Economic & Market Review and Outlook

During 2005 the U.S. economy and financial markets faced adversity on many fronts. The insurgency in Iraq, terrorist bombings in London, catastrophic hurricanes, sharply higher energy prices, and numerous interest rate increases by the Federal Reserve all took their toll. However during 2005 the economy expanded at a healthy pace, the unemployment rate declined and stocks, thanks to a fourth quarter rally, managed to provide positive, though uneven, returns. To the surprise of many the dollar reversed course and strengthened against a variety of foreign currencies. These results, in spite of the adversity, speak strongly to the resiliency of the U.S. economy.

Below, we highlight numerous gauges of the economy, stock market, interest rates, commodities and currencies. Table 1 provides a quick snapshot of 2005 and will serve as a reference throughout our discussion as we review the past year and look forward to 2006.

Table 1 - Important Economic & Market Statistics At The Start of 2005 & 2006

	2005	2006	% Change
U.S. GDP Past 12 Months Gain*	3.6%	3.4%	
Unemployment Rate	5.4%	4.9%	-9.3%
Real Weekly Wages	$ 532.22	$ 551.00	3.5%
S&P 500 Index	1211.92	1248.29	3.0%
S&P 500 Index Price/Earnings	20.37	18.27	-10.3%
Russell 2000 Index	651.57	673.22	3.3%
Russell 2000 Index Price/Earnings	52.55	39.34	-25.1%
EAFE Index	1515.48	1680.3	10.9%
EAFE Index Price/Earnings	17.68	18.2	2.9%
90 Day Treasury Bill Yield	1.85%	4.00%	115.9%
Federal Funds Rate	2.25%	4.25%	88.9%
10 Year Treasury Bond Yield	4.22%	4.39%	4.1%
Gold (Spot)	$ 438.40	$ 518.90	18.4%
Oil (Spot)	$ 43.45	$ 61.04	40.5%
Natural Gas (Spot)	$ 6.15	$ 11.23	82.6%
Euros Per Dollar	0.74884	0.84395	12.7%
Yen Per Dollar	102.63	117.75	14.7%
* Blue Chip Economic Forecast (Estimate)			

The Economy

Gross Domestic Product (GDP), the measure of the total value of final goods produced by a country, is used to measure both the size and rate of change of the economy. GDP for the U.S. increased throughout 2005 and actually reached its highest rate of growth during the third quarter - the same quarter that saw the hurricanes make landfall. While economic growth appears to have slowed in the final months of 2005, economists still predict a healthy rate of economic growth for 2006 as shown by the 3.4% GDP growth estimate in the table above.

With our economy growing steadily since 2002, the Federal Reserve continued to move from its long accommodative monetary stance to a more neutral stance. The most visible tool the Federal Reserve uses to make this transition is to raise the Federal Funds Rate, the interest rate at which banks borrow money overnight. The Federal Reserve has now made thirteen quarter point increases to the Federal Funds Rate increasing the rate from 1.00% in 2004 to 4.25% currently. The impact of these interest rate increases is

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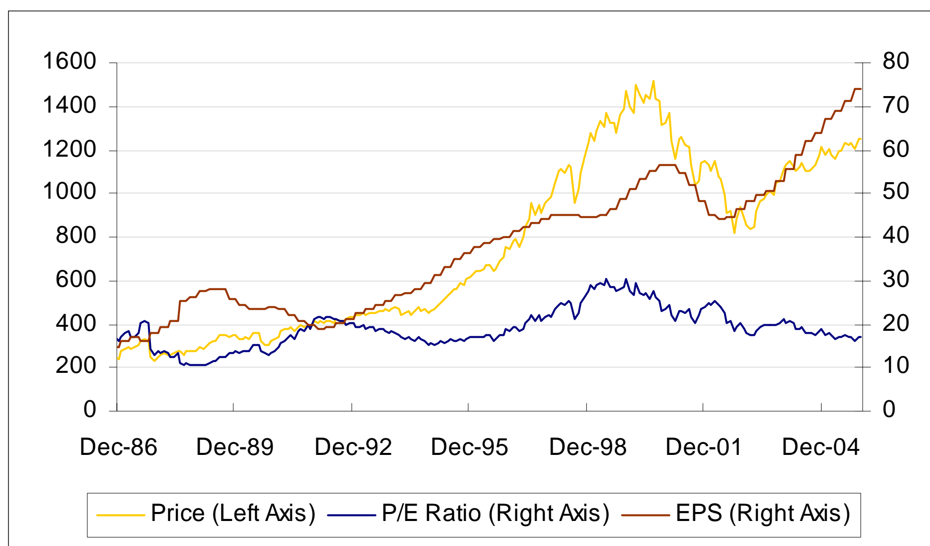
already starting to be felt in the more highly leveraged areas of the economy. One market that is sensitive to interest rates changes is the housing market, which appears to be leveling off after several years of large gains.

Unemployment decreased throughout 2005 in the face of massive relocation of employees and businesses from the hurricane affected regions of the USA. American employees, on average, also earned higher wages in 2005. These wages, coupled with a stronger dollar, helped offset an increase in import and energy prices. Had the dollar declined in value throughout the year oil and gas prices would have been higher than they actually reached. As we mentioned last quarter, high oil and gas prices are due more to a perception that supply will not keep up with rising worldwide demand than any current shortages. Natural gas prices are tightly coupled to domestic production and rose because of damage caused by the hurricanes. Fortunately, warmer winter weather has decreased demand and natural gas prices have declined significantly from their all time highs. Oil prices, on the other hand, continue to be near peak levels due to political instability in South America and the Middle East.

The Stock Market

The S&P 500 Index which tracks 500 of the largest U.S. based corporations provided a total return of 4.9% during the past year, including 3.0% from price appreciation and 1.9% from dividend payments. The energy and utilities sectors, despite posting declines during the fourth quarter, accounted for the lion's share of the index's return for the year. The energy sector provided a total return of 29.1% for the year while the utilities sector provided a total return of 12.8%. No other sector within the S&P 500 Index provided a return equal to or above that of the index. Smaller company stocks, as measured by the Russell 2000 Index, also provided positive results for the year with the index providing a total return of 4.6%. Larger gains were recorded by most overseas markets. The Morgan Stanley EAFE Index, which tracks 807 companies based in Europe, Australia, and the Far East, provided a return of 25.9% measured in the countries' own currencies. For U.S. investors, our currency's rising value dampened that return to 14.1%.

Figure 1 - 20 Years of S&P 500 Prices, Earnings, and P/E Ratio



As shown in Figure 1, while stock prices have risen in recent years, corporate earnings have risen even faster. This combination has caused the Price / Earnings (P/E) Ratio, a measure of stock valuation, to fall to the low-

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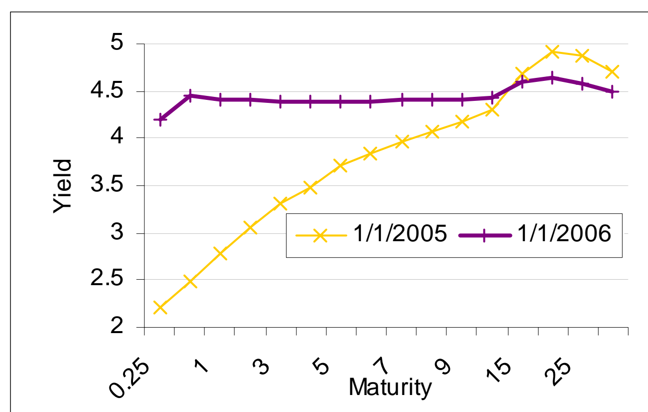
est level since 1996 for stocks within the S&P 500 Index. In other words, the price of a dollar of corporate earnings is on average the lowest it's been in the past ten years. The rapid growth in corporate earnings during recent years drove this development. Corporate earnings are expected to post their tenth consecutive quarter of double digit growth when fourth quarter 2005 earnings are reported. We expect this streak to come to an end during 2006 due to higher interest rates, an accounting rule change that requires stock options used as employee compensation to be expensed, and perhaps a slower economy. We are encouraged by the fact that stock valuations are at lower levels providing some support that stocks could move positively even in a slower growth environment.

The Bond Market
(and the much talked about yield curve inversion)

At the end of 2005 the yield curve inverted; interest rates for short-term bonds were higher than interest rates for long-term bonds (see Figure 2). In the short-term this simply means that yields on short and intermediate term bonds are as attractive as yields on long term bonds. This is beneficial for risk adverse income investors because it allows them to earn more interest income without accepting the added price volatility of long term bonds. In the long-term it could mean a number of things for both the economy and the bond market in general.

Figure 2 - The U.S. Treasury Yield Curve



The initial reaction by many people and the news media is that an inverted yield curve predicts the beginning of a recession. This has some basis in historical fact; however, the degree to which the yield curve inverts plays an important part in this analysis. According to a study by Federal Reserve Economist, Arturo Estrella, and Columbia University Professor, Frederic S. Mishkin, that relates yield curve levels with the probability of recession, at the initial inversion point, which is where the market stood at year-end, the chance of recession stands at only 20%. It is only when the level of the inversion widens to more than one percentage point that the chance of recession increases to more than 50% - so stay tuned.

Regarding the inversions predictive ability for the future direction of long-term interest rates, the answer is that it depends on the secular direction of interest rates that is in place at the time. According to a study we conducted at Goelzer, during periods of a secular rise in interest rates such as we experienced during the 1960's through the 1970's, yields on long-term bonds

continued to rise after the market inverted. However, during the secular decline in interest rates that began in the early 1980's and has continued to this day, long-term yields fell after the start of an inversion. At this time we have no evidence that the current secular decline in interest rates has come to an end and so we expect long term rates to continue their gradual decline.

The bond market generally favored higher quality bonds during 2005. After a two-year rally in high yield or below investment grade bonds, 2005 witnessed a reversal that caused high yield bonds to fall in value. This was not necessarily a surprise as the yield premium provided to purchase these issues had fallen to historically low levels. As the premium has widened over the past year, it has now come back closer but not quite up to the historical averages. This could be a sign that there is more widening to occur.

The Year Ahead

It is now our opinion that for those income investors that have been waiting for higher interest rates on short to intermediate maturity bonds, the wait is over. While the Federal Reserve may raise short-term rates higher this year, yields for short and intermediate maturity U.S. Government bonds are the most attractive we have seen in several years. Current market yields are higher than the median yield on long-term U.S. Government Bonds over the past 200 years. Another important factor is that yields in the U.S. are higher than those of most other developed countries. Combine that with the strengthening dollar and we end up with very attractive bond markets for foreign investors providing additional demand that can limit future increases in rates. We are now taking advantage of current yield levels by extending bond maturities to or slightly beyond our average maturity targets.

For the equity side of portfolios we are focusing on companies with high return on capital and positive free cash flow. Historically, a significant rise in interest rates tends to cause investors to seek higher quality companies. As borrowing costs rise, marginal return investment vehicles become less profitable or find their business models are no longer viable. At the same time high return on capital, cash flow positive companies continue to be profitable and become more competitive on a relative basis. This change in competitive position when combined with the lowest valuation levels in many years, discussed earlier, causes us to find attractive investments among high quality, large capitalization companies.

While we now favor investments in larger company stocks, we will continue to discuss the benefits of broadening the diversification of equity portfolios through exposure to mid cap, small cap, and international equities. Late last year we introduced our unique process and began incorporating these asset classes into equity portfolios at Goelzer. We look forward to discussing this process and its benefits with you throughout 2006. For more information please contact Kyle Fisher at (317)-264-2608.

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