Seasonal Musings: The Song Remains (Uncomfortably) the Same

What does the year-end convergence of market opinion say about the prospects for the perfect soft-landing?

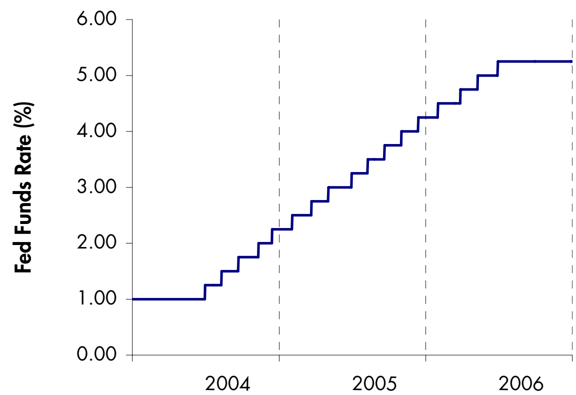
This is the time of year when those in our line of work produce the obligatory Year in Review and Outlook pieces, which attempt to offer up a unique look at what's going on in the markets. And every year as we review the myriad of offerings, we're usually blown away by the variety of ways the same investment environment gets cast. But that's as it should be, we suppose. The debates about what's gone on, and what it portends for the future, are the essence of markets. These annual pieces put the market's differences of opinion on display for all to see. What's fascinating to us about 2006, however, is not so much how the debates flip-flopped during the year, but rather how the market's opinions began to converge in an increasingly uncomfortable manner going into year-end.

Early in 2006 it was thought that the economy was growing too fast and that inflation was becoming entrenched. We disagreed. We left it to others to debate how high the Fed funds rate needed to be for the Federal Reserve to catch up with the perceived economic landscape. 5.50%...6.00%...Higher? Policymakers were thought to be woefully behind the curve, even though newly minted Chairman Ben Bernanke very clearly laid out the Fed's forecast. Few bought into it. Stocks struggled and interest rates rose. [See figure 1]

Later in the year it was feared that the downturn in housing would severely impact consumer spending and thus send the economy into a tailspin. The debate quickly shifted to whether we were heading for a hard versus a soft landing, and the Fed was again thought to be behind the curve – this time on the other side. We (boringly) remained in the soft landing camp. Bernanke reiterated his forecast and tried numerous times to explain that it wouldn't be impacted by each and every piece of economic data that popped up. Stocks rallied and interest rates fell.

So as we approached year-end, there appeared to be a growing confidence the Fed would indeed engineer the perfect soft landing, with the debate now centering on how and when that economic Nirvana would be reached. As you might expect, we tend to become a bit uneasy any time the consensus moves toward our way of thinking. But there is little point in being contrarian just for the sake of it, although we do take solace in that we still expect fewer rate cuts than the market is currently pricing in. What bothers us most, however, is the apparent blind trust that it's our monetary authorities that will lead us to the Promised Land. While we'd agree that Bernanke & Co. did a

Figure 1. Intended Federal Funds Rates
December 31, 2003 to December 31, 2006



Source: U.S. Treasury

decent job last year, we must emphasize that any Fed action will be the result of economic activity rather than the cause. To believe otherwise is to set one's self up to be severely slapped by the market.

But through it all, it seems clear that the market refuses to buy the Fed's forecast, which calls for a cooling housing market to slow the economy and re-open the output gap, which in turn pulls inflation down into the Fed's "comfort zone." Market participants still believe that the slowing economy will force the Fed to play catch-up by easing early and often in 2007. Nevertheless, it's our view the FOMC has made it abundantly clear that it's setting policy based on inflation.

It shouldn't be lost on anyone that the inflation data currently in use are lagging (and lousy) indicators, so the Fed has attempted to focus the market's fleeting attention span on its official forecast, which has inflation turning down in 2007. The idea is to get the markets to view the various economic releases within the context the Fed's forecast, and not to fixate on whether an individual piece of data points up or down. Easier said than done. The market still acts like it's all about the economy, which is understandable given that the Greenspan Fed's main interest was economic growth. The Bernanke Fed, on the other hand, seems to be more focused on inflation and the markets are having trouble making the transition. In the Bernanke model, economic data are simply means to an inflation end.

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Seasonal Musings (cont. from page 1)

This cycle's inflationary upturn has finally and stubbornly subsided, aided by the secular disinflationary forces (globalization and technology) that continue as major investment themes of ours. Pipeline pressures have been quick to roll over with even a moderate slowdown in economic growth, and we expect the inflation data to work their way into the Fed's comfort zone during the first half of 2007. Even though OPEC's defense of $55 - $60 oil seems to be working, headline CPI looks set to pull core inflation lower. [See figures 2 and 3] Yes, the counter-intuitive rent components of the various inflation measures will continue to move higher, but the recent massive Unit Labor Cost revisions clearly put a damper on the wage/cost spiral argument. Wide profit margins suggest ample room to deal with what the Fed euphemistically refers to as "resource utilization pressure" without having to pass through price increases.

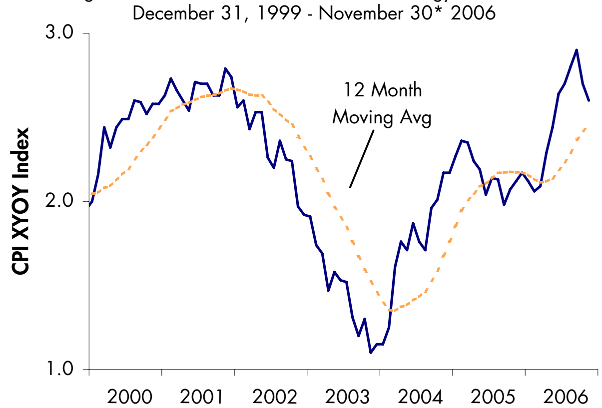
The slowdown in economic growth has been, and should continue to be, cushioned by a number of factors. Interest rates have fallen to the point where they have neutralized the last three or four Fed hikes, effectively providing fresh stimulus. The dollar is weakening on a trade-weighted basis, which boosts exports at a time when the global economy is as healthy as its been in a number of years. Headwinds from rapidly rising energy costs have abated, and many stock market indices are trading near multi-year highs. In addition, the corporate sector remains in excellent financial shape.

We continue to expect the domestic economy to trough in-and-around the 2% GDP level during the first half of 2007 before turning back up toward trend levels in the second half. The key rests with the U.S. consumer, and so far so good. Income is growing at a decent clip and the overall employment picture is holding up – and getting seemingly better with each of the head-shaking revisions that get reported. Consumer spending is hanging in pretty well and confidence, while off its highs, is still solid. Fed Vice Chairman Donald Kohn has characterized the current period as an inventory correction in the housing and auto sectors, but thinks that the rest of the economy is performing well. We find it hard to argue with his characterization. Housing will clearly be a drag on the economy, and its premature to forecast a rebound. Nevertheless, we believe the correction will likely be a rather mild, drawn-out process rather than the crash suggested by some.

All in all, outside of the Maria Bartiromo thing, a pretty good start for the Bernanke Fed. The new Chairman has worked hard to dismantle the cult of personality of the Greenspan era, and encouraged a higher profile of other FOMC members – most notably the aforementioned Kohn, who has definitely helped smooth the transition from one Fed chief to the next.

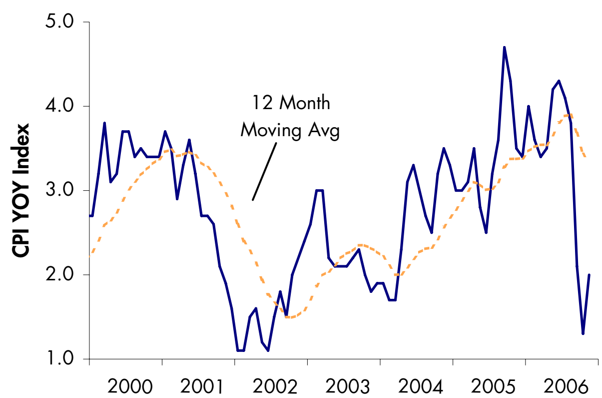
That's not to say, however, that we don't have a few nits to pick. First and foremost is this whole notion of potential GDP, which Fed members reportedly believe has fallen from 3.5% earlier in the decade. Unfortunately, there appears to be no consensus as to what level it has fallen; every FOMC member who comments seems to come up with a different number. We believe a clearer illumination of their thoughts is vital to the understanding of how this Fed operates.

Figure 2. Core Inflation
Change in Prices of all Goods Less Food & Energy - Year over Year
December 31, 1999 - November 30* 2006



Source: Bloomberg *Base Year 1982-1984=100*
** Latest data available as of publication date*

Figure 3. Headline Inflation (CPI)
Change in Prices of all Goods - Year over Year
December 31, 1999 - November 30* 2006



Source: Bloomberg *Base Year 1982-1984=100*
** Latest data available as of publication date*

If potential GDP were assumed to be in the 3.0+% range thrown out in the last few Fed speeches, as opposed to the 2.50% found in Fed staff reports, then more of an output gap would be opened if the economy were to slow as we expect. This would require an earlier ease than if the Fed were to operate under a 2.50% GDP potential model, where it would take longer for the slowing economy to reopen the output gap, and longer to help pull inflation down into the Fed's comfort zone. Given that we're more comfortable with the 2.50% number going forward – thanks to demographic drag – we continue to look for the first Fed ease in the third quarter of 2007. We can only assume that as part of the Fed's updated communication policy, we'll get more color on how they view the change in potential GDP – perhaps as early as Bernanke's next meeting before Congress in February.

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Another area of concern is that things seem to be going just a bit too smoothly for Mr. Bernanke, and we're growing uncomfortable with the calm. It just can't stay this quiet forever. Perhaps Mr. Bernanke is in the process of disrupting things a bit by accompanying Secretary Paulson on his trip to China. Given the importance of the so-called vendor financing arrangements currently driving global trade, and the significance of the carry trade in the highly levered financial markets, we're not altogether sure it's wise or appropriate for the Fed Chairman to be part of a group asking China to allow their currency to appreciate. Condemnations by a number of central banks of the impact of currency imbalances have been on the rise recently. Careful what you ask for, Ben.

Assuming that Bernanke's ill-conceived trip does not go off in his hand, we continue to expect only a gradual devaluation in the dollar in 2007. Sentiment against the greenback has once again gotten very one-sided, and the market might be in need of a time-out. We fully expect continued angst about central bank diversification away from the dollar, about the twin deficits, and about foreign demand for our securities to be reasons for the negative sentiment to continue. Nevertheless, we look for the negativism to be largely trumped by the desire of the world's central banks to keep their currencies competitive (see Thailand's clumsy "uh… never mind"), and by the still-massive pool of global capital looking for a relatively high yielding and safe home in the world's reserve currency.

10-year Treasury yields hit 5.25% over the summer and recently bounced off 4.40%. [See figure 4] Even though the trend is clearly down, yields much below recent lows are hard to get excited about. You could find more value in your hotel mini-bar. In the last Market Commentary we explained that we expected most of the activity over the next few months to likely be bounded by 4.50% and 5.00%, and see no compelling reason not to extend that forecast into 2007. That said, the market is clearly in a buy-dip mode and periodic surges below 4.50% are possible. Foreign and domestic buyers are trying to make up for being on the wrong side of the trade for the second half of 2006.

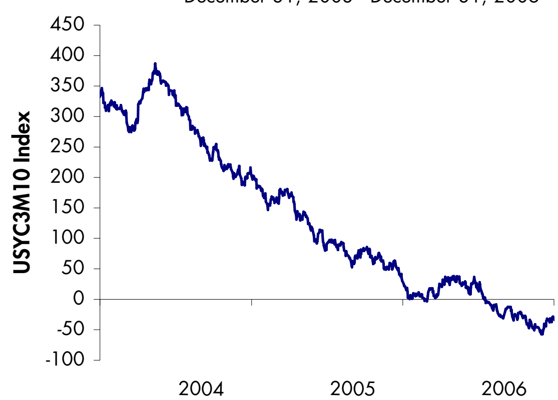
The yield curve's three-year old flattening/inversion trend is no doubt long in the tooth. [See figure 5] While we agree that it might not get significantly more inverted than current levels, we don't believe its ready to resume its more normal upward slope either. The short-end of the curve is positioned for the Fed to ease earlier than we expect, and the long end should continue to be well-bid thanks to the large pool of surplus liquidity and the desire of portfolio mangers to make up for being late to the global rally in the second half of 2006.

The secular forces of globalization and better monetary policy that we've written about, and summarized nicely by Ben Bernanke as "The Great Moderation," should continue to keep any changes to yields, and the yield curve itself, muted on an historic basis. The economic environment remains relatively benign and there is more than adequate liquidity to hold down real bond yields globally. As a result we continue to believe that the surprise "pain trade" for those expecting a return to "normalcy" in 2007 could be that yields end up lower, flatter and more range bound longer than currently expected.

Figure 4. 10-Year Treasury Yields
December 31, 2005 - December 31, 2006

Source: Bloomberg

Figure 5. 10-Year US Government Bond, 3 Month US Treasury Bill Spread
December 31, 2003 - December 31, 2006



Source: Bloomberg

That is not to say that our outlook is without risks. There's plenty to lose sleep over. Any time one expects a low volatility, relatively benign investment backdrop at the same time that the specters of volatile geopolitics, massive leverage, and unimaginable derivative exposures lurk in the wings, there's every reason to be wary of today's global yield grab. We'd be remiss not to put it front and center of our worries. But perhaps the time to be truly concerned is when these clear and present dangers are no longer on the minds of many. Until then, and it could indeed occur in 2007, we will very cautiously continue to survey the investment scene and take our best crack at unearthing the catalysts that could cause things to change. Season's Greetings and Happy New Year.

Equity Portfolios

The equity markets surprised many by closing 2006 with seven straight months of positive returns. The end of the Fed tightening cycle, benign inflation readings, a sell-off in crude, and strong corporate profit growth led to this sustained advance. Over the course of the year, almost $600 billion in supply was removed from the market via LBO's and share repurchases. This bullish technical factor keeps the bias to the upside as we head into 2007 despite a moderating profit outlook. Value stocks again beat Growth stocks during the quarter and the year and have now outperformed for an almost unprecedented seven straight years. With Growth stock valuation premiums well below average and with the market now digesting lower forecasted growth rates, we anticipate a shift in sentiment back to the Growth side of the equation. Historically, growth stocks have performed well in a moderating growth environment.

The fourth quarter was characterized by tight valuation spreads, a lack of sector leadership, mutual fund outflows, low quality stock outperformance, and a frenzy of private equity speculation. Everyone was fair game in the buyout talks from large cap industry stalwarts to small and micro cap newcomers. This led to a disconnect between fundamentals and stock prices. As a result, the environment proved challenging for fundamentally- based active managers with the majority of large, mid and small cap managers trailing their benchmarks for the quarter and the year.

Equity COMMENTARY

All of our equity products again produced positive returns this quarter. Within our portfolios, turnover remained low and there was little change in our sector positioning. We remain committed to our investment philosophy that is based on strong fundamentals and high quality growth and believe this style will deliver superior long term results for our investors.

We are optimistic regarding the prospects for US equities in 2007. Stocks are cheap versus bonds and real estate relative to historical averages, and we continue to see greater opportunities in growth stocks over value stocks in this environment. P/E multiples are poised to expand as we exit the Fed tightening phase. It appears to us that global economic data points neither to imminent inflation nor to recession, but we acknowledge that both warrant continued consideration. While the political landscape has changed and is sure to move markets over the course of the year, we maintain that fundamental investing will rule the day.