

# MONTGOMERY BROTHERS WEALTH MANAGEMENT

**Fourth Quarter, 2005**  
**Investment Outlook**  
**October 1, 2005**

## **Where's the Pony?**

Ronald Reagan used to tell a story of an optimistic boy who is given a pile of manure for his birthday. The boy jumps into the pile and starts digging through it with a huge smile on his face. When asked what he is doing, he replies "With all this manure, there must be a pony in here somewhere!" We remembered this story as we started to evaluate the ramifications of Hurricane Katrina and (later) Hurricane Rita. We find it odd that government is perceived to be a plodding bureaucracy until some disaster hits, and then everyone is surprised when it is, indeed, a plodding bureaucracy. When was the last time you had a really good experience with a huge bureaucracy? And when was the last time you were impressed by the service you received from the federal, or for that matter, state or local government?

Katrina hit Louisiana (possibly the most corrupt state, at least historically, in the Union) hard and seemed to zero in on New Orleans (probably one of the least functional cities in the United States). We're actually fairly impressed by what was done after the initial stumbles.

One pony that we've found was the prompt response by the *private* sector. Companies and individuals were fast to contribute money and goods, and to volunteer their efforts to help the victims of these *natural* disasters. Certainly, planning could have been better. But even the best plans seem to come unglued when you add in that wildest of wild cards: people.

Clients have asked what MBI thinks is the possible damage to the economy that will accrue from Katrina (and Rita). Our response is very little, especially compared to the damage that will be caused by the politicians responding to these disasters. Congress and President Bush are already playing up the ante over how much aid might be doled out in the face of these hurricanes. \$50, \$100, \$200, \$250 billion? The sky's the limit! Beside all of the people who were actually harmed, every special interest group in the universe is lining up for a piece of the action. Insurers want to be bailed out, municipal bond holders want to be made whole, casino operators want subsidies. States far from the hurricanes are queuing up for disaster relief. We're going to rebuild New Orleans regardless of the cost or advisability of doing so.

Pay for it? Naaa! Bush has said “no” to tax increases, and Congress has said “no” to spending cuts. So the budget deficit will go up. A few brave (?) politicians are pointing out the folly of this federal largesse. They’ll be ignored, at best, or branded as hard-hearted kooks, at worst. Let the private sector take the lead? Naaa! Allowing the private sector to address problems might solve the problems but buys no votes for politicians.

This reminds us of another Ronald Reagan story. When someone commented to Reagan that Congress was spending money like drunken sailors, he responded that such a statement was an insult to drunken sailors everywhere!

The Democrats think they may have found a political pony in Bush’s plummeting poll ratings and the increasing discomfort of fiscal conservatives in Republican’s cut-taxes and spend policies. And now, Tom Delay! The Democrats probably think that they make the 2006 election a horse race. We don’t know what the Republicans are thinking about.

The dollars to be spent on “disaster relief” aren’t all that significant to the bigger picture. Two hundred and fifty billion dollars over three years in an \$11.1 *trillion* dollar economy, growing at 3%, is really no big deal. But unlike hurricanes where the damage is immediate and devastating, fiscal irresponsibility is more like beach erosion: slow and steady.

If a little fiscal responsibility blew into Washington, DC on the coattails of Katrina we’d all be fortunate. It is, after all, an ill wind that blows no good but we are *not* holding our breath.

## **Economic Outlook**

Katrina will nick the economy for a percentage point or two of growth over the next couple of quarters and add a percentage point or two to inflation for the next year or so. However, the real longer term risk is from the green light the politicians have given themselves to continue their fiscally irresponsible ways. Even being in Washington really gives us no great insight into the potentially disastrous damage that this well-meaning, vote-buying deficit spending might unleash.

Thank heaven the economy was going strong when these disasters struck. Third quarter real final sales, a good indicator of the economy without inventory adjustments, rose at a 5.4% annual rate during the second quarter. (Weak inventory growth, however, brought reported GDP growth in at 3.3%.) The consumer, whose death has been widely (if not prematurely) reported, slowed their expenditures to a 3% annual rate. Consumer confidence *is* way down and why not, given weeks of unrelentingly negative news due to hurricanes and sky-high energy prices? Mercifully, consumer confidence is a lousy barometer of consumer spending in spite of being a great thermometer of peoples’ current mindset. The press and pundits love the consumer confidence data; MBI pays it little heed.

Meanwhile, even though jobs will be lost due to the hurricanes, job growth over the past twelve months (ending 9/05) was decent, showing an average of 187,500 to 232,500

new jobs per month (depending on which survey you use). Incomes have been going up at about a 5% annual rate. Importantly, the Federal Reserve reported that the second quarter was the eleventh consecutive quarter of record high US household net worth, which rose to \$49.8 trillion, and which was up 9.4% from a year earlier. In spite of an even faster 9.9% rise in household debt, net worth rose to 5.53 times disposable income versus 5.49 times in the first quarter. Montgomery Brothers expects consumer spending to continue, if not slightly accelerate, after the initial hurricane shocks wear off. After all, as we like to say, when the going gets tough the tough go shopping.

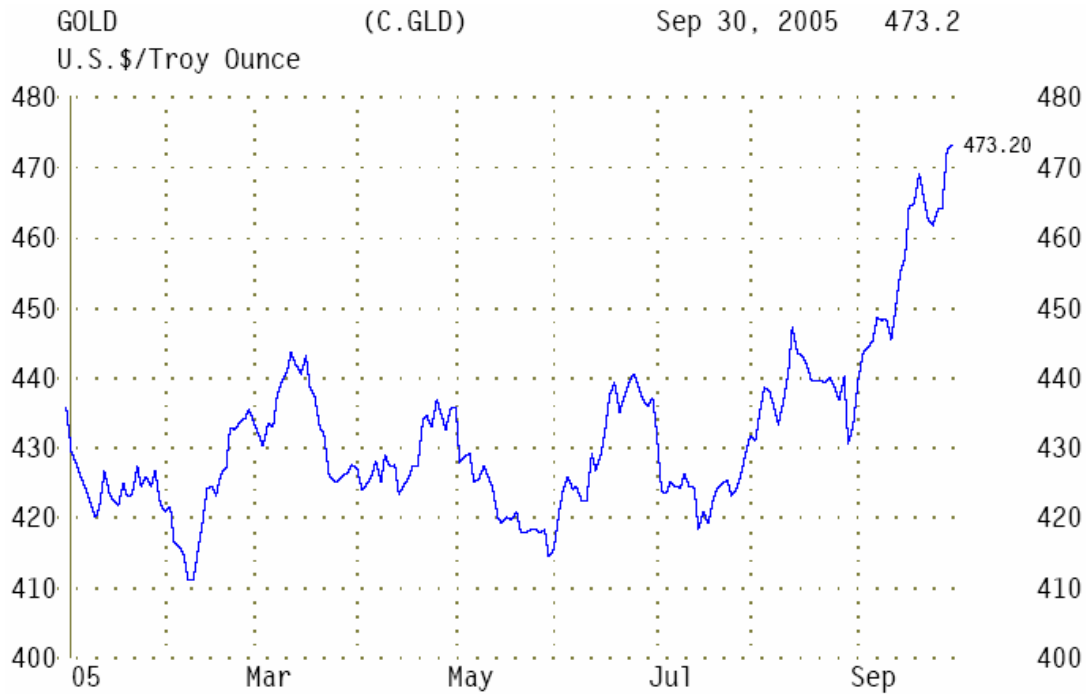
Inventories are likely to need some rebuilding but capital spending might take a short-term breather after a protracted period of relative strength. Recent surveys of corporate executives indicate that they see very little impact on the economy from the hurricanes and most of that is a short-term reaction caused by the near-term uncertainty. Many foreign economies are strong or improving, and US exports are expanding. Imports, however, due to rising energy prices, will impede stated domestic economic growth. Lastly, fiscal policy is turning expansionary again thanks to the fiscally irresponsible opening of the post-Katrina spending floodgates. (Remember, when government spending goes from a deficit of \$400b to a deficit of “only” \$300b, that’s considered contractionary. When the deficit goes from \$300b back up to \$400b, that’s considered expansionary.)

History shows that natural disasters rarely have a long-term negative impact on the economies where they strike. Much like the politicians are trying to outdo one another with the estimated costs of disaster relief, economists are playing games of one-downmanship in reversing their economic forecasts. Even before Katrina, Montgomery Brothers was predicting that economic growth was likely to slow from the 4+% GDP growth of the past two years to something close to its long-term average of 3.5%. Whoa, Nelly! That’s now the consensus forecast.

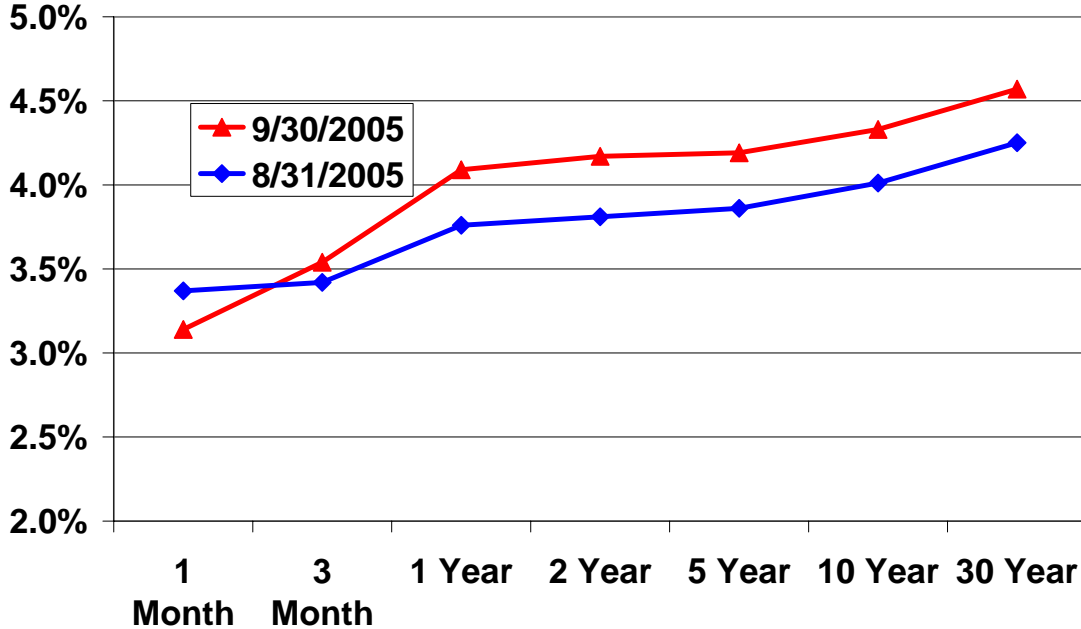
The US economy is far stronger and more resilient than most believe and certainly is a stronger steed than the one-trick pony that the press and politicians make it out to be.

## **Interest Rate Outlook**

Our initial reaction to Katrina was that a cessation in the Fed’s raising of short-term interest rates might be the pony to look for in Katrina. But, after hearing the political bidding war that broke out, MBI hopes that the Fed will stay its course. The rebuilding process and energy dislocations caused by these hurricanes will put additional upward pressure on price indices. If the financial markets were to believe that the Fed was going to monetarize some portion of these price increases, let alone the Federal Government’s increasingly irresponsible fiscal policy, inflationary pressure would mount. The recent rise in gold prices indicates a fear of this. The steepening of the yield curve since Katrina might be telling us the same thing. See below.



**Yield Curve for U.S. Treasury Bills, Notes, and Bonds  
9/30/2005 and One Month Earlier**



While most look to price indices to gauge inflation, MBI feels that inflation only becomes embedded in the economy when the Fed creates too much liquidity and monetizes too much of the federal government's debt. Part of the Fed's current tightening is meant to sop up some of the enormous amount of liquidity which it created earlier in response to the bursting of the tech stock bubble and the subsequent (mini) recession. But enormous amounts of

liquidity remain in the system chasing real estate and causing bond yields to be lower than they otherwise might be.

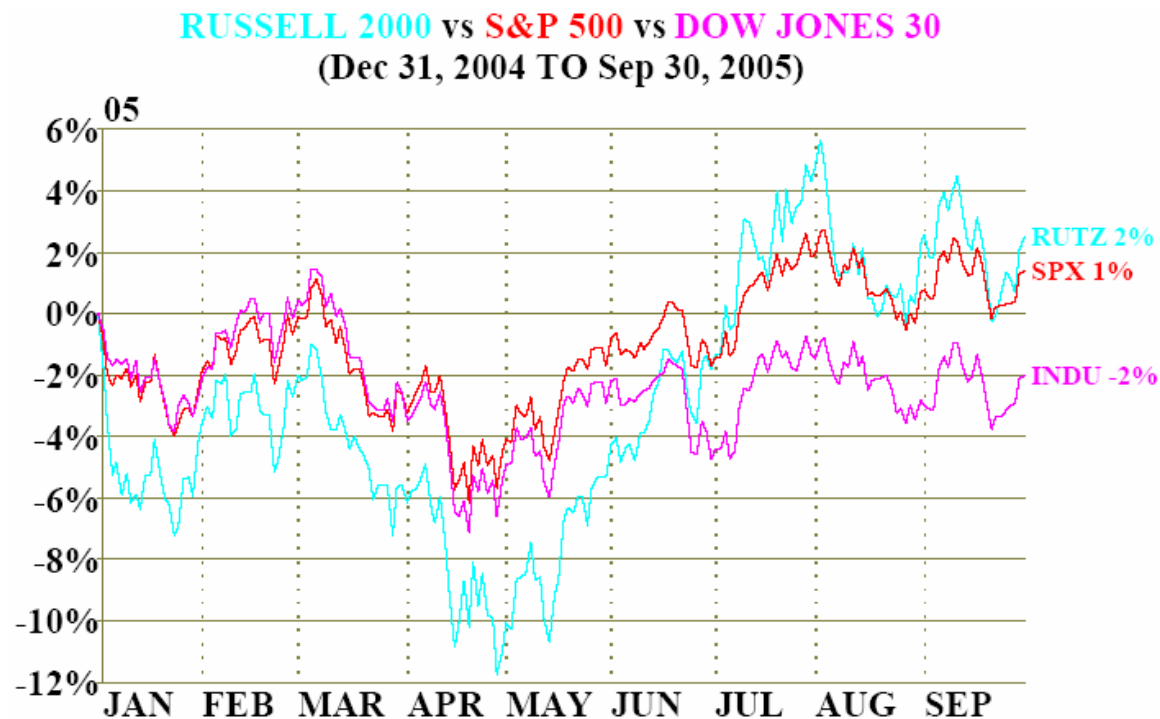
Fortunately, this time the Fed seems *unlikely* to print dollars trying to offset the effects of rising oil prices. In spite of protestations to the contrary, Greenspan seems to want to puncture the (perceived) real estate bubble. Is this to make up for having totally missed the very real technology bubble of the late 1990s? Unfortunately, Greenspan seems to believe that the Fed can fine-tune the economy *and* control inflation. MBI believes the Fed should concentrate solely on the latter.

The Fed is still far from neutral, let alone tight, with its current monetary policy. Even after eleven consecutive hikes in the Federal Funds rate, it's only at 3.75%. With most inflation gauges around 3%, that's a pretty low real interest rate. Expect more hikes!

With the economy strong, employment high, and inflationary indicators rising, the Fed has wisely decided not to consider Katrina an excuse to ease monetary policy. It's getting later in the business cycle, and the Fed is raising short-term rates while inflation is creeping higher and fiscal policy is turning irresponsibly more expansionary. Now does not seem to be a good time to be aggressive with bonds.

## Stock Market Outlook

The stock market is acting like a tired old nag. The major averages have gone nowhere this year and stayed in a very narrow band while getting there.



Even the small and mid-cap stock indices have made little progress in 2005 while their trading ranges have narrowed as well. Even though we've just entered October, during which we've historically had some truly awful markets, the fourth quarter is, on average and statistically, the best calendar quarter of the year. During last year's fourth quarter, the S&P was ahead 9% while it was up 9% for all of 2004. So seasonality *is* on the side of the bulls. Fortunately, valuations have improved. Shown below is the data from the October 2, 2005, issue of Barrons:

	9/30/2005	9/30/2004	% Change
<b>S&amp;P 500 Index</b>	1228.81	1131.5	8.6%
P/E Ratio	19.39	20.14	-3.7%
Earnings Yield %	5.16%	4.96%	4.0%
Earnings \$	\$63.36	\$56.17	12.8%
Dividend Yield	1.84	1.76	4.5%
Dividends \$	\$22.61	\$19.91	13.6%
Mkt to Book	3.35	3.49	-4.0%
Book Value \$	\$367.17	\$324.14	13.3%

(Source: Barrons, October 2, 2005)

While the S&P 500 was up 8.6% year over year (as of 9/30/05), the earnings per share for the S&P 500 increased by 12.8%, so the P/E actually declined by 3.7% to 19.4 from a year ago. The dividend for the S&P 500 increased by 13.6% and its yield rose by almost 5% from a year ago. So valuation is okay. Unfortunately, earnings growth is likely to slow, and rising energy prices and short-term interest rates are likely to put downward pressure on margins. The technical aspects of the market, unfortunately, do not look all that great to us. The technicals, however, are low on our list of considerations. MBI's bottom line is that while we aren't wildly optimistic about the market, we aren't pessimistic either. The market seems fairly to slightly undervalued.

During the first nine months of 2005 only the energy, utilities, and health care sectors outperformed the S&P 500. Montgomery Brothers continues to like the energy sector's prospects for the next several years and believes investors should be overweighted in the sector. MBI plans to use any price weakness in the oil patch to establish new positions in some of the energy industries where client portfolios are underrepresented, specifically the drillers and equipment/service companies. We believe that the political process provides a potential catalyst for these industries. The integrated oil and gas companies, the explorers and producers, and the refiners have been coining profits. Much of their profits and free cash flow has been used to buy back shares, raise dividends, and make acquisitions. Unwilling to settle by merely being fiscally irresponsible with the taxpayers' money, politicians feel compelled to get involved in the energy area and to do something symbolic to penalize the oil companies. Washington skies are dark with the trial balloons of excess profits tax proposals and, in spite of the previous failures of such Trojan horses, the politicians will not be deterred. Einstein once defined ignorance as doing the same thing over and over again while

expecting different outcomes. Ignorance is bliss in DC! Expect stupid energy-related legislation to be passed soon.

As a result, MBI expects that the oil companies will drill everywhere anyone will let them and that Congress will actually let them drill in more places. We find it humorous that when the disgraceful pork-laden piece of garbage mislabeled as the energy bill was passed, many whined that there were not enough conservation measures in the bill. There will never be more effective conservation measures than \$3.00 per gallon of gasoline. Net, net: we think that spending on drilling and exploration is going to increase dramatically.

So far, 2005 has been a lackluster year for the stock market, but MBI is cautiously optimistic that the year will end on a strong note. Would that make the fourth quarter a horse (pony) of a different color?

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Some charts courtesy of Baseline.