Investment Watch

We all eagerly awaited the arrival of the **Santa Claus rally**. After all, for the last two years he didn't disappoint us - yearend surges in the stock market put us in that holiday mood and put money in our 401(k)s. But this year Santa ran out of gas! Or maybe, it was the price of gas, or maybe it was Katrina, or maybe it was that dreaded "*Inverted Yield Curve*" that withered his spirits and ours as we watched the yearend rally fizzle and fade.

Santa may not have bestowed great riches this year. But *Christmas Present's* small gains are better than the spectre of the losses of *Christmas Past* and the long-term outlook may be rosier for our *Christmas Yet to Come.* Yes, we do face the unsustainable imbalances of our excessive twin trade and budget deficits. But let's not dwell on this like Scrooge would, but rather, try to figure out what the spirits would wish for us to see.

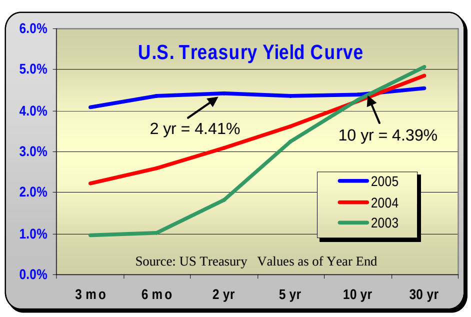
Among the many positive economic signs the ghost of *Christmas Present* would want to reveal would be: the record 15 straight quarters of double digit gains in corporate profits, robust GDP growth and extraordinary productivity gains. According to the Bureau of Economic Analysis (BEA) corporate profits continued their double digit gains over the past year even though depressed by the insurance losses due to Katrina and Rita. The consensus estimates 15% profit gain for 2005 and forecasts another 10%+ profit for the New Year. This bodes well for us long-term investors because we know corporate profits eventually drive prices.

The **P**rice/**E**arnings (**P**/**E**) ratio is the most common measure of how expensive stocks are. Because Earnings increased much more than Prices, due to 2005's meager returns, the **P**/**E** ratios have gone down. According to *Barron's* 50-Stock Average the Projected P/E decreased to **14.9** as of December 2005 from **20.5** a year ago. Generally speaking P/E ratios have declined steadily from the stratospheric highs at the century turn.

So stocks are cheaper exhibited by reduced P/E ratios? Yes, but no guarantees. Many pundits argue that even at 15 the P/E's are too high. They cite the fact that the *Barron's* 50-Stock P/E has been as low as 7 in the early 80's. But, we all remember the very high inflation and high interest rates of the '80s. Today, with very low core inflation and interest rates, higher P/E ratios may be more easily supportable. If you divide 1 by the projected **14.9** P/E ratio, you get a projected **earnings ratio** of 6.7%. Earnings ratios can be compared to high grade bond yields which today are about one percent lower. So what are the prospects for continued low interest rates?

Many economists predicted that the high price of oil, high employment levels and our swelling budget deficit would fuel inflation and dampen our growth. However, the BEA recently made an upward revision in the third quarter Gross Domestic Product (GDP) to 4.1%, while at the same time the Department of Labor, Bureau of Labor Statistics (BLS) reported the CPI dropping 0.6% for November, with core inflation readings holding steady at about 2% along with robust productivity gains at an annual rate of 4.7%. For now, the bah humbug, doomsday scrooge-like pessimism appears unfounded. This is what the Fed means when they say "*the expansion in economic activity appears solid... Core inflation has stayed relatively low… and longer-term inflation expectations remain contained.*"

Even though the Fed believes inflation is contained, it is still their worst nightmare. They continued their measured tightening by raising the Fed Funds rate ¼ of a point for the 13th consecutive time, a *Banker's Dozen.* They hoped that the long-term rates would follow the short-term rates up since they usually rise in tandem during a Fed tightening cycle. Much to their dismay, Santa didn't get their letter but rather brought a lump of coal in the form of that dreaded ***Inverted Yield Curve*!** The fed action of pushing up the short term-rates along with the *conundrum* of the persistently low, even declining long-term rates made for an unhappy last Christmas for Chairman Greenspan.



The U.S. Treasury Yield Curve plots the interest rates or yields based on maturity from short-term to long-term Treasury Notes. The chart demonstrates how the measured Fed action of increasing the Fed Funds rate from 1.0% in May 2004 to 4.25% at the end of 2005 has affected the Yield Curve. See how the curve flattened from 2003 to 2005. The Fed action pushed short term rates up but the 30-year rate has actually dropped.

An *Inverted Yield Curve* occurs when 2-year Notes pay a higher rate than the 10-year Notes. As you can see from the chart the 2-year Note yields 2/100's of 1% (or in financial jargon 2 basis points) more than the 10-year Note. Why is an *Inverted Yield Curve* dreaded? Because *Inversions* are rare and have preceded, and some think predicted, all of the last four recessions, but not all inversions foretell economic downturns. Yields inverted briefly in 1988 during the Asian financial crisis but this was the only time in the last 30 years that an *Inverted Yield Curve* was not a precursor to recession.

Inversions have correctly signaled economic downturns in the past. However, most economists, as well as Federal Reserve officials themselves, believe that globalization of the financial markets have dulled the predictive power of inversions. In addition, many pundits now believe the low long-term rates are not a *conundrum* at all, but rather, the logical result of a combination of factors - global liquidity and savings glut resulting in a lack of global demand coupled with heavy foreign buying, the ageing of the industrialized nations, and even lower rates abroad. Is the current *Inverted Yield Curve* artificially brought about by Fed tightening and not the result of economic realities?

Trying to explain Greenspan's *conundrum* has taxed the brainpower of the most sophisticated fixed income experts. Bill Gross who runs the largest bond fund in the US did a 180° turn around last year and now predicts "Globalization, demographics and central bank transparency… will keep yields low for some time to come." He also argues that these aggregate global trends have reduced all short-term interest rates by 2% and therefore the Fed funds rate of 4.25% may already be too high.

The Fed has signaled that they will continue to raise short-tern interest rates through Greenspan's retirement on January 31st. If long-term rates remain low, as many now believe, the Yield Curve will become more inverted allowing Wall Street strategists to debate an *Inversion's* recessionary effects, as well as, Greenspan detractors to condemn his actions one last time even into his retirement.

Although the holiday spirit didn't inspire a Santa Claus rally, this **"*Ho Hum*"** Christmas reduced P/Es, which stabilized the stock market, and elevated bond yields which should make us feel a little less vulnerable and a little more hopeful as the New Year dawns.

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