2005 YEAR END REVIEW:
GOODBYE GREENSPAN, HELLO CHINDIA

The Federal Reserve spent all of 2005 in a continuous interest rate-raising mode, which decreased the value of almost all bonds except long-term maturities. The dollar was up about 15% versus the yen and euro, as interest rate differentials increasingly favored U.S. instruments. The U.S. economy continued to perform strongly, in spite of record energy prices and the devastation of hurricane Katrina. Corporate profits were up 13%, nearly twice the long-term average, yet stocks went mostly nowhere. In short, less than average returns were recorded throughout the stock and bond markets last year:

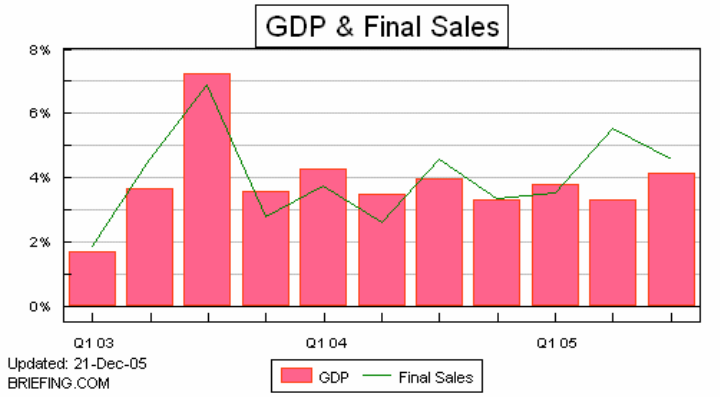
ANNUALIZED
RETURNS AT DECEMBER 31, 2005

	Year To Date	Last 12 Months	Three Years	Five Years	Ten Years
S&P 500	4.89%	4.89%	14.39%	2.73%	9.07%
Value Line Composite	3.33%	3.33%	16.55%	1.21%	2.35%
Citigroup 5 Year T-Note	.05%	.05%	4.71%	4.86%	5.26%
Lehman Five Year Muni	.95%	.95%	2.59%	4.61%	4.78%
Citigroup 3 Month T-Bill	3.00%	3.00%	1.77%	2.21%	3.72%
CPI	3.40%	3.40%	2.99%	2.58%	2.56%

In our year end review, we offer our thoughts on the economy, stocks, bonds, and global events. We think 2005 will be noted mostly for the end of the "Greenspan era" at the U.S. Federal Reserve Bank, and as the year when many investors began to accept the notion that China and India (Chindia) assumed their role as the drivers of future demand for global goods and services.

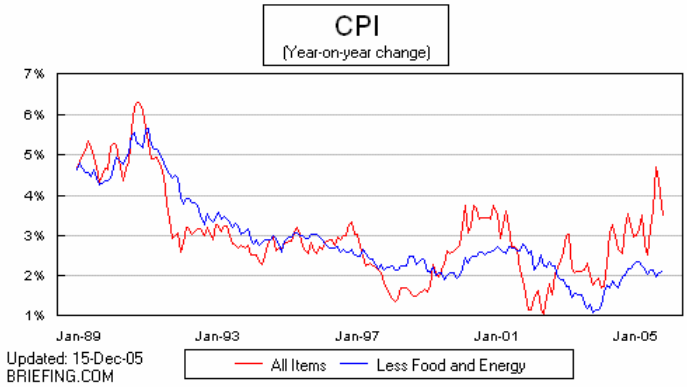
Macroeconomic Review

The U.S. economy delivered strong gains in 2005, with GDP running at 4.1% in Q4. It looks to be on a sustainable growth path as we enter 2006:



On average, we expect 3.0-3.5% GDP growth in 2006, with quarterly ranges of 2.5%-4.2%. We expect the first half to be stronger than the second half, as interest rate increases begin to bite. Corporate America (enterprise spending) should lead the way this year, as companies are flush with cash. Consumer spending should lighten up a bit, as the housing market flattens, layoffs continue in many legacy industries (autos, airlines etc.), and credit card and home equity loan debt is repaid (the consumer savings rate is now negative!). This macroeconomic construct should be supportive of stocks, but we think investors should be careful where the consumer is concerned.

On the inflation front, energy prices spiked in the 3rd quarter, propelling headline indices like the CPI through the 4% level for the first time since the early 1990's:



A significant risk to the markets is the potential for a rise in "pass through" inflation, thus pushing the CPI sustainably above the 4% mark. Because the price of inputs have risen dramatically (think natural gas), primary producers have been forced to announce price increases. Most of this has been absorbed in the intermediate stages of production, but we are beginning to see end users, i.e. consumers, foot the bill. We expect the CPI to trend higher in early 2006, followed by a moderation to 3.5% or so. But a trickle of price increases could become a torrent. Consumer spending would decline in such a scenario. Investors should watch this closely.

The Stock Market

Energy and utility stocks were the only real movers in 2005. Take those two sectors out, and stock returns were flattish to negative last year:

S&P 500 Sector	'05 PriceReturn
Basic Materials	2.2%
Consumer Discretionary	-7.9%
Consumer Staples	1.3%
Energy	29.1%
Financials	3.7%
Healthcare	4.9%
Industrials	0.4%
Telecomm	-9.0%
Technology	0.4%
Utilities	12.8%

Yet, since Q3 of 2001, corporate profits are up 80%, interest rates have fallen, and the PE ratio on the S&P 500 has contracted from 37 to 18. By many measures, stocks are cheaper now than they have been in years. What gives?

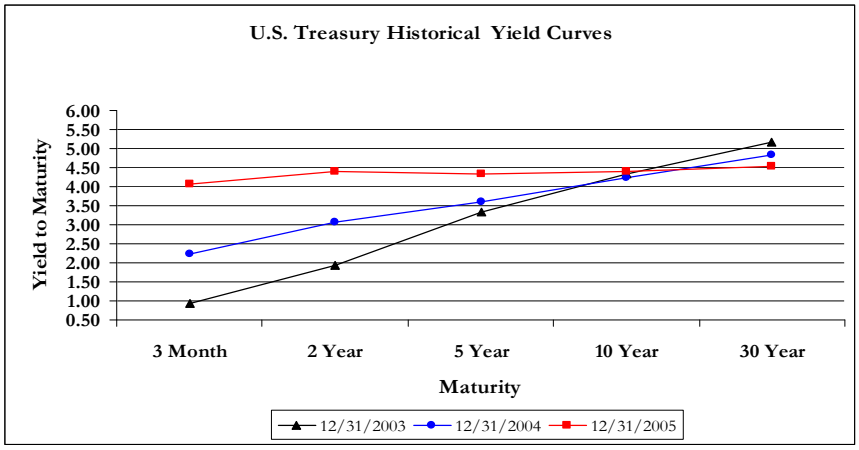
We think that significant detritus has emanated from the fiscal and regulatory arenas which are meaningfully retarding stocks. Federal spending has grown much faster than GDP in the past 5 years. A massive new entitlement has been created with Medicare Part D. Sarbanes-Oxley has created huge new compliance costs for publicly traded companies, even forcing some smaller enterprises to "go private". Health care costs continue to spiral out of control. Meanwhile, tort reform languishes as the plaintiff's bar continues to extort billions in settlement proceeds (the larger the target, the better). The extension of the 2003 tax cuts is now highly uncertain. Geo-political tensions are rising, from the Middle East to the protectionist ranks of many US legislators. As icing on the cake, the U.S. has done absolutely nothing to prepare for the looming meltdown of the Social Security and Medicare/Medicaid programs as the baby boomers age in. Add to that the threat of a global flu pandemic, coupled with unknown but fairly certain future terrorist strikes, and it is no wonder that stock investors are demanding a greater risk premium, whether in lower PE's, higher dividend yields, or more transparent accounting.

This increased risk premium means that PE multiples will have a tough time expanding, and with earnings set to slow, we do not see any reasonable catalyst for meaningful returns on the horizon. Lower PE stocks and great dividend payers should do better in this environment.

2005 also saw the continued outperformance of "risky" assets (Russia was the top performing bourse in 2005), as a world awash in liquidity sought to squeeze out every last morsel of return. We do not believe a long term case can be made for such continued outperformance and we think investors should have only modest allocations here.

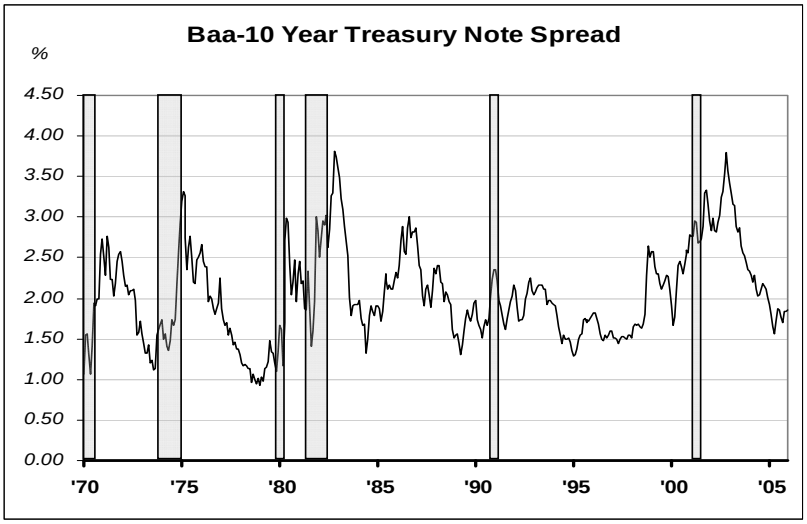
The Bond Market

On December 14, 2005, the Fed raised its overnight lending rate (Fed Funds) for the thirteenth consecutive time by a quarter of one percent to 4.25%, causing short rates to continue their upward ascent:



There has been much discussion in the popular press recently about an "inverted yield curve", when short term bonds yield more than long term bonds (most folks look at the 2 Year Treasury versus the 10 or 30 Year Treasury). In the past, this "inversion" has had a pretty good track record at predicting recessions. But we don't think that is in the cards for now.

To begin with, an inverted yield curve does not tell the whole story. As we have long advised clients, "corporate credit spreads" need to show meaningful widening AT THE SAME TIME as an inversion to confirm an economic slowdown. Credit spreads are the additional yield an investor receives by investing in a "risky" asset, like a corporate bond, instead of a Treasury bond (risk-free asset). Because corporate bond investors are very sensitive to the creditworthiness of an issuer, any hint of a pending economic slowdown is quickly translated into higher yields (wider spreads). Spreads tend to widen prior to recessions (shaded areas):



Source: Argus Research Co.

At present then, credit spreads remain subdued and do not suggest a meaningful slowdown.

The other issue at work is the "inexplicable" stickiness of long term bond yields (i.e. long yields have not risen at all even as their short maturity cousins have gotten whacked). This "conundrum", as posited by Mr. Greenspan, is a reflection of "hyper-demand" for long duration assets by massively under funded pension plans, both public and private, domestic and international. Simply put, they need to lock in a reliable rate of return to help earn an assumed rate of return that has dwindled meaningfully, at the same time that their liabilities (payments to pensioners) are coming due.

In addition, net foreign buying of US government bonds was $1.1 trillion last year (at October 31), versus issuance of $780 million. Simply put, demand exceeded supply. In fact, a recent Federal Reserve study estimated this "foreign buying" had driven yields down by 1.50%!

Lastly, the Fed has been much more "transparent" in their monetary policy actions, removing much of the uncertainty about future interest rate movements, allowing "uncertainty premiums" to deflate along with long term yields. These three factors do much to explain the conundrum. Long yields should be higher, but they aren't. Thus the inversion is somewhat "artificial" in our view.

On the other hand, Fed rate hikes have always produced a dampening effect. We think the critical point the "press" is missing is that it always takes time for these increases to work their way through the system. Eighteen months is about right, so the rate hikes of summer 2004 are just now starting to bite. Continued rate hikes risk an "overshoot" which is typical of the Fed, and should be curtailed in the absence of inflationary data. However, the new

Fed Chairman, Ben Bernanke, will want to show his inflation fighting resolve, so we suspect that 2-3 more rate hikes are baked in the cake.

Trends in 2006

Natural resource companies have been the shining stars of the 2005 market. Oil, natural gas, coal, copper, you name it, they all did well. We think the "cyclical" or "deep cyclical" label that has heretofore been attached to these industries will gradually be modified, as they prove their true worth in an era of increased demand and constrained supply. In a word, scarcity. Chindia (China and India) has an emerging middle class that will make the US and Europe in the post-WWII years look like a midget. When they emerge from poverty, they will spend much differently than "rich" consumers (no iPods before a home refrigerator; no Xbox before a home plumbing system). This gets magnified by hundreds of millions. You get the point. Think metals and energy; that's where the marginal demand will be found.

At the same time, major producers of energy, like Russia and Venezuela have been flexing their muscles, not content to honor long term price contracts in an era of escalating spot prices. The Ukraine learned recently how it feels to be held hostage when OAO Gazprom (i.e. the Russian government masquerading as a private company) threatened to cut off natural gas supplies unless they agreed to a huge price hike. In Venezuela, Senor Castro-Light (a.k.a. Chavez) has made no secret of his populist re-distribution tendencies. Meanwhile, Iran continues to thumb their nose at the West, and is intent on provoking conflict in their pursuit of nuclear capabilities / an Islamic Caliphate. (Parenthetically, the US Senate this fall rejected any energy exploration in miniscule sections of the Artic National Wildlife Refuge and offshore areas of the U.S. East and West coasts, thereby demonstrating their utter incompetence in helping to advance America's energy security. The flow of petrodollars to corrupt regimes will thus continue.)

So it is not enough just to own energy/metal assets. Investors should focus on those assets that are located in politically secure areas of the world. In the next economic cycle, and the next, and the next after that, these assets will be in far greater demand than they are today. It won't make a difference, though, if the state confiscates them.

The Abramoff scandal will cast much needed light on the cozy but corrupt relationships between K Street lobbyists and Congress. This episode will accelerate the Republican decline this year as they have proven to be just as subject to influence-peddling and as adept at spending taxpayers' money as their Democratic rivals. Bush has exacerbated Congressional porcine proclivities by failing to veto a single bill during his tenure as Chief Executive. All this political turmoil in the U.S. will be a net negative for foreign confidence in the U.S. (and thus U.S. bonds and the dollar). Should an increasingly left-leaning Democratic Party prove ascendant in the fall elections, their strident protectionism and commitment to raising taxes on income, dividends, and capital gains will not sit well with global investors.

Hedge funds have been all the rage for the past several years. Now comes news that a significant number of US public pension funds have decided to allocate big money to these managers. Their timing could not be worse. Hedge fund returns have converged toward a (lower), index-like mean as thousands of practitioners opened up shop to collect 2% annual fees plus 20% of (hoped-for) profits. This is no longer an inefficient corner of the markets and investing in hedge funds today is a perilous exercise, according to David Swenson, who was among the first to use hedge funds as the chief investment officer of Yale University, and who now possesses the best long term track record in the endowment fund world. Unfortunately for the retired teachers and policemen of AZ, CO, and other states, their future will become less secure as a result.

Private equity (large pools of private capital) made a splash with their leveraged buyout of Sungard Data Systems in 2005, the largest such deal since the fabled RJR Nabisco transaction of the late 1980's. They will remain active buyers of "non-core" assets of large corporations this year. These relatively new entrants to the M&A field have thus broadened the acquisition market to include financial buyers (as opposed to industry participants, or strategic buyers), boosting asset sale prices and increasing the likelihood that targeted assets will find a buyer. This is a big plus for stocks.

The housing market will not "collapse" as some pundits predict. While short rates are up, hurting those with adjustable rate mortgages, long rates have gone nowhere, and still offer relatively cheap financing. While local markets, especially in coastal areas, may display some dislocation, overall we think housing prices are likely to stagnate this year in the absence of long rates spiking upwards.

The dollar had a nice run in 2005, but it is set to reverse, probably as and when US short rates peak. (Investors should remember that short rates in Euroland and Japan have only now begun their tightening cycles). We have written before about the massive trade imbalances that exist, with China, Japan, etc. all running huge surpluses. The U.S. current account deficit in 2005 averaged 6.4% of GDP, the highest level ever, and up from 2005's 5.5%. In 2005, China's trade surplus more than tripled, rising to $102 billion, with exports up 28%. For now these dollars are being re-cycled into long term Treasuries and agencies. But as Ben Stein is fond of saying, "if something can't go on forever, it won't". At some point, the creditor currencies must be revalued upwards, and there must be some semblance of internal demand in creditor nations to increase consumption of domestic goods rather than export them to the US. While we would prefer a sharp and quick administration of the necessary medicine (i.e currency adjustments), it appears that the world has decided on a slow-acting IV drip. Gold will move inversely to the dollar, and select foreign issues will provide investors needed resiliency as the dollar declines. Given our "IV Drip" theory, the needed adjustment may take several years to play out, and, like us, investors should use this time to research foreign economies and issuers and evaluate their various portfolio effects.

Related to this "U.S. competitiveness" issue is the grim battle being fought by legacy U.S. industries to hold down their **health and pension costs** for employees and retirees, when most global companies (ex-USA) do not have such a burden (health care costs are paid for by governments). It is our belief that the U.S. is moving inexorably towards a single payer health care system, for this very reason (remember we already have one for the elderly and indigent in the form of Medicare and Medicaid). It will come in fits and starts, but the current turmoil in the U.S. auto industry is just a taste of things to come. In the "defined benefit" (pension) world, companies are racing to either "freeze" benefit accruals or deny entry altogether to new workers as a means of lowering costs. There is also serious consideration being given to mandating the disclosure of these pension and health care liabilities on a company's balance sheet. At that point, the financial health of many companies and industries will plummet. Investors should look closely, now, at how these "funding gaps" affect the net worth of a company.

Summary and Outlook

2006 is likely to see some slower growth, probably in the second half, but we don't think a recession is in the cards. Look for GDP to trend towards the mid to high two's from mid three's now. Short rates should peak around 5%, and, while we may have a "yield curve inversion" as a result, we don't think long yields are going to race upwards any time soon, especially while inflation remains quiescent and foreigners remain eager buyers of our debt.

For stocks, the 24% growth in operating profits in 2004 and 13% growth in 2005 cannot continue. Earnings growth will slow down, perhaps significantly. But 5-7% is not bad, in fact, it is a very "normal" performance, and we expect stocks to perform within a continued trading range.

On the plus side, the stellar condition of corporate balance sheets and very active private equity fund acquisitions should be very supportive of stocks this year. Corporate America is flush with cash, and operating cash flow continues to improve, so whether increasing dividends, stock buybacks, or acquisitions, a nice floor exists for most industries.

However, in light of the aging bull market, slowdown in profits, and increased risk premiums, we think investors would be well advised to seek out less fully valued stocks.

Geo-political risks remain high, with Iraq and Iran likely to dominate the headlines. Unexpectedly high and stubborn energy prices, which may rise even higher, rank as the biggest intrinsic risk to companies and industries in 2006.

In 2006 then, as in 2005, the "song remains the same". As we have advised for some years now, investors should moderate their expectations as markets continue to post more normal return patterns. We continue to believe that long term holdings of high quality issues purchased at attractive prices will be a winning strategy for investors who realize the enduring worth of patience and prudent diversification.

Published January 18, 2006