

## The Summer's Surprise: A Yield Curve Ball

*Determining which way the bond markets are headed is not as simple as most analysts think*

Looking back at the third quarter of 2006, we just can't seem to let go of the notion that the bond market was caught leaning the wrong way. Markets have a way of doing that, often getting pushed off-balance by consensus momentum and a hyperventilating media. It's a process that can mutate into the kind of self-feeding cycle found at the end of the second quarter, where perception began to separate from reality. Sure, there might have been a few hints about how things were going to turn out, but really... who knew?

Well, as it turns out, we did. In the last edition of Seneca Capital Management's Quarterly Commentary we explained that 10-year Treasuries yielding 5.25% were attractive and that market sentiment appeared poised to change in a heartbeat. [See figure 1]

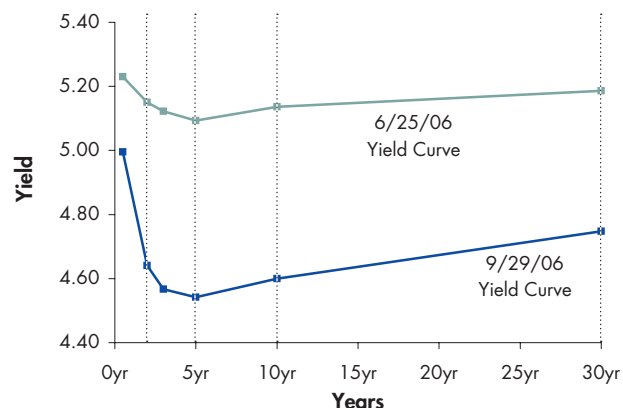
### Housing data changes the debate

Almost from the minute the quarter began, market participants seemed to morph from debating whether the economy was growing too fast or getting set to slow, to debating whether we were heading toward a soft or a hard landing. We find it fascinating that just as the consensus began to finally embrace the concept of a housing-led consumer slowdown, they appeared to be shocked when it looked like it might actually be happening, which then led to the fear that it would soon metastasize into a recession. Concerns about an overheating economy disappeared faster than spinach from grocery stores.

As we've written often, this is an economy that is addicted to credit, and highly sensitive to the dosage. Higher interest rates, an inverted yield curve, and the slowing velocity of money – in response to above-trend growth and a cyclic upturn in inflation – all did their job. Demand has clearly been impacted by the decline in the housing market, and consumers have backed off their liquidity-induced spending spree. Our view is that house prices could fall by as much

**Figure 1. Historical Yield Curve Comparison**

U.S. Treasury Yields  
June 25, 2006 vs. September 29, 2006



Source: Bloomberg

as 5% nationally over the next 12 to 15 months, perhaps more in certain regions. The key, though, is the impact on consumer sentiment. [See figure 2, next page]

No doubt the media will continue to breathlessly report horror stories about homebuyers who got in way over their heads, and Congress will surely get into the act by trotting out some poor lending exec to be publicly horsewhipped. Indeed, this has been as much a lending bubble as it has a housing bubble. Nevertheless, we don't anticipate a self-feeding collapse of consumer confidence leading to a full-on housing meltdown, and expect the cycle's excesses be resolved by real prices (ex: inflation) staying flat over the next 5 or 6 years. [See figure 3, next page]

### A softer landing ahead

We see no reason to change our call for domestic GDP in the sub-3% range for the remainder of the year. Further out, we look for the economy to slow a bit more, to the 2¼ to 2½% range in the first half of 2007, before picking back up toward the 2½ to 3% area in the second half. This should be enough to re-open the output gap, although there is currently a rather inside-baseball debate going on at the Fed about how much "potential" GDP has fallen this decade. Our read is that this should result in more tolerance for the kind of mild economic growth we envision than the Fed has exhibited in the past economic slowdowns.

**Fixed Income**  
COMMENTARY

(cont. on page 2)

## The Summer's Surprise (cont. from page 1)

We're clearly in the soft-landing camp. The primary reason for our rather sanguine view is that thanks to the economy's sensitivity to credit, lower interest rates - along with lower energy prices - will help to cushion the economic contraction much the same way they acted as shock absorbers on the upside [See figure 4]. The fact that interest rates never reached the level of nominal GDP, which marked monetary overshoots in the past, also suggests a more muted policy response this time, because the Fed never really became "too restrictive." Think of it as a beltless tightening. In addition, consumer balance sheets are strong, banks are in good position, and the corporate sector is healthy. Lower energy prices and interest rates, along with higher stock prices, already appear to be cushioning consumer confidence - even with housing weakening.

The economy began slowing before the current cyclical bout of inflation could gain traction, and perhaps even more important, before inflation expectations got out of hand. Even though a few statistical anomalies may remain in the inflation data over the weeks ahead, the worst news is likely behind us. Too bad we can't say the same about Terrell Owens. Anyway, we expect headline CPI to trend down from today's 3½% to 4% level, toward the Fed's preferred sub 2% zone by the end of 2007.

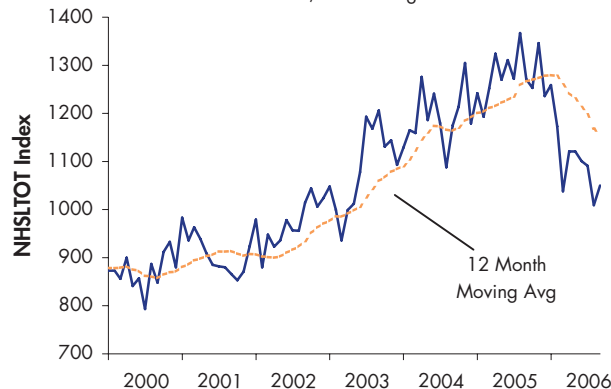
### An orderly decline

Like many others, we believe that the longer-term trend of the dollar is down. Unlike others, however, we think it will be an orderly decline, and only after some of the current negative sentiment gets unwound. Our expectation of an orderly decline is in direct opposition to a recent IMF report, which effectively lays out the consensus case for the "... risk of a disorderly decline" in the value of the dollar. From a purely technical standpoint, it seems to us that there are simply too many people on one side of the trade. First it was Buffet, then Gates, and now the IMF. The dismal performance by the U.S. golf team in the 2006 Ryder Cup couldn't have helped matters either. Global portfolio managers have long been underweight U.S. assets, and the story they all tell is getting a little shop worn. You know the story: the U.S. economy is slowing, the Fed is done, other central banks are still tightening, and - woe is the dollar - don't forget those trade imbalances.

There are also a number of fundamental reasons why we don't feel the dollar is set for a free-fall. First, in today's competitive global marketplace, it's really not in any country's best interest to have a rapidly appreciating currency, especially against the dollar. Accordingly, any meaningful dollar weakness would likely be met by foreign central bank support. Additionally, there are still plenty of excess savings looking to find a home, especially in a

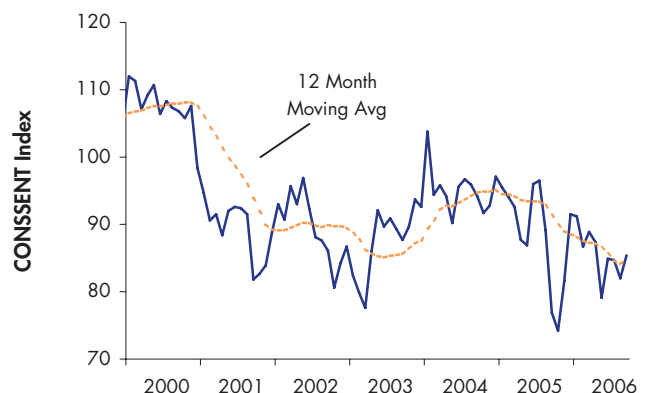
(cont. on page 3)

**Figure 2. New Home Sales**  
Seasonally Adjusted U.S. New One Family Houses Sold  
December 31, 1999 - August 31\* 2006



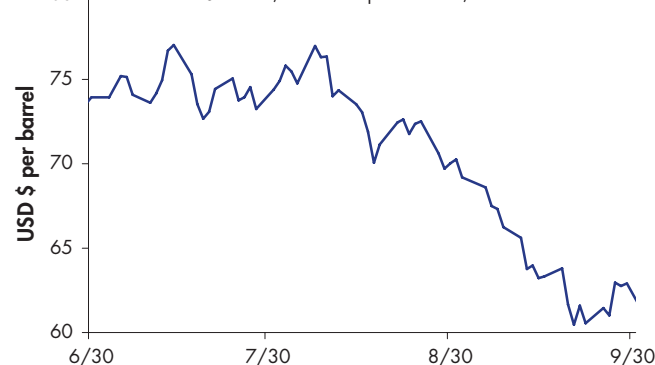
Source: Bloomberg  
\* Latest data available as of publication date

**Figure 3. Consumer Confidence**  
University of Michigan Survey of Consumer Confidence Present Sentiment  
December 31, 1999 - September 30, 2006



Source: Bloomberg  
Base Year 1966=100

**Figure 4. Price of Crude Oil**  
U.S. Crude Oil Futures, New York Mercantile Exchange  
June 30, 2006 - September 30, 2006



Source: Bloomberg

## The Summer's Surprise (cont. from page 2)

weakening global economy where one would expect the propensity to save to increase. Finally, yields in the U.S. remain attractive on a global basis. The net result is that we believe that dollar bears could get frustrated for a while longer before the trend resumes – in an orderly fashion. Further, we wouldn't be surprised to see a "return of the conundrum" as interest in U.S. financial assets picks up.

As 10-year Treasury yields hit 5.25% near the end of June, bond bears began their disappearing act. By late September, when you really should be back at school (sorry, couldn't help it), the 10-year had fallen all the way toward the 4.50% level – clearly an impressive run - before ending the month at 4.63%. [See figure 5]. While we remain generally positive on the fixed income market over the intermediate-term, we're a bit cautious over the near-term. It seems likely that the Fed has finished tightening policy for this monetary cycle, although we're not as sure about what comes next as the market seems to be. An easing of Fed policy as early as January is currently built into bond prices. Given the sometimes-random nature of economic data, and trader's tendencies to over-react to what amounts to little more than statistical noise, there exists the potential for the market to become distracted by the shiny objects called economic releases, and begin to question some of its newfound bullishness.

After spending the second quarter of 2006 establishing the top of the trading range, the third quarter began the process of trying to find the bottom of a new range. While the actual bottom could go beyond recent lows if spending and sentiment decline further, we believe most of the activity of the next few months will likely be between 4.50% and 5.00%. Accordingly, we would look for opportunities to lean against the top part of that range, by extending duration above benchmark levels if opportunities allow.

### A return to normalcy

Now that the market seems convinced the Fed is finished tightening monetary policy, and that an easing is just around the corner, most are now expecting the yield curve to begin steepening again. While we agree that the three-year curve-

**Figure 5. 10-Year Treasury Yields**  
December 31, 2005 - September 30, 2006



Source: Bloomberg

flattening trend is getting a little long in the tooth, and that the curve will eventually assume its more normal upward slope, we're not so sure that it's set to occur just yet.

The short-end of the curve appears over-extended for now and could be in for a surprise if the Fed pauses longer than is currently expected, or if policymakers were to target "potential" GDP in the 2.5% area, down from 3.5% earlier in the decade. We expect the long-end to remain well bid globally as the Bernanke's savings glut gets set to gear up. Finally, the secular forces we've written about so often should continue to keep any shifts in the yield curve relatively muted on an historic basis.

As a result, it appears that too many people expect a rapid re-steepening of the yield curve, and that the surprise "pain trade" for portfolio managers over the near-term could end up being that the curve stays rather flattish – perhaps even a bit inverted – longer than what is currently expected.

### Organizational Update

We'd like to take this opportunity to welcome Ann-Therese O'Neill to our client service team. Ann-Therese joined us in August with nine years of investment-related experience. Most recently she was Vice President of Institutional Sales at BB&T. As Portfolio Advisor, Ann-Therese will be working with our institutional clients and consultants.

We also want to wish the best to Mark Shamia, Chief Operating Officer, who departed Seneca on October 1st. Mark's departure has been planned for several weeks and he and his team have been working closely to ensure a smooth transition.

# Equity Portfolios

The equity markets had a number of macro considerations to digest in the quarter as moderating economic growth limited inflation pressure, ultimately helping to push most equity indices higher during the 3<sup>rd</sup> quarter of 2006. Yields retreated as the 10-year Treasury declined from 5.15% at the start of the quarter to 4.65% by the end of September. In the third quarter, equity investors cheered accelerating retail sales as consumer names were a clear beneficiary of the 20% retrenchment in oil prices. Meanwhile, LBO activity picked up and a flurry of “who will be next” speculation spread across industries and economic productivity data continued on its positive trend. While we are clearly in the midst of a deflating housing bubble, and its corresponding effects on the stock market are yet to be fully realized, we believe that collective earnings growth remains strong and equity valuations compelling. In fact, the S&P 500 will soon post its 13th consecutive double-digit earnings gain this quarter, and valuations have contracted year to date. Stock selection is critical given the well-documented macro uncertainties, but we have a constructive view on the stock market in general and growth equities in particular.

All of our equity products posted positive returns in the quarter. However, the magnitude of appreciation was not evenly distributed given the clear divergence in performance between large cap stocks and small cap stocks during the quarter (S&P 500 up +5.2% vs. Russell 2000 up +0.1%). Value again outperformed growth, a trend we see fading as growth outperformed value in the final two months of the quarter and more importantly, in light of current valuation and profit growth expectations. During the third quarter, we took advantage of the sell off in the second quarter to add to our highest conviction ideas and in some cases rotate into previously expensive, higher quality names. We benefited from this strategy as several names rebounded sharply from oversold conditions. Throughout the quarter we added to our previously underweighted Consumer Discretionary sector positioning to take advantage of lower oil prices, better sales growth, and attractive valuations. In general, our slightly more aggressive stance on Telecom and our underweight of the Industrials and Energy sectors

were our largest contributors while our Financials sector underweight detracted most from performance.

2006 has been a challenging year for active managers generally. For example, only 20% of active large cap growth managers outperformed the Russell 1000 Growth benchmark in the first three quarters. We are pleased that our large cap growth performance has placed us in this select group.

**Equity**  
COMMENTARY

We continue to believe that we are in a mid-cycle slowdown.

It looks to us as if global economic data points neither to imminent inflation nor to recession, but we acknowledge that both warrant continued consideration. We believe equity valuations are attractive and continue to see greater opportunities in growth versus value stocks in this environment. Our equity portfolios reflect our expectation that superior performance over time lies in longer-term fundamental investing in high quality growth stocks, a philosophy to which we remain steadfastly committed.

## Equity Team Update

It's been a year since our equity team, under the leadership of Doug Couden, assumed responsibility for Seneca's growth equity strategies. Over the past twelve months, several enhancements were made to our investment processes and performance has followed. Over the last year each of the growth products has shown improvement in performance relative to its benchmark. In a tough investing environment for growth managers, we have also seen great improvement in our peer group rankings. We remain committed to our proven growth equity philosophy and committed to delivering above market long-term performance with our disciplined investment approach. Our success thus far has resulted in new equity asset flows in recent months and we are optimistic that our revitalized performance is a direct result of our improved investment processes. As always, we welcome the opportunity to share our views on the market discuss performance and your portfolio in more detail. Thank you for your support.

*Past performance is not a guarantee of future results. This commentary is the opinion of the adviser. There is no assurance that the adviser's opinions or expectations will be correct. This report is intended for informational purposes and not as investment advice.*

*The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which consists of the 3,000 largest U.S. companies based on total market capitalization. Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index.*

*The S&P 500® Index is an unmanaged market value-weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index.*