



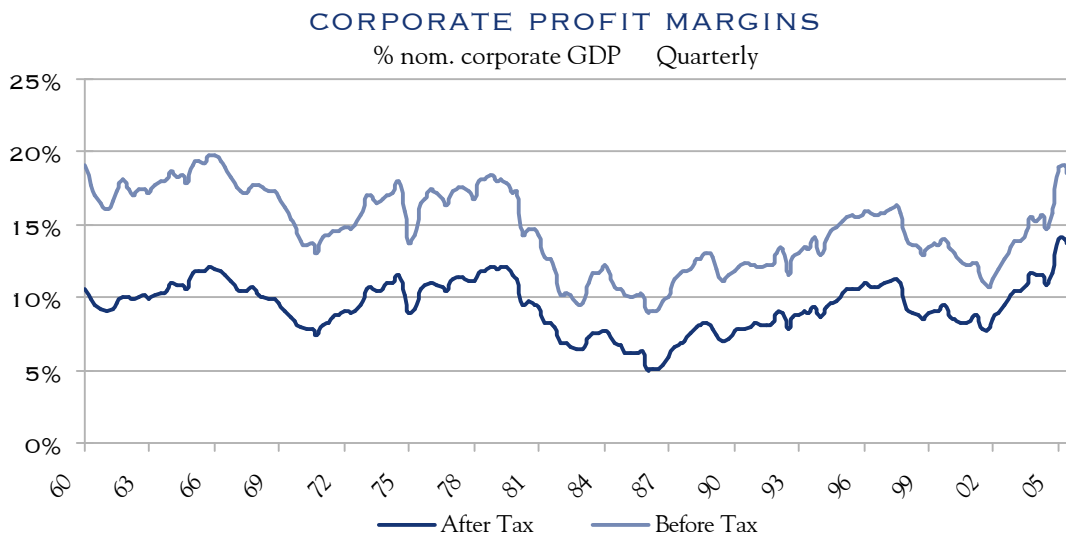
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THE U.S. MARKET: A DETOUR, NOT A CRASH

The recent decline in stock prices has raised fears that a bear market may be in the making. While investor sentiment apparently has been contaminated by a recurring bout of pessimism, we believe that the three most important yardsticks that typically set the market’s direction are all decidedly favorable. These are: economic growth, corporate fundamentals and valuations.

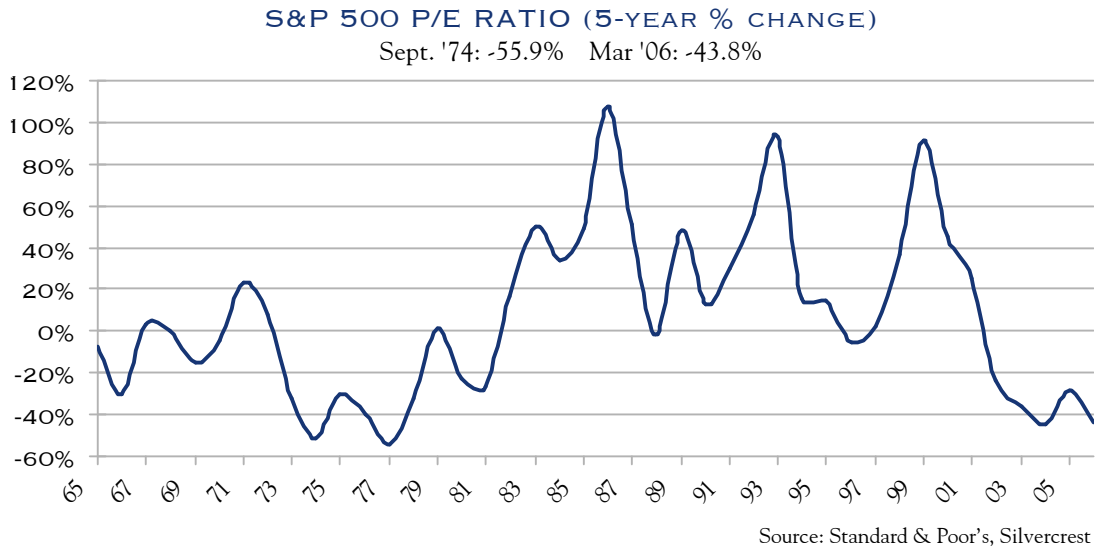
Economic growth has recently exceeded early forecasts, with the first quarter’s solid gain provoking upward revisions for the rest of this year. Even a tempered expansion, however, should be viewed positively as it will serve to contain or reduce commodity prices, restrain attendant inflationary pressures, and most likely place the Fed on hold. Despite the weakness in housing and the impact of rising energy prices, recent employment growth and rising incomes should continue to support consumption.

Corporate fundamentals—specifically balance sheets and cash flows—are sufficiently robust that a rapid deterioration logically cannot be forecast. Although capital spending has finally recovered to record levels, it has lagged its historical pace because of its changed composition: specifically, technology requires fewer investment dollars than the old “smokestack” industries. Hence, corporate coffers are not likely to be depleted anytime soon. Meanwhile, profit margins, as measured by any acceptable yardstick, are at the highest level in 40 years or longer.



Source: Decision Economics

Similarly, the market's valuation is on solid ground. The Standard & Poor's 500 is currently trading at about 15.2 times this year's estimated earnings, or at 40% of the ratio reached at the peak of the "irrational exuberance" of the late 1990s. Historically, bear markets have unfolded when multiples escalated at the same time that interest rates were also on the rise. This has been the case with every major market decline over the past 50 years. According to ISI, S&P 500 earnings are up about 120% from the market low of 2002 while the Index is up only about 68%. Equally relevant is that long-term interest rates are lower today (at 5.17%) than they were at the market's low in 2002 (at 6.80%).



Similarly instructive has been the comparative performance of global stock markets. With very few exceptions, U.S. growth has been superior to that of most economies, while stock market returns have been relatively meager domestically. Therefore, one can argue that, on a relative basis, the U.S. market has been a laggard with some catch-up in its future while other countries have discounted much of the near-term expectation.

Of course, there are always potholes on the road. Those of greatest concern are the persistent weakness in the dollar and the potential impact that the rise in the cost of energy and a decline in housing prices would have on consumer spending.

In the case of the dollar, there is widespread suspicion that Washington is largely standing aside as the greenback depreciates in the hope that this may help remedy the trade deficit. A historical perspective would reveal that, immediately following the Plaza Accord in 1985, the dollar sustained a decline of 23% but the market responded by surging 45% over a two-year period while interest rates dropped by almost 500 basis points. Obviously, the rationale behind such realignment was that a lower dollar made the U.S. more competitive, shrank trade imbalances, and reduced the need for external borrowing. Therefore a weak dollar policy may be appropriate under the circumstances.

In the course of the past 20 years, much has changed in the global economic realignment, with adjustments becoming more rapid and less fraught with risk. The involvement of hedge funds and other short-term traders in both the commodities and currency markets—on the long side of the former and the short side of the latter—will likely accelerate whatever correction is in store for both, thus removing them as sources of instability for investors.

May 16, 2006

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