

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Mid-Fourth Quarter, 2005 Investment Outlook Update November 18, 2005

Full of Sound and Fury, Signifying Nothing

Shakespeare's Macbeth

There's a lot of noise out there, people, so be careful. One of the ironies of the information age is while there is so much more information, it seems to have less informational content. It's more like noise than news.

Take the recent off-year elections. The Democrats hold the governorships of Virginia and New Jersey and we are (mis?)informed that there is a political sea-change occurring. While few will deny that George Bush is a controversial and, at least currently, unpopular President, the death knell for conservatives, in general, and Republicans, in particular, might be a wee bit premature. There is no doubt Bush's popularity has plummeted. Why, it's as low as Congress' and only slightly below that of Democrats. The idea that these recent elections will straight line to the Democrats retaking the House and Senate in 2006, is beyond ludicrous. But to read the papers and listen to the evening noise (err, news), it's a "slam dunk." If anything, this handful of local elections may presage a swing by both Republicans and Democrats back toward the political middle. While the press and pundits babble on about how the Republicans have "lost their discipline" maybe a few of them are finding their way and possibly even a little political backbone. Well, you can always hope.

There have been a few small and tentative steps by a handful of politicians towards fiscal responsibility, but small and tentative are the operative phrases. "Spending cuts" are too often euphemistic for reducing the rate of increases in spending and seldom, if ever, real reductions. All too often, even tiny reductions in the rate of increase are met with deafening screams from each and every special interest and their political patrons. "Tax reform" is similarly greeted with howls of pain from every beneficiary of political largess who might see their stipend reduced. The lack of spending restraint and the unlikelihood of (real) tax reform could negatively impact the 15% capital gains and dividend tax rate extensions which may become casualties of this new found fiscal responsibility. We hope not.

Virtually every second-term presidency in the last century has been plagued by plummeting popularity and by scandals. In fact, second-term presidencies are the most convincing argument to move to a single, six-year presidential term. (But I digress.) Political sea-changes are few and far between and the Republicans ARE in disarray, at least for now. But the fact that the Democrats have no plan, few clues and only a handful of attractive candidates, might be viewed as negatives. Also, the Democrats have the Republican's most valuable player – Howard Dean! who recently coined the term “Merlot Democrats” to describe the party's core constituency and supporters. Would you want to be known as a “Merlot Democrat”? Ahhhhhh!

Economic Outlook

Similarly, we keep hearing and reading about the impending collapse of the U.S. economy. After ten consecutive quarters of GDP growth above the thirty-year average, one would think that maybe you'd hear some positives. You'd be wrong. The argument that fifteen quarters of economic growth, a doubling in oil prices, thirteen consecutive increases in the Fed funds rate and a couple of devastating hurricanes might lead to an economic slowdown is pretty convincing. While few are flat out predicting a recession, forecasts of “stagflation” (slow growth, higher inflation) abound. We admit that we continue to be impressed by the U.S. economy's resilience and we've been in the positive camp. MBI remains in the minority of economic bulls.

In general, good news continues to be drowned out by bad noise. The consumer continues to plow ahead, refusing to buckle under to the rumors of their demise. Global economies continue to expand. (Why even Japanese and European economic growth might rocket into low single digits.) Corporations are, by and large, flush with cash and a capital spending pick-up seems probable. Inventories are low and the trade deficit is likely to improve as oil prices return to normal.

On the negative side of the recession argument, the long-forecasted real estate bubble (we've seldom heard such dogged forecasting persistence) might be starting to deflate. A dramatic bursting is unlikely, but the “told-you-so's” could prove psychologically negative but definitely will be deafening. And, our friends at the Fed are likely to keep raising rates for a bit longer, adding to the negative chorus. MBI continues to believe that growth will be higher and inflation lower than the consensus is forecasting. That's been our story and we're sticking with it.

Interest Rate Outlook

“Are you now or have you ever been....an inflation dove?” This is the type of tough questioning that the press and politicians had for Ben Bernanke who was unanimously approved to succeed Alan Greenspan as Chairman of the Federal Reserve. Given 25 years of hard fought victories against inflation and a sense of institutional propriety that is legend at the Fed, it's highly unlikely that Bernanke would admit to being an inflation dove – even

if he was. MBI expects little, or no, change in Fed policies for the foreseeable future but that's easy to forecast when monetary policy is flown by the seat of the Fed's pants. The discipline of inflation targeting could be an improvement.

Alan Greenspan is a legend and is highly revered by most politicians and members of the press. He has single-handedly saved the economy and financial markets from ruin on many occasions and is largely responsible for most, if not all, of the successes of the global economy and financial markets for the past eighteen years. Or, so the story goes! The real story is that the Fed has a great deal of moral suasion over the economy, has control of the Fed funds rate at its disposal, and the ability to buy and sell U.S. Treasuries for its own account. (This last item is the true building block of inflation.) But it really is not the all encompassing economic power that it's cracked up to be. It is much more interesting to make it seem as if the Fed, in general, and the Fed Chairman, in particular, are like the "all and powerful Oz." The fact is that the financial markets are able to, and would, discipline the Fed should it drift very far from anti inflation orthodoxy. Once upon a time the Fed actually carried a much bigger stick and, while MBI understands the important role it plays, much of the Fed's cachet is a figment of press and politicians' hype and imagination.

Meanwhile, short-term rates continue to rise and the yield curve continues to flatten. The flattening yield curve remains Montgomery Brothers' greatest economic concern. In all likelihood, the Fed has two more turns of the monetary screws under Greenspan then one or two more under Bernanke, who needs to show his inflation fighting "bona fides." The Fed has a history of overdoing it but our guess is that, while Greenspan doesn't want to be seen as soft on inflation at the end of his term, Bernanke certainly doesn't want to be blamed for a recession at the beginning of his. Stay tuned!

Stock Market Outlook

Montgomery Brothers has long been impressed by the ability of the press and the pundits to explain virtually every wiggle and jiggle of the stock market. We are still, however, waiting for a plausible explanation of why the Dow dropped 500 points in a single day in October of 1987. Meanwhile, as the major stock averages continue to trade in an historically narrow range, each wiggle and jiggle seems to take on greater and greater significance. All the while, it's becoming harder and harder to outperform the market averages even as the pressure to do so builds. As we drift towards the end of 2005, these short-term performance pressures will increase since year-end bonuses for all too many hinge on it.

The sectors which did the best (energy and utilities) during the first three quarters, have done the worst so far in this quarter while some of the sectors which had performed poorly earlier in the year (financials and materials) have been among the best sector performers so far during the fourth quarter. Noisy explanations abound.

Seasonally, November and December have (historically) been a favorable time to be invested in the stock market. The old “Santa Claus Rally,” don’t you know? But nerves are frayed as this disappointing and frustrating year limps towards its end. And, as it does, the performance pressures build as underperformers strain to get ahead and outperformers try to hold their gains. This might explain why \pm 100 point days on the Dow have been twice as frequent so far this quarter as they were earlier in 2005.

MBI remains nervously and cautiously optimistic on the stock market outlook into year-end 2005 and early 2006. However, given what we see as full valuations and deteriorating technicals, we are more nervous and less optimistic than we were earlier. We will listen to all of the noise emanating from Washington and Wall Street but try to pay it little heed. It is, after all, more noise than information and often signifies nothing or at least not much.

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