

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Fourth Quarter, 2006 Investment Outlook October 1, 2006

Wearin' of the Green!

Maryann and I just went to Ireland for a week to sightsee and play golf. While I was out of the office, the Dow went up 185 points or 1.6% to close at a five-year high on the day I got back to the States, less than 0.5% below its all-time high in January, 2000. The market then declined on the Friday that I returned to the office. While I don't take it personally, I am expecting calls and e-mails from clients and friends suggesting that I go away more often and that if the market is going up while I'm gone to stay away.

Many of you may have read recently in TIME Magazine the article in which Ireland was referred to as the "Celtic Tiger." The Emerald Isle is, indeed, *booming* with low unemployment, a rapidly growing economy, and lots of home and office building. There is not much left of the poverty which was prevalent a quarter of a century ago when Maryann and I first vacationed there. Much of the credit for Ireland's economic renaissance can be credited to the policies of lowering tax rates, reducing regulation, encouraging free trade, and liberalizing immigration, which the Irish government initiated during the late 1980s and early 1990s. Additionally, a relatively well-educated and English-speaking populace along with plenty of government incentives made Ireland a logical place for U.S. companies to base European operations.

Both the United States and Ireland have experienced a long period of largely uninterrupted economic growth, but naysayers abound. Reading the Irish newspapers made me feel right at home. Articles stated that the Irish real estate market had propelled the economy upward but was a bubble about to burst. When the bubble bursts, consumer spending will collapse and the economy will tank. It's a small world after all!

One of the best things about this vacation was the welcome respite from the political theater of the U.S. mid-term elections. Except for a news summary I got one morning at one of our hotels containing a *New York Times* headline that both parties planned to use negative advertising (I couldn't quite figure out why it was considered news, let alone headline news), we were blissfully spared U.S. politics for seven blessed days. Instead, we had to satisfy our political voyeurism with the travails of Bertie Ahern (the Irish Prime Minister) who apparently borrowed money or took bribes (depends on whether you like or loath him) from political supporters back in the early 1990s. It felt like home.

Since the beginning of the year things have gone from bad to worse for the Republicans. In spite of all of the benefits of incumbency, the public seems sick and tired of Republicans, in general, and with George Bush, in particular. The Democrats appear to have a better than 50/50 chance of regaining control of the House, a bit less in the Senate. But it's weeks until the election and lots can happen, so it's anyone's guess.

The markets are unlikely to take a Democratic win in November very well. Old liberal Democratic war horses will gain power and talk will shift to raising taxes, increasing social spending, and expanding protectionist policies. Regardless, gridlock is likely to continue if not get worse. Interestingly, most believe that gridlock is good for the stock market, but a recent *Financial Analyst Journal* article argues that just the opposite is true. Regardless, we see little reason to view any results from November positively. Given the past six years, it's hard to be optimistic about the last two years of George Bush's final term in office.

Economic Outlook

I returned to the United States refreshed and ready to reexamine my core beliefs and forecasts about the U.S. economy and financial markets. But, alas! In spite of what seems momentous on a daily basis, not much happened during the week I was out of the office. Housing hadn't gone off a cliff; the economy had neither overheated nor slumped; interest rates went down; the stock market went up.

While I was gone, the participants in The National Association of Business Economists survey reduced their consensus forecast for economic growth. This followed government reports that economic growth had slowed. Forty-six percent of NABE respondents cited higher energy prices as the biggest threat to the economy. The survey was conducted between August 9th and 24th. Oil prices peaked in mid-August. Additionally, the Bureau of Economic Analysis released its revisions to the National Income and Products Accounts (NIPA). Unfortunately, over the past several years, the revised NIPA data showed that economic growth was lower and inflation higher than previously reported. This is *not* what one wants to see.

Henry Paulson took over as Secretary of the Treasury replacing John Snow, who did a poor job convincing the American public that the U.S. economy was doing as well as George Bush has been telling us. The administration hopes that Paulson, former head of Goldman Sachs, will be the Republican equivalent of Robert Rubin, former head of Goldman Sachs, who as Secretary of the Treasury, *was* able to convince the public that Bill Clinton was good rather than lucky when it came to the economy. Good luck, Hank! And welcome to Washington.

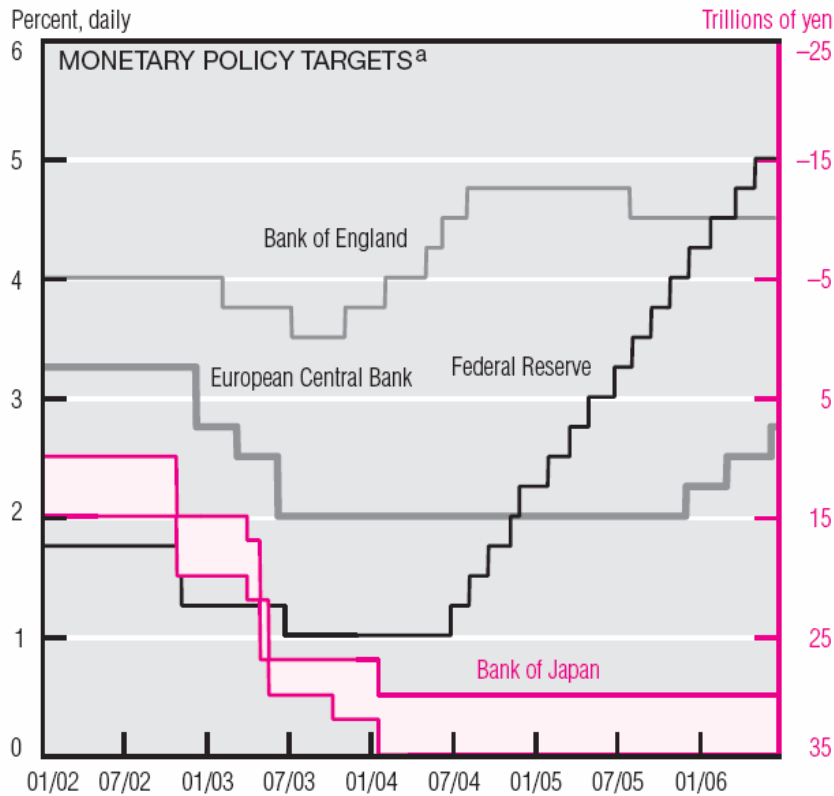
In a world of polls and indexes, we recently came across one we weren't familiar with: *The Washington Post* – *ABC News* Consumer Comfort Index. Yet another measurement of consumer confidence, it can range from a high of +100 to a low of -100 and recently read -12. In existence since 1985, its all time low was in February 1992 at the

beginning of the greatest bull market in history and the longest economic expansion on record, and its all time high was in January 2000 — near the top of the stock market bubble and about a year before the economy went into recession.

Given the current consensus forecasts of the NABE of slowing economic growth and the near neutral comfort level of American consumers, it’s difficult to be too negative on the economic outlook. With the exception of housing, things look pretty good.

Interest Rate Outlook

Ben Bernanke is not Irish. So it wasn’t too surprising not to see his name in print for the week that I was in Ireland. But now that I’m back, I return to the steady diet of “what will the Fed do next?”— so popular with the U.S. financial press. In our opinion, the outlook for monetary policy remains data dependent, so as we’ve been saying, “it all depends.” A closer examination of the rest of the economic world (easier to do in Ireland, which is more globally focused than the domestically-myopic United States) indicates that interest rates are going up everywhere else and are likely to continue to do so.



The Fed’s credibility, valuable currency in monetary policy, is at stake. The bond market seems convinced that we’ll have the proverbial “soft landing.” Since the Fed last raised rates, the 10-year bond yield has declined from a 5.25% yield to 4.63%; junk bonds have rallied and yield spreads have stayed narrow. Additionally, oil prices have weakened, gold prices declined, and the dollar rallied. While we’d like to be as convinced as the bond market that inflation will decline and we wish Ben and his colleagues at the Fed the “Luck of the Irish,” our doubts remain. While it seems logical that slowing economic growth will

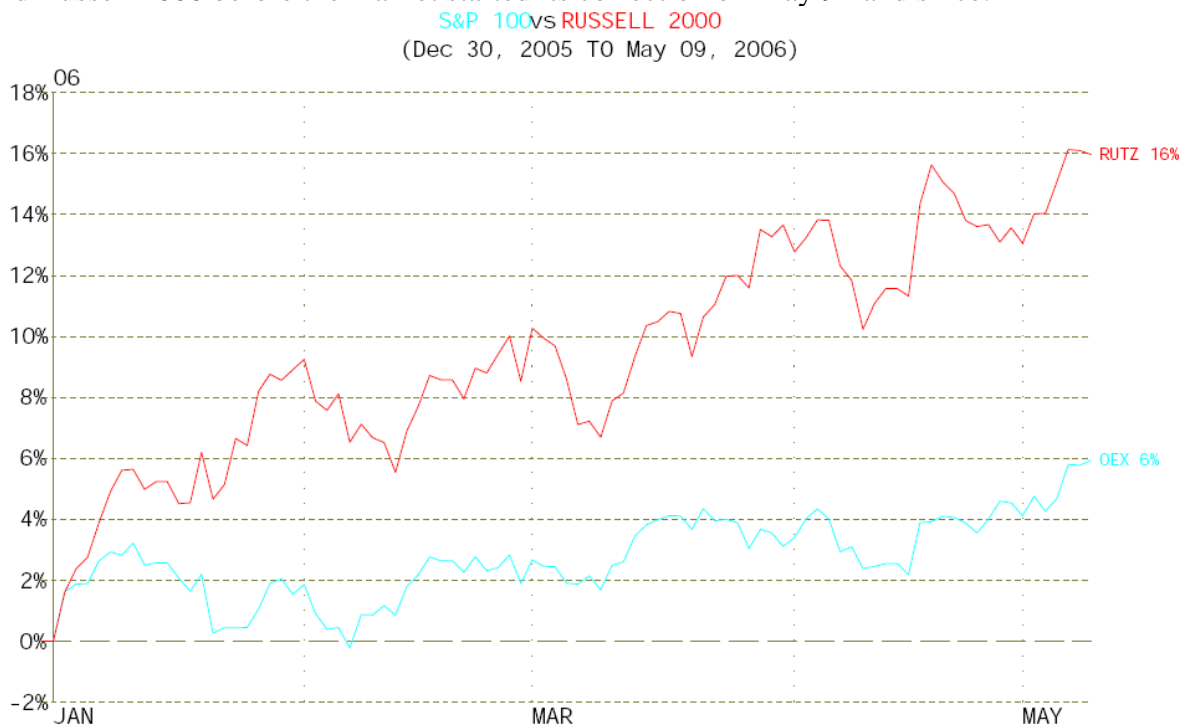
reduce inflationary pressures, recently released transcripts from the Fed’s meetings in 2000 show that the Fed was too worried about inflation back then and got monetary policy wrong just before the last recession. Could the Fed *and* the bond market be wrong?

Stock Market Outlook

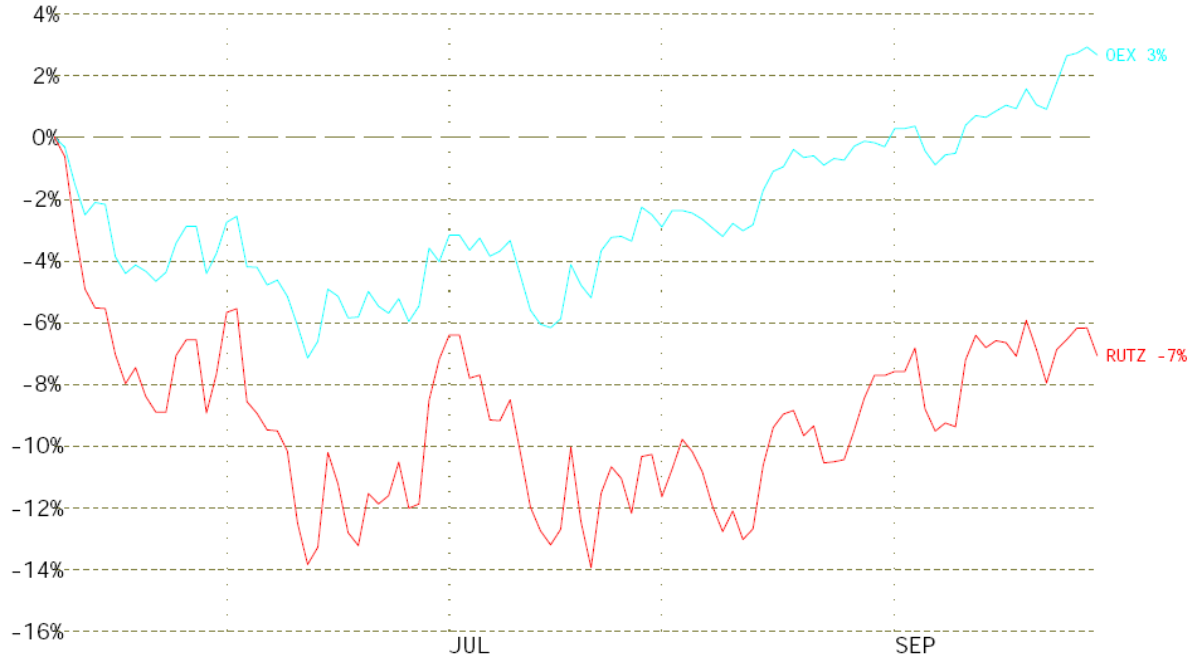
My idea of high risk is playing Ballybunion with good friends in a driving rain with 40 mph gusting winds for a two dollar nassau. I know I’m going to score poorly and lose a lot of golf balls and probably a couple of bucks, but I’m likely to survive. Far too many stock market investors think they’re merely playing a small stakes game at Ballybunion on a bad day when they could be playing Tiger Woods on his home course for big stakes after the United States lost in the Ryder Cup. You’re not sure what you’re doing and you could lose **BIG!**

The stock market did well during the historically weak third quarter. The S&P 500 rose 4.6% during the quarter which was a welcome relief after its decline in May and June, and compares favorably with the average 2% decline during the third quarter over the past 16 years. While much has been made of the Dow Jones Industrials flirting with its all-time high, the S&P 500 is still 12% below its all-time high; the NASDAQ composite is 50%+ below its all-time high. Meanwhile, the small- and mid-cap stock indices hit all-time highs long ago and continued to set new highs until the May–June “correction.”

From the good news/bad news files, it looks like the performance leadership has finally shifted from the small- and mid-cap stocks, as represented by the Russell 2000, to the large-cap stocks as measured by the OEX. Both are up above 9% so far in 2006, but as you can see from the charts below, there was a distinct shift between the performance of the OEX and Russell 2000 before the market started its correction on May 9th and since.



S&P 100 vs RUSSELL 2000
(May 09, 2006 TO Sep 29, 2006)



The good news is that MBI has been looking for this leadership change for quite some time. The bad news is that we're now somewhat less positive on the stock market outlook for the rest of 2006 since some of the fourth quarter rally we were forecasting may have happened during the third.

We fear that the proliferation of alternative investment products, the recent outperformance by small- and mid-cap stocks, and the increasing popularity of international investing could be leading many investors to take on more risk than they think they are. All of these investments play a role in a well-diversified portfolio, but increasing one's exposure to any investment after a long period of outperformance entails more risk than is often readily apparent. Besides, few feel they're taking much risk when they're making money, and almost everyone feels that they're taking too much risk when they're losing money. But aren't we all looking for that pot of gold at the end of every (investment) rainbow?

We've managed to get through a seasonally weak period during the poorest performing year in the average four-year presidential cycle in pretty good shape, so let's not blow it. While others are getting increasingly optimistic, we see some reasons for caution but not too many to be pessimistic. The market is back up toward the upper end of its gently upwardly sloping trend lines; longer-term interest rates have already declined; and price earnings multiples have risen to high levels, at least by historic standards. Economic growth is slowing, which could cause corporate profits growth to slow, but from record levels in absolute and relative terms. Hedge funds are looking to raise funds from the public, both by selling their own stock to the public and by making it easier for the "little guy" (and we don't mean leprechauns) to get into their funds — these are not good signs. Investor sentiment has turned positive but is far from euphoric. Quietly, this market is set to become the longest cyclical bull market without a 10% correction since the 1930s, so we remain due.

Next year my stepbrother, Tommy Walsh, turns 60 and we're all going to Ireland again.

Top o' the Mornin' and Sláinte is táinte!

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Some charts courtesy of Baseline and Federal Reserve Bank of Cleveland.