Q '05 (as recently of May of 2005), even though the first quarter ended nearly three months earlier. No misplaced optimism here! Maybe we should take solace from all the nonsensical economic doomsday predictions. It seems that we are most at risk when the majority feels that we aren't.

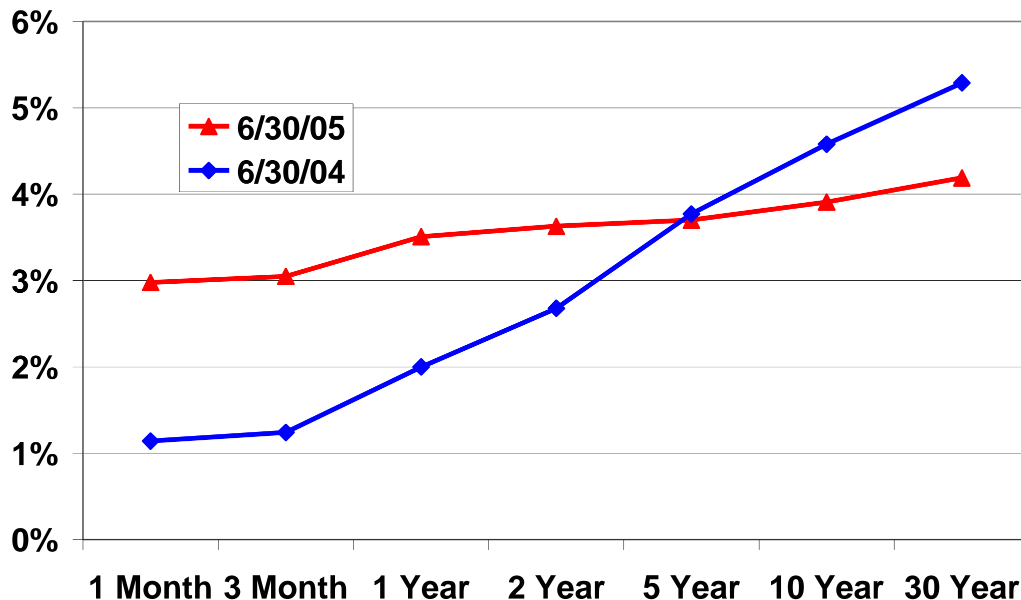
Even though energy prices are likely to take a bite out of consumer purchasing power, there's a lot of consumer purchasing power to have a bite taken out of. A recent Manpower survey predicts U.S. firms will be hiring at a solid pace during the third quarter, and recent revisions to the employment data show wages and salaries growing at nearly a 7% annual rate. This goes a long way to explain why state and federal tax "receipts" are surging and the (federal) budget deficit is declining faster than anyone expected. Throw in surging home prices (and their effect on consumers' psyches), rising corporate profits, and rapidly expanding global trade, and the economic Armageddon forecasts seem a bit misplaced. Second quarter GDP may come in a bit weak if corporations are successful in working down the small flare-up in inventories which occurred during 4Q '04 and 1Q '05, but the recent (re)strengthening of industrial production might indicate that we are past even that "soft patch." So we're not too worried about the economic outlook. Nor does MBI feel that inflation is likely to be a problem. Global competition, the strengthening of the dollar, and the slowdown in money supply growth indicate, at least to us, that the worst of the inflationary pressures may be behind us. The July 1 front page article in *The Wall Street Journal* said it all in its headline "Economists See Modest Growth and Many Worries." Don't they always?

Interest Rate Outlook

It's a conundrum, don't you know! On the first anniversary of the beginning of its current tightening campaign, the Fed raised the benchmark federal funds rate 25 basis points. This

was the ninth such increase in a row and brought the rate up to 3.25%. More importantly, the Fed gave every indication that this measured pace of rate increases would continue, thereby crushing hopes that the Fed was close to the end of raising short-term rates. On the same day, longer-term interest rates declined.

With this most recent increase, the Fed voiced confidence in the economic outlook but concerns regarding inflationary pressures. Ironically, the bond market seems to have exactly the opposite set of concerns as can be seen from the yield curves, which compare the yield curve as of June 30, 2005, to that of a year ago, which is shown below.



Flattening yield curves are thought to be predictors of slowing growth and diminishing inflationary pressures. Inverted yield curves are considered harbingers of recession. Fear abounds that if the Fed persists in raising short-term rates, the yield curve will invert. The last time the yield curve inverted was in early 2000, and it did precede the most recent U.S. recession. While there are cases where inverted yield curves did not precede recessions, the current combination of rising short-term rates and declining long-term rates is highly unusual and an inverted yield curve would be a cause for concern. A greater possible cause for concern, at least in our opinion, is the Fed's insistence that it is right and the markets are wrong. It's not smart to try to fool Mother Nature! Or finesse the financial markets.

Forecasters, breaking with the tradition of forecasting the recent past into the immediate future, continue to predict higher rates are ahead. Like a broken clock, they'll be right eventually. But some are starting to break ranks. The "global savings glut" camp is growing, and no lesser light than Bill Gross (the bond guru of PIMCO) is predicting that the yield on the ten-year bond could range between 3% and 4.5% for the next three to five years. Many, MBI included, have a tough time telling clients to buy bonds at near 45-year low yields, but it might be the right thing to do. But in a reminder of how fickle the bond markets can be, interest rates rose across the yield curve on July 1, when both the ISM Index and the

University of Michigan consumer confidence data were announced at higher levels than expected.

Stock Market Outlook

Early in June, a stockbroker friend asked if the paint had dried in our offices, and for the better part of the second quarter the stock market was, indeed, like watching paint dry. Then, after fighting its way to a tiny gain for the year, the market experienced one of its periodic high volatility moves, unfortunately down, wiping out what little we had to show for being invested in stocks so far in 2005. During the first half, the total return from the S&P 500 was negative 0.8% and the total return from the average diversified U.S. equity mutual funds was negative 0.3% according to Lipper Analytics. These returns were less than those from the money market funds and are indications of not only the uncertainty but also the efficiency of the equities markets.

MBI is not fearful of owning stocks in general, just owning certain stocks in particular. The stock market appears reasonably priced (not cheap, nor expensive) to us. The outlook for the economy is good, and the prospects for profit growth are decent. But all this is well known, generally accepted, and already priced into stocks. Stock market volatility was recently at nine-year lows, even while individual stocks continue to periodically be taken out and shot (and often taken out and shot, again!). MBI believes that market volatility is in secular decline due to the greater efficiency of large numbers of very smart people playing both sides of the market. Investors, in general, and hedge funds, in particular, are increasingly short-term oriented and momentum focused. Mood swings are more pronounced. Shown below is the trading pattern of the S&P 500 during the first half of 2005. Over it we have imposed the four-week moving average of the ratio of bulls to bears on given dates from the weekly American Association of Individual Investor sentiment survey. (High ratios indicate bullishness, while low ratios represent bearishness.)

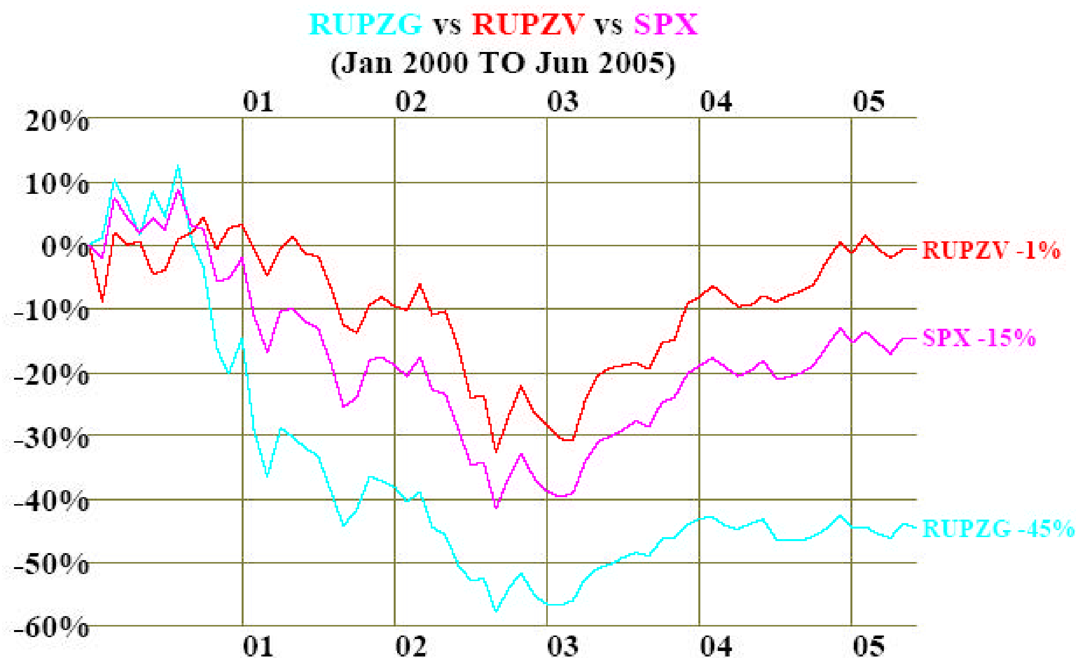
Key to overlays:
Date
AAII Bull/Bear Ratio, Moving Average

Darn good contrary indicator, eh?

One worrisome factor is the increasing amount of leverage being used and risk being assumed by investors trying to enhance returns above the paltry rates we've experienced recently. Two large hedge funds have recently folded; expect more to follow suit.

The latest gem of pundit sophistry is the belief that the second half of 2005 will be an instant replay of the second half of 2004. We sure hope so. If the Fed were to stop raising rates, or even announce that it would stop soon, there would probably be a decent rally. MBI believes, however, that the recent tedium would quickly reassert itself, and the monotony of most of the first half is likely to continue during the second.

MBI continues to feel that a few macro "themes" make sense. Large-cap growth stocks have been out of favor but could regain favor, especially if the economy does slow. The chart below compares the price action of the Russell Top 200 Growth Stock Index to that of the Russell Top 200 Value Stock Index and to the S&P 500 itself over the past five and a half years, ending 6/30/05.



This is an increasingly popular theory, but while we feel it has validity, we see little indication that investors are embracing the concept in any, let alone wholesale, numbers. We continue to prefer companies paying growing, well-covered dividends. In a period of low returns it's nice to see, at least, some current and tangible return. MBI also believes that the energy sector is attractive over the long term, and that large oil companies represent good value and have above average earnings growth potential. Additionally, sooner or later, the big oil companies will, or will be forced to, spend money on exploration which should benefit the drillers and oil services providers. Unfortunately, when the energy sector does well, the rest of the stock market often doesn't. Health care seems to be back in favor. Besides showing favorable price momentum, the sector is also relatively cheap on a valuation basis and relatively defensive if the economy stalls.

Lastly, we've been increasing our exposure to tech stocks. If the market makes any move up, this sector could be in the vanguard. Like large-cap, blue chip growth stocks, the tech sector has largely been out of favor. If, as we expect, corporate America starts to spend

its cash horde on capital expenditures, tech (the cyclical companies of the twenty-first century) should benefit. We caution, however, that the tech shares are often richly priced, are relatively volatile, and are subject to periodic earnings disappointments.

Sometimes the stock market gets things just about right; MBI believes that now is one of those times. We think that both the bulls and the bears will continue to be frustrated.

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Some charts courtesy of Baseline.