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Quote of the Quarter

"If inflation has been near the high end of the acceptable range and policy makers foresee the significant risk that inflation and inflation expectations may rise… then stronger action in the form of tighter monetary policy may prove necessary."

Dr. Ben Bernanke
Federal Reserve Chairman, Nominee

FEAR, ANXIETY, and EXPECTATIONS

My, how quickly things can change. In June of this year, the date of our last *Investment Watch*, we wrote:

> *"A typical mid-cycle slowdown is apparent, which guides us to an estimated Real GDP (Gross Domestic Product) growth rate of 3.0 - 4.0% for 2005, down from 4.4% in 2004, but healthy and above trend nonetheless."*

Second quarter Real GDP was reported as growing 3.3%, down from 3.8% in the first quarter and down from peak year-over-year growth of 4.7% in early 2004. Higher energy costs were taking a toll, and more importantly, the duration of strength from the U.S. consumer was long in the tooth. So it was natural, or typical, to experience a deceleration in consumption.

However, going into mid-summer the economy re-accelerated. Consumer spending advanced in June, after a flat May, and Consumer Confidence rose to a level not experienced since early 2002. By the end of July, Retail Sales had increased more than 10% over prior year sales. The service sector, as measured by the Institute of Supply Management Service Index (ISM), had reached its second highest measure on record, indicating service sector strength. This index indicates the strength of orders as seen by purchasing managers in the service sector. Similarly, manufacturing (measured by the ISM-Manufacturing Index) was re-accelerating, following an earlier respite. As a percent of sales, inventories reached record lows by August and production increases were required in order to replenish low shelf inventory. Likewise, Construction Spending was at a high level, though decelerating, and Durable Goods Orders surprisingly increased. The fly in the ointment was higher energy costs. Still, energy represented more of a nuisance than an all-out problem. Many companies either had room to absorb the costs or had pre-established pricing measures designed to offset such events by contractually passing on the price.

The key point is that the economy was strong and getting stronger leading up to hurricane season. In fact, by the end of the 2nd quarter, U. S. Economic growth had experienced nine consecutive quarters of greater than 3% GDP and forecasts called for a tenth by the end of 3rd quarter. **This represents the best U. S. economic growth since March of 1986 and stronger than any extended period of strength during the decade of the 1990s.** Then there was Katrina! Followed by Rita!

Hurricane Destruction

Hurricane Katrina made landfall on August 29th. As the nation's costliest natural disaster, early estimates of financial destruction climbed over $200 billion. Most economists immediately cut estimates for third quarter Real GDP by one-half percent. GDP consensus had called for 4.1% growth, so the reduction took estimates to a still above trend 3.6% growth rate. In an $11 trillion economy, "feared" economic destruction spanned far greater than the Gulf region with its shipping and energy interests. Accordingly, immediate discussions as to the possibility of a Fed Reserve rate pause ensued. Precedence demonstrates that the Fed has been quick to respond to economic shocks, and this event certainly qualified as a shock. Congress was quick to allocate over $62 billion in aid for rescue, recovery and repairs.

All thoughts of a pause were abruptly dismissed as a result of energy induced inflation acceleration. Gulf coast offshore crude oil production accounts for 29 percent of total U.S. production; crude oil refining capacity accounts for 47 percent of total U.S. production; and offshore natural gas production accounts for 19 percent of total U.S. production. Also, a significant portion of the Gulf coast's petroleum products—

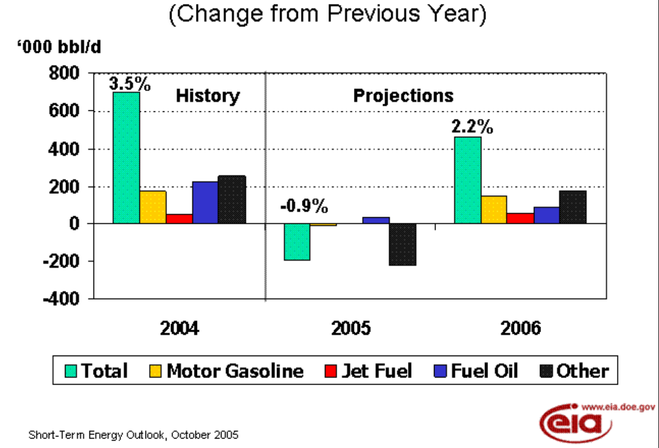
gasoline, diesel, and jet fuel—is shipped to Eastern U.S. markets through pipelines or transported up the Mississippi River to Midwest markets. Immediately following Katrina, 95% of the region's oil production and 88% of the region's natural gas production were "shut-in." Oil futures surged as high as $70.85 per barrel, up from $55 - $60 in July, Natural Gas reached $14.75 mcf (per thousand cubic feet), up from less than $8 mcf, and gasoline at the pump went over $3.00. Then came hurricane Rita.

Leading up to Rita's actual strike, "anxious" calls for $4.00 to $5.00 gasoline were predicted with some even projecting as much as $7 per gallon. "Anxiety" rekindled thoughts of price fixing and gasoline lines experienced in 1973. On September 24th, hurricane Rita hit. According to the EIA (Energy Information Agency), 16 refineries along the Gulf Coast shut down as a precautionary measure and to allow employees to evacuate. Damage to some of the refineries, and the lack of electrical power supply to others, prevented their immediate return to service. Additionally, hurricane Rita resulted in over a dozen natural gas processing plants going off-line owing either to flooding, lack of supplies, an inability to move stored liquids, or safety precautions.

Energy Supply – Demand Relief

Actions taken by the U.S. Government, including the loan of crude oil from the Strategic Petroleum Reserve (SPR) and the nationwide waiver on the requirements for summer gasoline and for low-sulfur diesel, helped to ease pressure on markets and the distribution system. In addition, the IEA (International Energy Agency - Paris) directed its member nations to make an extra 2 million barrels of oil per day available to the market. It is commonly noted that "fear" of the disruption of oil availability is a problem, not availability itself. Refined products, specifically gasoline, are another matter. Katrina and Rita fractured an already stretched U. S. refining infrastructure, created by the lack of refining capacity, and presented a significant potential risk of shortages. In response, a large portion of the IEA directed oil was released in the form of refined products, specifically targeting gasoline and refined product needs and significantly lowering the risks of shortages.

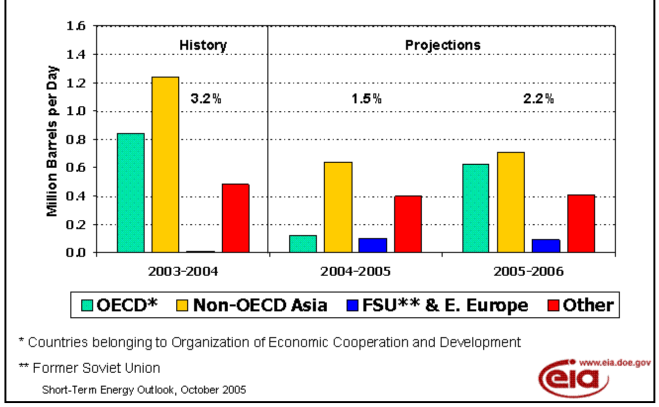
Figure 9. U.S. Petroleum Products Demand Growth
(Change from Previous Year)



Abruptly rising energy prices, brought about by hurricanes Katrina and Rita had a substantial impact on demand. Thus, lower demand assisted the supply side of the U. S. energy equation. Total petroleum demand in the United Sates in 2005 is projected to average 20.5 million barrels per day, or 0.9 percent less than in 2004. This demand level is 290,000 barrels per day less than the level previously projected by the EIA. Hurricane-related disruptions combined with increased prices resulted in a lower demand for petroleum products relative to pre-hurricane predictions.

Also as a result of higher prices, worldwide petroleum demand growth is projected to slow from 2004 levels, averaging 1.8 percent growth per year over 2005 and 2006, compared with 3.2 percent in 2004, as stated by the IEA. This reflects a downward revision from the earlier estimates and results in a reduction of demand by 0.5 million barrels per day in average annual worldwide oil demand.

Figure 7. World Oil Demand Growth
(Change from Previous Year)



As of this writing and as a consequence of the earlier mentioned factors, oil futures have moved below $60 per barrel with gasoline prices dropping more rapidly, back to June levels. While still high, gasoline has been observed at prices in the low $2 range, significantly off the Labor Day high price average of $3.05 per gallon, marking the biggest decline in 50 years. Natural gas prices, while down to $11.86 mcf, will likely prove more stubborn as the bulk of natural gas production originates from North America. Modern technologies allow for the importation of natural gas and natural gas liquids, however, insufficient storage and transportation infrastructure eliminates importation as a means of materially increasing natural gas supplies. Add the fact that the winter heating season is fast approaching, and it is likely that natural gas prices may remain elevated for a longer time period. The EIA predicts that energy costs for winter heating will be significantly higher.

Economics - Post Hurricane Devastation

Most economic reporting has a minimum lag of a month, up to a full quarter delay or longer. Pre-hurricane data was clear – an accelerating economy, inflation growth slowing with core inflation (inflation less volatile food and energy pricing) well contained, a strengthening U.S. dollar, improvement in consumer spending from a mid-cycle slowdown, and a steadily improving job market in 2005. Energy was always a wild card. But pre-hurricane, it still seemed apparent that the Fed was nearing the end of its rate increasing cycle. But what about the post-hurricane economy? Consumer confidence plunged –

which is normal after any shock. Will the consumer continue to spend as they worry, as often is the case, or will spending dry up, as it did during the 1990 oil spike? What impact will energy prices have on business spending? How will the Fed respond?

The earliest data available was the ISM Purchasing Managers Index, which was expected to decline. Surprisingly, the data showed a significant increase in manufacturing, suggesting uninterrupted activity and a rapid recovery from the hurricane destruction. Then again, the prices paid index increased an uncomfortable amount. The ISM Service Data was reported as less than expected, but still in a growth mode. Next was the monthly Payrolls Report for September. Consensus expected a net reduction of -150,000 jobs, with Katrina accounting for the bulk, as the rest of the nation continued on a 200,000 monthly job increase track. The report showed a net loss of only 35,000 jobs, much better than expectations. Fast forward to the recently released 3rd quarter GDP report. **Real growth increased by 3.8%, better than anyone expected, accelerating up from 2nd quarters' 3.3% growth. Overall inflation (GDP Deflator) increased 3.1%, though the "core" inflation index declined to a reasonable 1.3% growth rate. Consumer Spending grew at a 3.9% rate, the strongest for the year, and Business Fixed Investment slowed to a respectable rate of 6.2%.**

Progressing further through the post-hurricane economic data, **a view of slowing but "better than expected" growth emerges. In fact, the resilience of the U.S. economy is nothing short of remarkable, given the obstacles challenging growth. The retail consumer appears to be slowing, but not halting. Industrial production is moderating, with manufacturing expanding, as low inventory levels remain in a rebuilding state. Inflation has become worrisome, as it surged on the back of energy prices, but core inflation appears well contained, demonstrating little pass-through to the consumer level.** Even though recent price increases seem to be centralized around energy, we do have to pay for energy, so costs are higher, and the Federal Reserve members remain vigilant.

Through the Fed's Eyes

Regardless, the Federal Reserve Board recently raised the Fed Funds Rate to 4.00%, an increase of 25 basis points (0.25%) for the 12th consecutive time since June 2004. Additionally, the Fed indicated the desire to remove policy accommodation, which means a probable rate increase at the December 13th meeting, barring a sudden slowdown in economic activity. This action by the Fed was well telegraphed and anything but a surprise.

> *"Elevated energy prices and hurricane-related disruptions in economic activity have temporarily depressed output and employment. However, monetary policy accommodation, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity that will likely be augmented by planned rebuilding in the hurricane-affected areas. The cumulative rise in energy and other costs have the potential to add to inflation pressures; however, core inflation has been relatively low in recent months and longer-term inflation expectations remain contained."*
>
> FOMC November 1, 2005 Statement

In recent weeks, Federal Reserve Presidents Yellen, Poole, and Lacker along with Vice Chairman Ferguson have been very outspoken with a clear, concise message in the face of numerous headlines of rising inflation "expectations." The Federal Reserve Board has the clear objective of containing inflation!

> *"Undoing inflation expectations can be a matter of a couple of years… If we were to end up overshooting on the Target Federal Funds Rate on the high side and we found that the economy slowed more quickly than anticipated, then cutting rates could restore growth relatively quickly."*
>
> St. Louis Federal Reserve President Poole

During the past seventeen months, the Fed has been targeting an elusive "neutral" Fed Funds Rate, a rate that would neither stimulate inflation nor slow growth. In recent weeks, the "fears, anxiety, and expectations" of higher inflation have grown louder, much like the volume of deflation "expectations" in 2003. Then, the Fed pushed rates to forty-five year lows, squashing deflation risks and reflating the economy. The Fed knows that unchecked "expectations" can become self-fulfilling, leading to undesirable realities.

> *"I consider it reasonable to put the current neutral rate in a range of 3.5 percent to 5.5 percent, placing the current 3.75 percent level (at the time of her comments) toward the lower end of that band. This suggests a presumption that the rate will need to be raised further."*
>
> San Francisco Federal Reserve President Yellen

Fed Chairman Nominee Dr. Ben Bernanke

After an illustrious eighteen years at the helm of the Federal Reserve Board, Chairman Alan Greenspan will leave his post at the close of January 31, 2006. As such, there will be two more FOMC (Federal Open Market Committee) meetings under his watch; two opportunities for targeted rate adjustments or a pause under his watchful eye. Taking the Fed at its word (a measured pace), economic data between now and January 31st will prove instrumental to any rate decision. Accelerating growth or accelerating inflation will be cause for another increase. In the meantime, a December 13th Fed Funds increase to 4.25% seems in the bag.

Assuming confirmation, Fed Chairman Nominee, Dr. Ben Bernanke, will guide the FOMC in its March 28th decision. Since his nomination, much has been discussed with respect to his being a "hawk" on inflation (quick to react to inflation threats) or a "dove" (more tolerant of inflation pressures.) Based on observed writings and commentary, we anticipate Dr. Bernanke's policy guidance to be similar in nature to that of Dr. Greenspan.

Interest Rates

On September 2nd the 10-year U.S. Treasury closed with a 4.02% yield – today the yield has increased to 4.58%. What changed so dramatically? One item was much better than "expected," 3rd quarter Real GDP, which resulted in above trend growth in place for 10 consecutive quarters and the most

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vibrant economic growth since early 1986. A second was hurricane-induced inflation "expectations."

Additionally, Manufacturing expanded nicely again in October, along with Prices Paid, another measure of pricing pressure. Though indications of slowing housing are apparent, September Construction Spending expanded again, pushed by Residential Spending. Real Consumer Spending declined in both August and September, yet the year-over-year gain was a healthy 2.9%. However and as stated in the FOMC statement, planned hurricane related stimulus is soon to come, if not already adding to growth.

U.S. growth needs to slow to sub 3.0% levels, like it did many times in the 90s. Moderation would likely negate some of the inflationary pressures brought about by nominal growth in excess of 6% (Nominal GDP.) Some moderation has surfaced on the demand side of energy, but it's too early to tell if this relief is temporary. On the other hand, higher winter heating expenses will likely curtail consumer demand, though this argument stems from a push of commodity inflation, which would not likely quell inflation concerns.

Currently, we see "demand destruction" on the energy side, with stubborn but easing pricing, indications of moderation on the consumer demand side, no evidence of labor or wage inflation from the Employment Cost Index, and core inflation in a slowing trend. According to the WTO (World Trade Organization), higher energy prices are dampening demand in oil importing countries and world trade is slowing, which adds to the case for moderation and ultimately, increased stability in global interest rates and inflation.

Simply put, and best described by the bond model work of ISI Group (International Strategy & Investment), if real growth slows into the mid 2% range, energy prices flatten, and core inflation remains in the 2% area (currently 1.3%), then Fed tightening can soon come to an end and bond yields can subside. If instead, energy prices significantly rise further and core inflation moves closer to 3%, bond yields have further to climb.

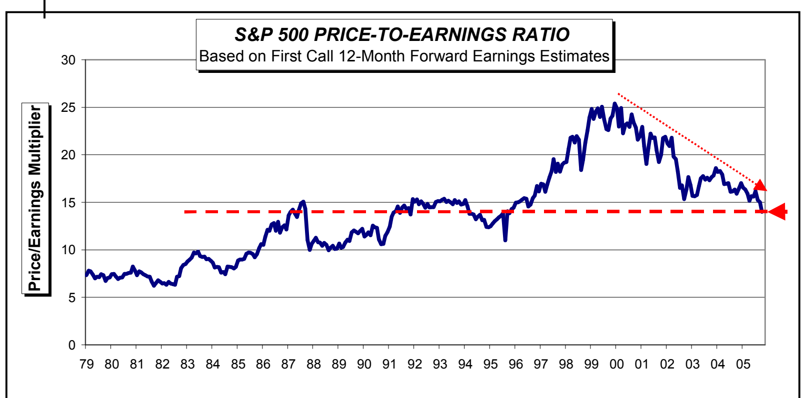
U. S. Equity Markets

After 13 straight quarters of double-digit profit growth and possibly a 14th by the time this earnings season is over, large U. S. industrials are sitting on $612 billion in cash, according to Standard and Poor's. That is equal to 7 percent of their market value and the highest level since 1988. Yet from the mid-January 2004 peak to the mid-October 2005 trough, the S&P 500 Index shows a mere 3.3% price appreciation over 21 months. The Dow Jones Industrial Average is down 3.3% over the same period.

Both the S&P 500 Index and the Dow Jones Industrial Index remain below their respective high marks of more than 5-years ago. Yet in both instances, earnings and dividends are significantly higher today. Using the most conservative measures for the S&P 500 Index, earnings are 32% higher today than in 2000, and the dividend rate has increased by 36%. Corporate Profits and Profit Margins have grown to record highs. Dividend Payouts have increased, and corporate balance sheets are in the best condition ever, and flush with cash. Even so, the S&P 500 is 21% lower today vs. its 2000 peak price.

The last rolling 5-year period to experience negative investment returns was in 1978, which was a result of 1973's market peak. Today's economy is in much better shape than that of the 1970s and the financial conditions of 1970's Corporate America holds no comparison to current corporate strength, such as margins, productivity, and cash. So we make no comparison there. Nonetheless many similarities do exist, when focusing on the equity markets, most of which center around investor behavior.

The "go-go" days of the early 70's drove price valuations unsustainably high, similar to the "exuberant" days of the 90's. As investors shunned the equity markets following the unwinding of the peak 70's pricing, the valuation that investors were willing to pay for stocks, the P/E ratio, was cut in half, even though earnings improved. Likewise, the high price valuation of the S&P 500 in 2000 was over 25 times earnings and has been recently compressed to only 14.0 times forward earnings. Put another way, the last time the market carried this level of valuation was in 1995; only then the 10-year U. S. Treasury note yielded 6% - 7% vs. our current yield of 4.58%.



Other similarities, such as money flowing to real estate and savings accounts vs. equities could be addressed, but **our key point is that we believe equities are attractively priced at current levels.** In 1978, the low Dow Jones Index price of 742 was crushing when compared to the 1973 high price of 1052. But in hindsight, it presented one of the best investment opportunities in a generation, only no one knew it, and it took time to materialize. Today, the Dow Jones Industrial Average is 10,432, fourteen fold higher than in 1978. **Assuming the Fed contains inflation, and we think they will, the yield generated by corporate earnings should have particular appeal to investors, and especially relative to other asset classes. We may again be looking at long-term opportunity that is yet to be recognized by the markets.**