

Market Commentary

Reasons for Hope

It is likely that the Fed is much closer to the end of its interest rate increases than the beginning.

Stock market performance in 2005 was similar to 2004. There was little movement in the broad market averages for the first ten months of the year followed by a small year end rally. Broad market averages were up slightly for 2005, but this is largely due to strength in only a few industry sectors (energy in particular).

The equities market lackluster performance is due mostly to the following:

In 2005 the Fed repeatedly raised interest rates. The last time this occurred in 1994 the performance of the stock market was similarly poor.

The price of energy went up dramatically in 2005 crimping consumer spending. Although energy plays a smaller role in the economy now than it did two decades ago, rising energy prices still get the consumer's attention.

The Federal budget and trade deficits continue to climb to potentially dangerous levels in 2005 causing concern about the value of the dollar, inflation, and the future economic power of the U.S.

Certainly there was no less geopolitical turmoil in the world in 2005 than 2004. Threats of terrorism, the war in Iraq, tensions with China, domestic unrest in France all create uncertainty, and uncertainty is bad for stock prices.

While valuations are not as outrageous as the tech sector was in 2000, stocks are not cheap in terms of historical price to earnings multiples. This leaves little room for substantial appreciation without a positive catalyst.

Given these negative factors it is in many ways rather encouraging that the stock market has done as well as it has. This provides some reason for optimism in 2006.

It is likely that the Fed is much closer to the end of its interest rate increases than the beginning. Most analysts expect two or possibly three more increases, but even that will leave interest rates low relative to rates in the 1970's, 1980's and 1990's. Equally important, the Fed's actions have had little impact on longer term rates. The benchmark ten year Treasury rate is up only slightly since the Fed started to raise rates.

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Gasoline prices have fallen substantially from post-Katrina levels and oil producing countries are very conscious of the fact that rising prices have an impact on demand. New production has come on stream and there is a new commitment to adding refining capacity. SUV sales have been weak which indicates a new sensitivity to energy conservation. Thus we are very skeptical about the doomsday scenarios such as the prediction of oil at more than \$100 per barrel in the near term.

While stocks are not screaming bargains, there are still some good values in the market. We continue to believe that the sweet spot in the market is in dividend paying stocks. If, as we believe, stock price appreciation is going to be modest and uneven in the near future, it is important to garner some predictable returns that dividends provide.

Thus we enter 2006 feeling cautiously optimistic about portfolio returns in the coming year.

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