

## **Economic Conditions & Market Outlook**

Not surprisingly, the beginning of the calendar year is when investors have historically searched for signs that will portend the market outlook for the twelve months ahead. From the often inaccurate, yet still followed, “January Effect” to the tongue-in-cheek and thoroughly debunked “Super Bowl Indicator,” market forecasts and forecasters are in full bloom this time of year. Forecasting adds a sense of control and predictability to things that are neither, with many predictors looking for patterns in random events and then incorrectly deducing cause and effect. And while most predictive methodologies purport a higher degree of sophistication than whether an AFC or NFC team reigns victorious, many market prognostications remain remarkably inaccurate.

Why? Simply put, the globe’s multinational economies and accompanying markets have so many variables moving in so many different directions that any forward-looking predictability of overall market outcomes based on past ‘correlations’ becomes hit-or-miss at best. To wit, some market observers noted that 2005 was the first time the Dow Jones Industrial Average did not jump more than 10% in a calendar year ending with the digit ‘5,’ inferring that last year’s DJIA anemic performance of -0.61% was somehow out of character. This implied correlation between date and data was hopefully not used as a harbinger of upside market performance by investors when they started off last year.

While the above example of misleading cause/effect correlation may seem too absurd to entice anyone, the desire to extrapolate long term economic moves from singular events remains strong. Fast forward to the start of 2006 and many financial pundits were wringing their hands over the appearance of an ‘inverted’ yield curve during the last part of December 2005. In essence, a yield curve inversion means that shorter-term interest rates are actually higher than their longer-term counterparts; a flip-flop of the norm in which fixed income investors are typically rewarded with higher yields for taking more risk via longer term bond maturities.

Why the concern? Because an inverted yield curve has been linked with most of the economic recessions in recent U.S. history; specifically the recession that started in March 2001, as well as the ones in 1990, 1981, 1980, 1973, 1969, and 1960. A compelling correlation? Perhaps. But similar to assessing the validity of something as ludicrous as a NFC gridiron victory assuring a year of market prosperity, it is imperative to determine whether and why any singular event might have a lasting impact on overall market performance.

In the case of the inverted yield curve, it is not the curve itself that inherently causes any economic problems. Instead, an inversion has typically been indicative of the Federal Reserve raising short-term rates too far in an effort to slow growth and inflation that instead ground the economy into a recessionary halt. Currently, despite fourteen consecutive quarter-point interest rate increases by the Fed, short term rates are still rather low versus historic averages. The real contributor to this recent inversion was the continual high demand for 10-year U.S. bonds which has kept longer-term interest rates relatively low, as noted in a previous *Investment Update*. So while the result may remain the same, the cause and effect may be very different indeed.

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This again underscores one of our firm's core principles; that good investment strategists and asset managers objectively interpret market data without predetermined expectations. They are neither dyed-in-the-wool bulls nor bears because there is usually more than enough information to make the case for either side. Discernment is critical. Our view is that successful long-term asset management is not the result of crystal-ball prognostication but instead results from the diligent focus on portfolio fundamentals and the nimble response to inevitably changing markets

So what current economic factors may influence the market in the months ahead? The economic expansion continues to percolate along for the fifth year in a row. Due to this ongoing growth, it is widely expected that the Federal Reserve, now under new leadership, will continue its current course of raising rates until a targeted 4.75%-5.00% Fed funds rate is reached sometime mid-year. Inflation will most likely creep upward as worldwide demand for energy grows and higher petroleum costs work their way through the economic pipeline.

Individual consumer confidence remains high. However, it is yet to be determined whether the combination of slower appreciation in real estate prices and higher interest rates will hit the home equity piggybank hard enough to curb still robust consumer spending. Continually increasing energy costs could also potentially dampen consumer enthusiasm and reduce household disposable income but to date, somewhat surprisingly, that has not been a significant factor.

Corporate spending continues to be modest and this lack of outflow has helped many companies reach and maintain near-record levels of profitability. The average operating earnings for Standard & Poor 500 companies have increased at double digit rates for several consecutive years, a pace that cannot continue ad infinitum. Rising energy, labor and healthcare costs will likely dampen this corporate bottom-line growth but certainly not stifle it entirely. And companies will eventually need to bolster capital spending for improvements to infrastructure and technology. In the meantime, this profitability has left companies flush with cash and contributed to higher dividends, stock buybacks and an increase in corporate merger activity.

It is always important to remember that the economy and the stock markets do not move in lock step. So despite the economic growth and record profits, the S&P 500 index closed up only +3.00% while, as noted, the Dow Jones actually fell -0.61% for calendar year 2005. The Nasdaq Composite Index squeezed out a +1.40% annual gain but remains under its March 2000 high water mark by nearly -56.00%. Additionally, the markets were relatively nonvolatile during the year, spending most of the time in a relatively narrow trading range.

The resulting ho-hum performance of the equity markets as a whole masks significant gains that were made in the several industry sectors, most notably Energy and Utilities. (Incidentally, both sectors were held last year by Roof Advisory Group at above-benchmark weightings.) For example, while the Dow Jones Industrial average limped in at -0.61% as noted above, the Dow Jones Utility average topped off the year at +20.95%. Not bad for a segment of the market not too long ago dubbed by so-called 'market mavens' as being appropriate for only widows and orphans. This example further illustrates the importance of equity selection, particularly in a range-bound market, because even within the Utilities sector there were very distinct winners and losers.

Additionally, the performance of stocks viewed as fundamentally 'value' oriented again collectively outpaced the returns of their 'growth' style counterparts. This continues a trend that started after the tech bubble burst, with the Russell 1000 Value Index gaining +29.3% for the five calendar year period ending December 2005, compared to a -16.7% decline in the Russell 1000 Growth Index for the same timeframe.

Returns from the bond market were modest in 2005 as well. Most bonds prices fell during the year as rates continued to rise but bond interest payments typically offset this decline in value, allowing the more moderate fixed income indices to eek out positive total return numbers for the year. As a whole, short term fixed income vehicles, i.e. money markets et al, provided the most attractive net return of any broad asset class for the period.

In general, 2006 bodes more of the same for the markets with several possible caveats. On the equity side, it would not be surprising to see a higher degree of price volatility driven primarily by either positive or negative investor perception. Positive factors could range from the Fed coming to the end of its rate hiking progression, thus eliminating one uncertainty currently keeping investors nervous, to increased corporate capital spending, reduced energy costs, and ongoing positive earnings results. Negative factors could range from higher than expected inflation as a result of rising commodity and energy costs to a dramatic drop-off in corporate earnings and a slowdown in the economy as a whole.

Longer-term bond rates may remain somewhat depressed but we are already seeing the beginning of an uptick in some intermediate yields that mirror rising shorter term rates. As with stocks, bond market success in 2006 will require ongoing diligence and selectivity. Moving forward, rising interest rates will also put upward pressure on the returns that investors expect from stocks to be adequately compensated for the additional risk. Without that premium, investors may choose to remain on the equity sidelines or ultimately allocate more toward fixed income securities.

Overlaying these issues is the war in Iraq and geopolitical tension in the Middle East and beyond. Any steps toward resolving our military involvement overseas would tend to be perceived as a market positive while increased uncertainty, conflict and spending would be viewed in a less than favorable light.

Consensus within the financial community regarding the specific direction of the economy is often a rare commodity. These differences of opinion are even harder to reconcile when trends and indicators remain middle-of-the-road, thus prompting some observers to see the glass as half-empty while others see it as half-full. Add to this the country's current political polarization and it's no wonder 2006 might seem to offer a real mixed bag. This dichotomy was illustrated recently in Forbes magazine where page 132 contained an article titled "Long And Optimistic," outlining why "*In the U.S. stock market, better times are ahead*," while page 134 featured "A Dark Year Lies Ahead," an article explaining why "*The coming end of the housing mania will push the U.S. and the world into a recession*." Hmm...well, at least the "Super Bowl" theory eliminates confusion.

### **Our Tactical Investment Stance**

Roof Advisory Group's disciplined strategic investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's personal investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- For the majority of clientele, we remain ***one step below maximum equity allocation*** as defined by their individual investment policy. The firm maintained this equity allocation position throughout most of 2005, with the exception of a brief drop to equity range midpoint immediately following the one-two punch of hurricanes Rita and Katrina in early autumn.
- We continue to ***add new equity positions*** when attractive buying opportunities are presented. The firm's individual equity focus favors companies with solid management, consistent earnings, low P/E ratios (18 or below), dividend yield (2.5%+), and annual appreciation potential (10%+). Stocks outside these parameters are also used when unique pricing or appreciation opportunities exist. Equities are sold if they no longer meet the parameters prompting their original purchase or when reaching a predetermined price target. Price reductions on certain selective 'growth' style stocks have compressed their P/E ratios to the point where we see an attractive entry point.

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- As always, *diversification remains a priority* for both equity and fixed income portfolio components. Overall exposure in equities is regularly evaluated for diversification based on style, business grouping, and industry sector while fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region.

While the firm does not make deliberate industry sector bets, above-benchmark concentrations can result from our equity selection process. As a result, currently *Energy, Utilities, & Telecom* sectors are now often concentrated at *slightly above index weightings*; with *Industrial Materials, Business Services, Consumer Goods & Information Economy* being held closer to *market weight*. The *Financial Services & Healthcare* sectors are *slightly underweighted*, with *Consumer Services* being notably *below benchmark level* concentration.

- Our general *leaning towards large cap stocks* has served client's well and remains intact. Mid/small cap equity exposure is typically at mid-point or below defined policy range. Specific international equity exposure is maintained through large multinational firms rather than strictly foreign-based companies that entirely avoid the U.S. market.

- New accounts and large cash infusions are typically phased into their targeted investment policy levels. The *deployment of cash for equity purchases is currently paced* based on market opportunity while the *deployment of cash for bond purchases has accelerated* as more attractive short term rates have started to appear, particularly during the past thirty days. This will continue as bond yields improve.

- Individual bonds are used for larger fixed income portfolios to control quality, maturity, and yield. In the past, our overall fixed income management process has favored high-quality, investment grade bonds (BBB and better) of short to intermediate term maturity (2-15 years) and have targeted an average bond portfolio duration of 7-9 years.

However, we have notably *shortened average bond maturities* over the past several years due to the rising interest rate environment, with most of our portfolios *currently exhibiting durations of 3 years or less*. On the taxable bond side, the firm typically favors the yield pick-up often offered by corporate paper, although *recently very short term CDs and selective short U.S. Agencies* have provided the *most attractive taxable bond opportunities*.

Similarly, utilization of *short maturity municipal bonds* has been selectively *increased during January* as yields and availability continue to improve. A client's tax bracket/account determines whether taxable or tax-free bonds are more advantageous. In all portfolios, overall bond quality is not sacrificed in the pursuit of higher yield.

**E. Jeffrey Roof**