



When Bad News is Good News

October 10, 2005

A review of the third quarter in almost any context has to start with the impact of hurricanes Katrina and Rita, clearly defining events from both an economic and emotional perspective. The scale of destruction and disruption they caused seems to make everything else that happened in July and August less relevant. Certainly perspective is important, but there is no question that economic forecasts dating from before the storms have become obsolete. Attempts to assess how these storms will affect the national economy have focused on the negative impact of the cost of energy. The word "bubble" comes to mind – especially since we keep hearing of those industries benefiting from rapid and unsustainable rising prices. Yet no one has spoken of the oil bubble – though prices have tripled in two years to as high as \$70 a barrel.

Reviewing the history of oil-market booms and busts confirms that we are in the midst of a classic oil, even an energy-bubble and that, if history is a guide, prices will eventually fall, perhaps dramatically. Despite apocalyptic warnings, the world is not running out of oil and the pumps are not going to run dry in our lifetimes – if ever. The mechanism that will prevent long-term catastrophic shortages in energy is the free-market incentive to make profits. In the end, the advent of new technologies and new energy discoveries – all inspired by the profit motive – has brought crises to an abrupt end, enabling oil and electricity markets to resume their virtuous long-term downward price trend.

WHEN BAD NEWS IS GOOD NEWS

The bad news emanating from the hurricane damage is ultimately good news for economic activity as rebuilding across the south central U.S. rises into the hundreds of billions of dollars and triggers a long-term increase in the demand for capital and labor. We estimate that such spending that otherwise would not have occurred will add at least ½% growth to the U.S. economy over the next two to three years even though the short-term numbers may suffer as a result of the storms.

As the stock market entered the fourth quarter, investors were divided between hope for the year-end rally and concern that an inflation-sensitive Fed will keep the market in negative territory. For larger companies that have experienced the benefits of a stronger economy and low interest rates, we can see why the media paints an apprehensive picture. However, we have consistently said that stocks of innovative, leading growth companies are undervalued relative to large cap stocks and should be attractive to investors especially when many of the “mega-cap” companies have fat balance sheets and the appetite to acquire smaller, profitable companies. Record purchases of small companies support our thesis so far this year, and we think it will be true through the end of the year and well into 2006. Moreover, international equities continue to offer opportunities for growth as more countries embrace capitalism, foster free trade, and engage in expansive fiscal and monetary policy. The well-known stock market indices may remain in a sideways trend, held back by rising interest rates, slowing earnings growth and investor ambivalence, but we believe that good growth stocks are positioned to outperform.

The U.S. Economy

In evaluating economic data, remember that statistics don't lie but statisticians do. Most of August's data, including reports on retail sales, producer and consumer prices, and industrial production, reflected no impact from Katrina or Rita. Probably not until January or March of 2006 will the health of the economy be revealed in the statistics and start to resemble underlying business conditions. Interpretations of these data will provide ample opportunity to see the economic glass as half-full or half-empty.

In the meantime, economic data released recently has been largely positive. The latest report on the nation's industrial activity in September highlighted once again the amazing resilience of the U.S. economy. The ISM manufacturing index jumped to 59.4% in September from 53.6% in August. Growth in orders, production and employment all accelerated, according to the survey's respondents and some said they are already seeing orders related to the rebuilding. But strong demand was accompanied by significantly higher costs, as the prices paid index jumped.

On the consumer side, what we know is that initial and continuing unemployment claims have moved higher and consumer confidence has slipped, both changes directly related to the storms' effects specifically the surge in gas prices. Despite these negatives, consumers have proven remarkably resilient to virtually every obstacle that has confronted them over the past four years, and \$3+ gasoline is only the latest hurdle. Had consumer spending and confidence not already been beset by higher interest rates, a two-thirds jump in oil and gas prices, and a sense that the war in Iraq was not going well, we suspect that the U.S. consumer would take this latest hurdle in stride. Our view remains that consumers will sustain the economic expansion into and through a fifth year, which more or less coincides with calendar 2006.

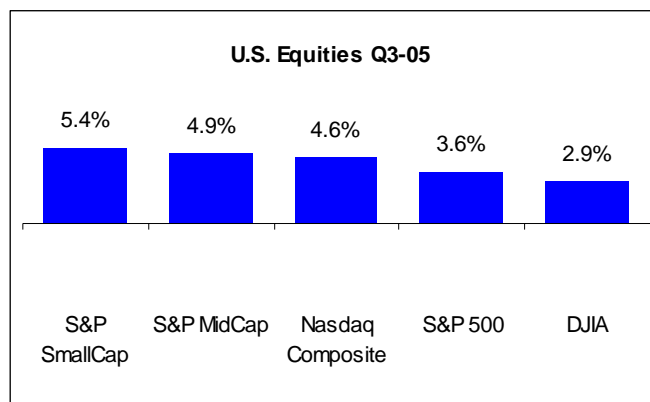
There is no question that the aftermath of the storms cut into third-quarter GDP growth. For the fourth quarter and probably into 2006, rebuilding of storm-damaged property will provide a boost in jobs and production in some sectors of the economy, but economic uncertainty is still higher than normal. Key to the direction of growth and inflation over the next 12 months is how consumers and businesses cope with the latest round of energy price hikes – if they stick. This issue is multifaceted, one in which the severity of the coming winter, the speed of recovery in the energy infrastructure and, to no small degree, consumer and business confidence all will participate.

The Federal Reserve's latest FOMC press release after it raised rates 25 basis points to 3.75% in September suggests that it views economic slowdown and accelerating inflation as roughly equal risks to the economic expansion. Since the middle of last year, the FOMC has implemented 11 successive ¼ point increases in the Federal funds rate, the short-term interbank borrowing rate the Fed uses to implement changes in monetary policy. While economic growth has been strong in the face of the monetary tightening, we have now reached the point where the yield curve is nearing an inversion, that is, short-term rates have nearly equaled or exceeded long rates. Complicating matters is the very sharp rise in the prices of natural gas and heating oil. Analysts see these energy price increases as being inflationary and support future Fed rate increases. If the price of oil falls sharply then we may get a second look from the Fed about raising interest rates.

Before the hurricanes hit, we thought we knew where the economy, the Fed, and long-term rates were headed. The Fed would get to 4% and stop. Growth in the economy would soften in 2006 to growth levels considered strong (3.3%). Long-term rates would remain stable at or near current levels as the Fed succeeded in controlling inflation. Now, we believe that near-term activity will suffer but our long-term economic expectations give the benefit of the doubt to resilient U.S. consumers and businesses' ability to deal with higher costs through productivity gains. This resilience means that the expansion will continue, albeit at a subdued rate for the next few months, and though inflation may tick higher, core inflation (ex food and energy) is unlikely to move beyond the 2.0%-2.5% range.

U.S. Financial Markets

Despite the double-whammy from Katrina and Rita, U.S. equities got off to a good start in the third quarter; July's price gains of 3.6% for the S&P 500 and 6.2% for Nasdaq Composite took these indices to four-year highs. Stocks gave back a little in August, but then held their ground in September. For the third quarter, equity investors came out ahead with returns of 3.6% for the S&P 500, 4.6% for the Nasdaq Composite and nearly 3% for the Dow Jones industrial average. In terms of sectors, Energy was the clear winner. Mid-cap names in the sector led the way. Oil and natural-gas exploration and production company Chesapeake Energy and coal producer Fording Canadian Coal continued their multiyear runs with 57% and 37% increases, respectively. The Utilities sector was the second best performer while Telecommunications came in third. Media and consumer services were the only sectors to post losses for the quarter. Media fell about 1%, with major newspapers such as the New York Times and the Washington Post down. In consumer services, retailers Abercrombie & Fitch and PetSmart suffered losses. All in all, eight out of ten S&P 500 industry sectors were up – a very good showing. Small cap stocks (+5.4%) continued to outperform large cap stocks while growth stocks outperformed value.



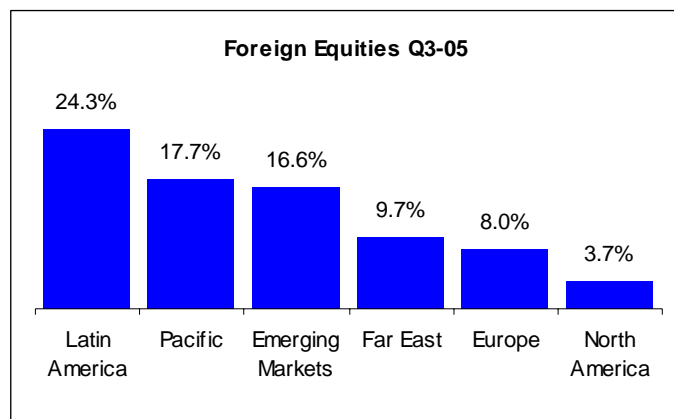
Equities should show a strong finish this year. Corporate performance remains outstanding as the majority of companies have reported higher-than-expected second-quarter earnings. In addition, estimates for full-year earnings growth have continued to advance. There may be some sector-specific disappointments due to Hurricanes Katrina and Rita, but we expect profits growth in the double-digits. Those smaller growth companies that focus on innovation and increased productivity will thrive.

Fixed-income securities experienced a rough third quarter as the yield on the 10-year Treasury reached a four-month high of 4.4% before gradually retreating to 4.0%. This yield was the highest in about four years and the highest long-term yield since April. The culprit was oil as energy prices peaked at almost \$70 per barrel at the end of August. Concerns about a potential slowdown caused by a decline in consumer spending have quickly given way to concerns about inflation due to higher energy prices. During the quarter, corporate bond returns were mixed as downgrades from Moody's reminded investors that little progress has been made to improve problems that plague North American auto manufacturers. Issuance of new securities was healthy over the last three months as lower interest expense continues to act as a major factor in driving corporate profitability where maturing debt is refinanced with lower coupons. High yield bond prices suffered as investors grappled with the multitude of negative issues affecting the airline and automotive industries. Moreover, with the lasting effects of Katrina and Rita still unknown, investors sought out higher quality issues.

The 10-year Treasury yield remains remarkably low, but it faces some hurdles going forward, including continued higher interest rate policies of the Fed and the prospect for inflation. At the corporate level, businesses remain remarkably risk averse by rebuilding liquidity and solvency and taking a cautious approach to investing. Such behavior is generally a positive influence on the bond market by contributing to tighter credit spreads. But there is a change underway as corporations become more aggressive in order to satisfy their equity investors. This action may conflict with the interests of bond investors. Given these risks, we believe bond returns, at best, may equal coupon income – possibly less if the yield on the 10-year Treasury backs up towards the 5% range.

Foreign Financial Markets

Global stock markets rallied in the third quarter despite rising energy prices and concerns about global growth prospects. Emerging markets in particular have benefited from the rise in commodity prices. Latin America benefited from increased investor demand for equities and was the best performing region for the third quarter as investors shrugged off political turbulence. Brazil and Mexico were among the strongest performers soaring 28% and 22%, respectively, as investors focused on improving fiscal and macroeconomic policies.



Asia Pacific equity markets came in second. In Japan, Prime Minister Junichiro Koizumi's landslide election victory returned the Liberal Democratic Party to power with a mandate to privatize the country's mammoth postal system (that also serves as a savings bank and insurance company) and pursue a program of smaller government. Japanese stocks rose 21% as investors rewarded an improving economy, a healthier banking sector and good corporate profits. Australian equities gained nearly 10% while equities in Singapore struggled to gain 3% as investors shunned electronics companies that make up the majority of the index.

Emerging market equities rose more than 16% as investors continued to be attracted by macro-economic factors, including the potential for higher earnings growth combined with company-specific factors such as lower valuations and higher dividends than can be found in U.S. domestic stocks. Indeed, a recent Morgan Stanley Capital International report showed emerging market equities trading around 12 times their earnings over the past 12 months, compared with nearly 20 times in the U.S. At the same time, emerging market equities boasted an average yield of nearly 3%, compared with about 1.7% in the United States. South Korean stocks soared as domestic investors incrementally increased their exposure to local shares through retirement accounts. In addition, healthy corporate balance sheets attracted foreign investors resulting in a gain of 21% for the local Kospi index. India's Sensex index also hit its highest level ever this quarter (+20%) as investors bet on the country's strong economic growth. Conversely, Taiwan's benchmark index fell nearly 2% amid concerns about the island's weakening economic growth and fears that demand for its technology exports could decline.

European equities benefited from corporate cost-cutting and consolidation. Germany's DAX index rose nearly 10%, France's CAC-40 was up nearly 9%, and London's FTSE-100 index increased 7%. Although Germany performed especially well in the third quarter, the outlook was uncertain following national elections in which neither Angela Merkel's Christian Democrats nor Gerhard Schröder's incumbent Social Democrats mustered a clear majority. (As of this writing Angela Merkel will become the new leader of Germany). The fallout extended across Europe, further slowing the Continent's economic recovery. Analysts blamed Britain's economic performance for holding back U.K. equities – particularly the banking sector. Perhaps the best news for U.S. dollar investors in European markets was that the euro and pound didn't weaken significantly against the dollar during the third quarter.

Many corporations, from large multinationals to nimble companies with global supply chains and sales, have found that their best markets are in the developing world. Thousands of smaller and mid-sized companies that use information technologies and low trade barriers to compete internationally will continue to have double-digit growth. We continue to favor those growth companies that focus on developing new technologies to improve productivity.

Conclusions

The end of an era is at hand. After nearly 18 1/2 years on the job, Alan Greenspan is required under law to step down at the end of his full term as Fed governor on January 31, 2006, which means he has three more FOMC meetings to preside over. Akin to the election of a new pope, the changing of the guard at the Fed is a rare and important event for the U.S. and world financial system. In the past 27 years, it has happened only three times. In each of those instances, the transition did not go well – financial markets quickly seized up, eager to test the mettle of the new central banker. This Fed transition could upset financial markets in the short-term until market participants have the opportunity to become familiar with an emblematic new chairman while the committee maintains its commitment to price stability.

Wall Street analysts expect S&P 500 earnings to rise 12% this year and 10% next year. The 12-month forward price-to-earnings multiple of 15.5x earnings means that the market is fair to slightly undervalued – an encouraging picture given how well corporations have been performing. Moreover, innovation and productivity continue to blossom. Voice-over-internet protocol (VOIP) technologies and high-band Wi-Max for wireless internet hold the promise of a new wave of information access at lower costs and faster speeds that should be a boon to everything from internet commerce to mobile telephony. Nano-technologies are moving out of the realm of fantasy and into the sphere of business applications. In addition to strong earnings growth, corporations have been achieving record profitability and continue to generate substantial free cash flow. This profitability has generated rapid dividend increases and share buybacks that further enhance shareholder value. We also expect an increase in merger activity as corporations move from their risk-averse, rebuild-the-balance-sheet perspective to focus more on growth.

One risk to our positive outlook for the economy and financial markets is the Republican disarray in Washington. Post-Katrina, the GOP has been on the defensive and lacking intellectual cohesion. Some in the House of Representatives want to cut spending to offset Katrina relief, while others in the Senate want to increase spending by federalizing Gulf Coast health care via Medicaid. The House Majority Leader has come under suspicion for influencing the sale of stock from a blind trust and Tom Delay has been indicted for misuse of campaign contributions, and President Bush now has a conservative revolt over his Supreme Court nominee. The obvious market concern is that the pro-growth political majority of recent years is in jeopardy –and, as a result, the plan to extend the 15% tax rate on capital gains and dividends to 2010 from 2008 is running into trouble. The danger is increasing that the GOP will lose control of the Congress and in the process suffer a reversal in the stimulative programs that got the economy rolling during the past three years.

In the end, U.S. financial markets should prove to be resilient to current investor concerns about rising interest rates and inflation, geopolitical uncertainty, high energy prices, growing budget and trade deficits, and housing bubble concerns. We believe that high quality growth companies will provide the best opportunities for gains over the next six to twelve months. And we continue to believe that China and India offer tremendous opportunities as well as other developing economies that continue to benefit from higher commodity prices, free trade and the implementation of new technologies.

Another of my Yogi Berra favorites characterizes the latest perception of political leadership: “If you don’t know where you’re going, you’ll end up somewhere else.”

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