

# Monthly Chartbook

## December 2005

Will the New Year bring investment joy?

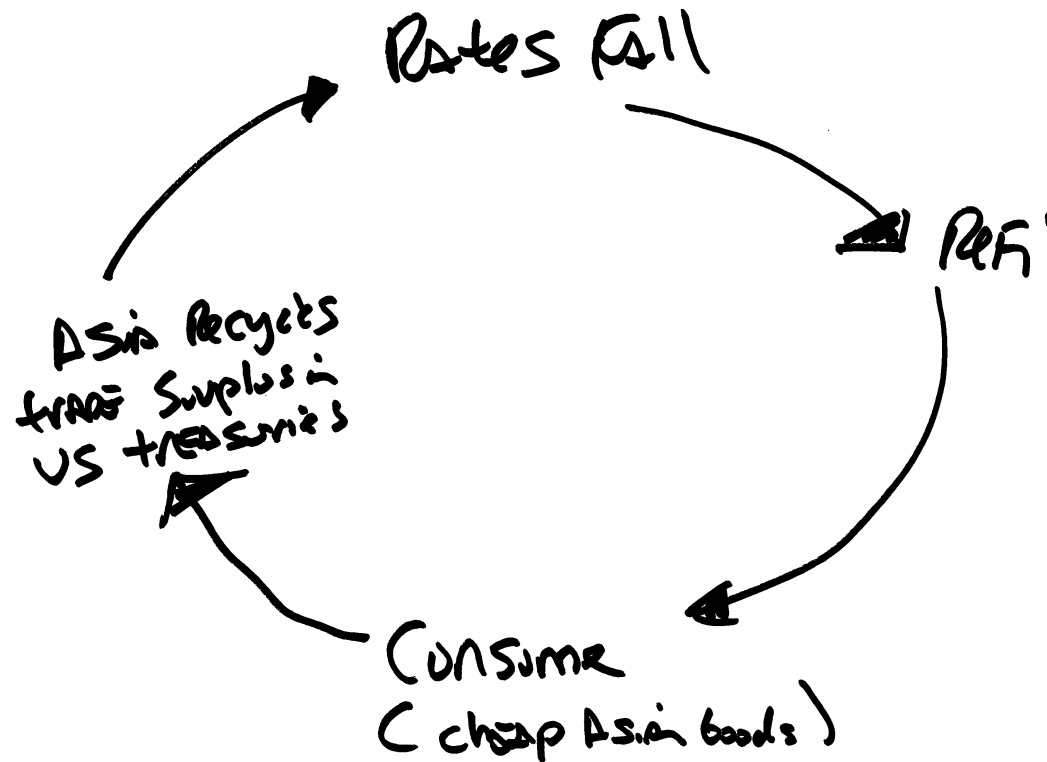
## **Looking back**

Based on average returns, for the five year trailing period the top domestic stock fund categories have been Real Estate (+18.60%) and Natural Resources (+16.07). This makes perfect sense and is evidence that the right investment strategy has been to focus on asset classes leveraged to falling interest rates and rising commodity prices.

Will the next five years repeat? Not very likely; we have been in a cycle of consumption driven by equity extraction that cannot continue at the same pace over the coming five years.

## Equity Extraction Cycle

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## *Macro-economic research*

### **Looking ahead...**

#### Bears

- Bull rally in a secular bear market
- Trade sideways for a decade or more
- Debt levels dangerous
- Valuations well above historic averages

#### Bulls

- P/E reasonable at the low level of interest rates
- Asians have to recycle trade surpluses as we are “central bank to the world”
- Earnings growth continues
- Average company balance sheet flush with cash

#### Cornerstone says...

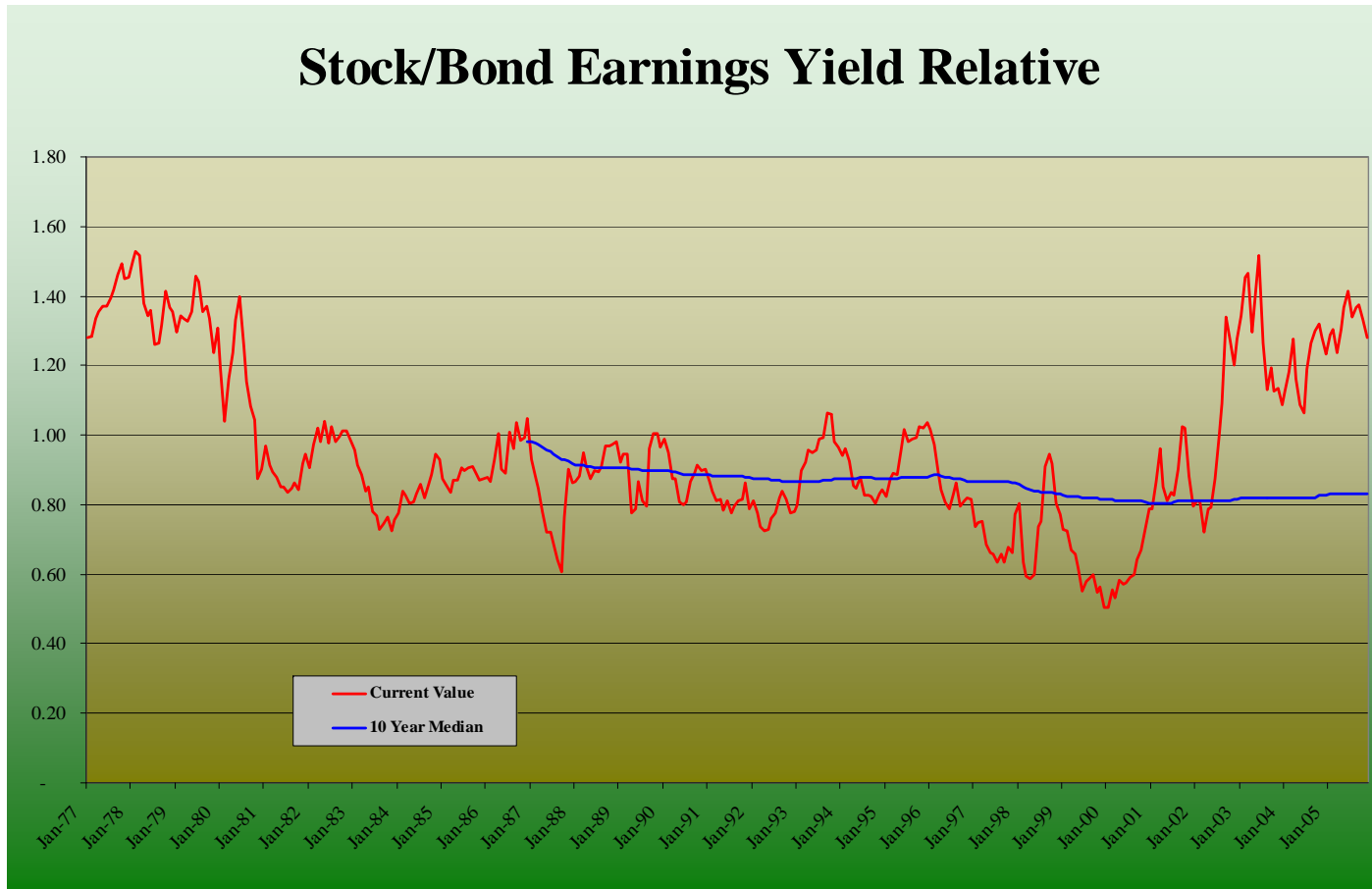
- P/E cannot expand until Fed stops and inflation slows
- Rates and forward earnings critical to any thesis owning stocks
- With t-bond yields at 4.375 to 4.75, returns twice that in stocks should be considered excellent

# Macro-economic Research



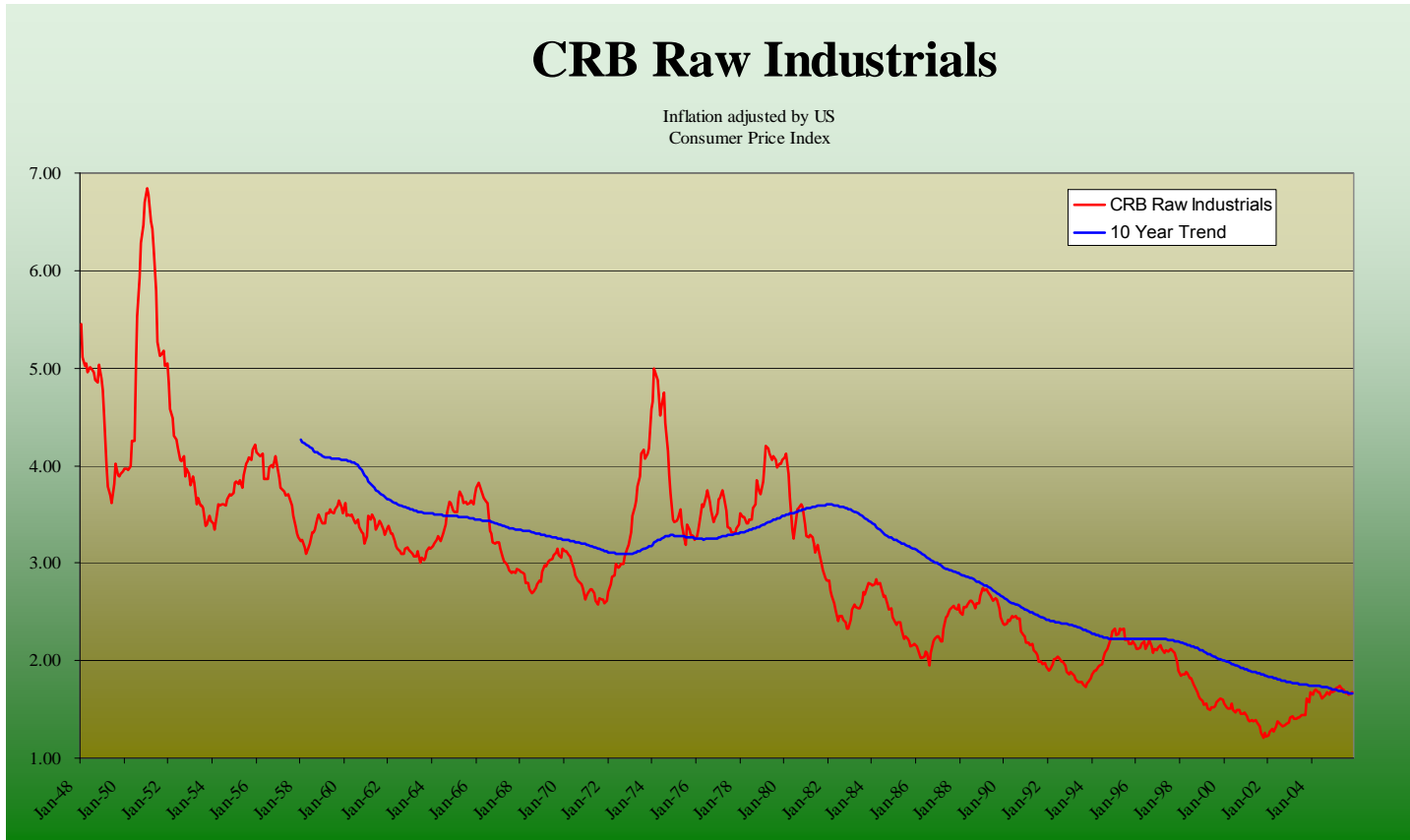
This is an annotated 100 year chart depicting the Dow Jones Industrial Average, floating around the internet. The assertion is that years of plenty are followed by years of lean. In part, we are agree that we are range-bound in the equity markets, fenced in by interest rates and earnings growth, but we are not bearish.

## Macro-economic Research



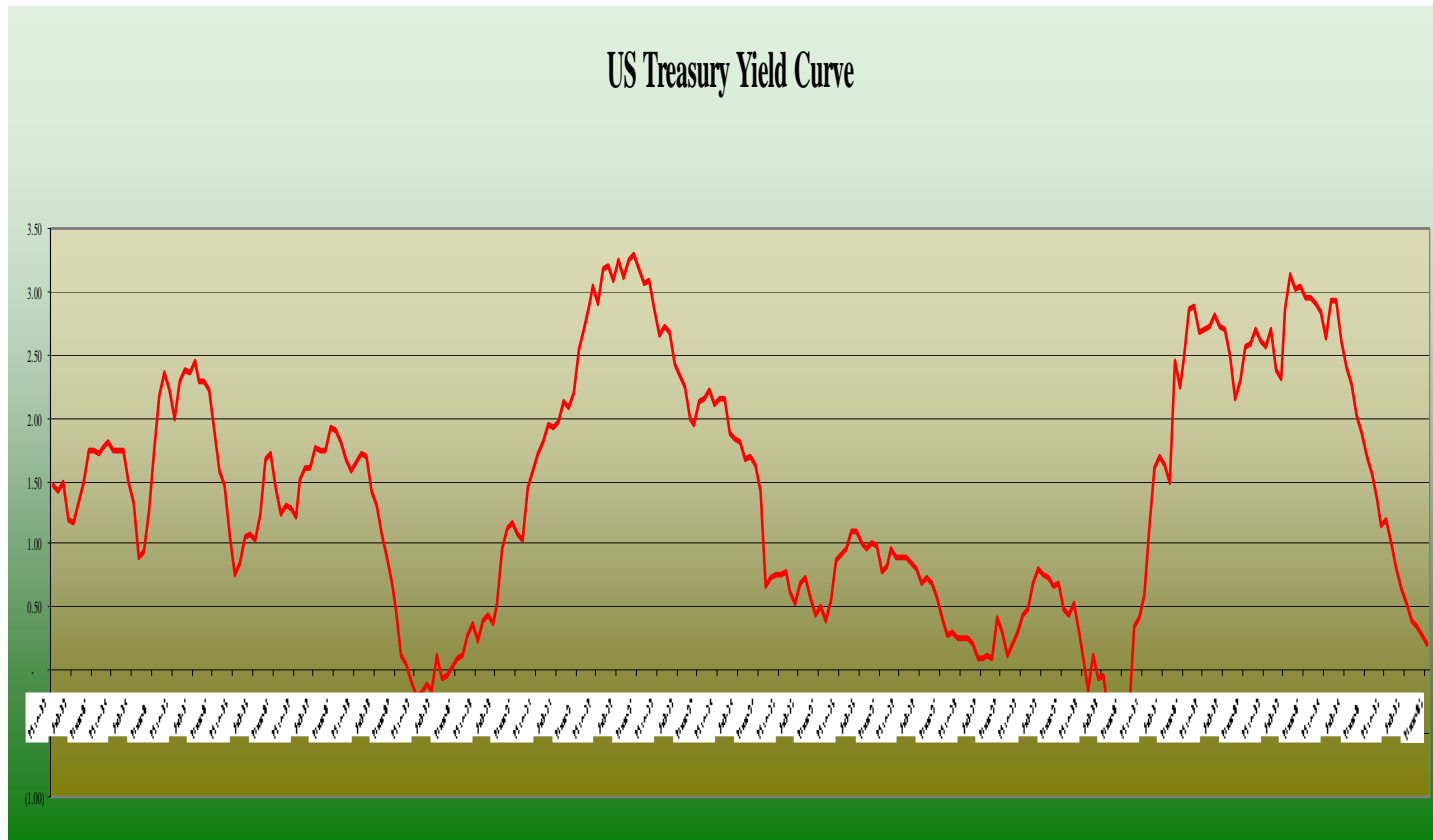
Unless you think that interest rates are going to skyrocket, stocks are grossly undervalued relative to the level of interest rates.

# Macro-economic Research



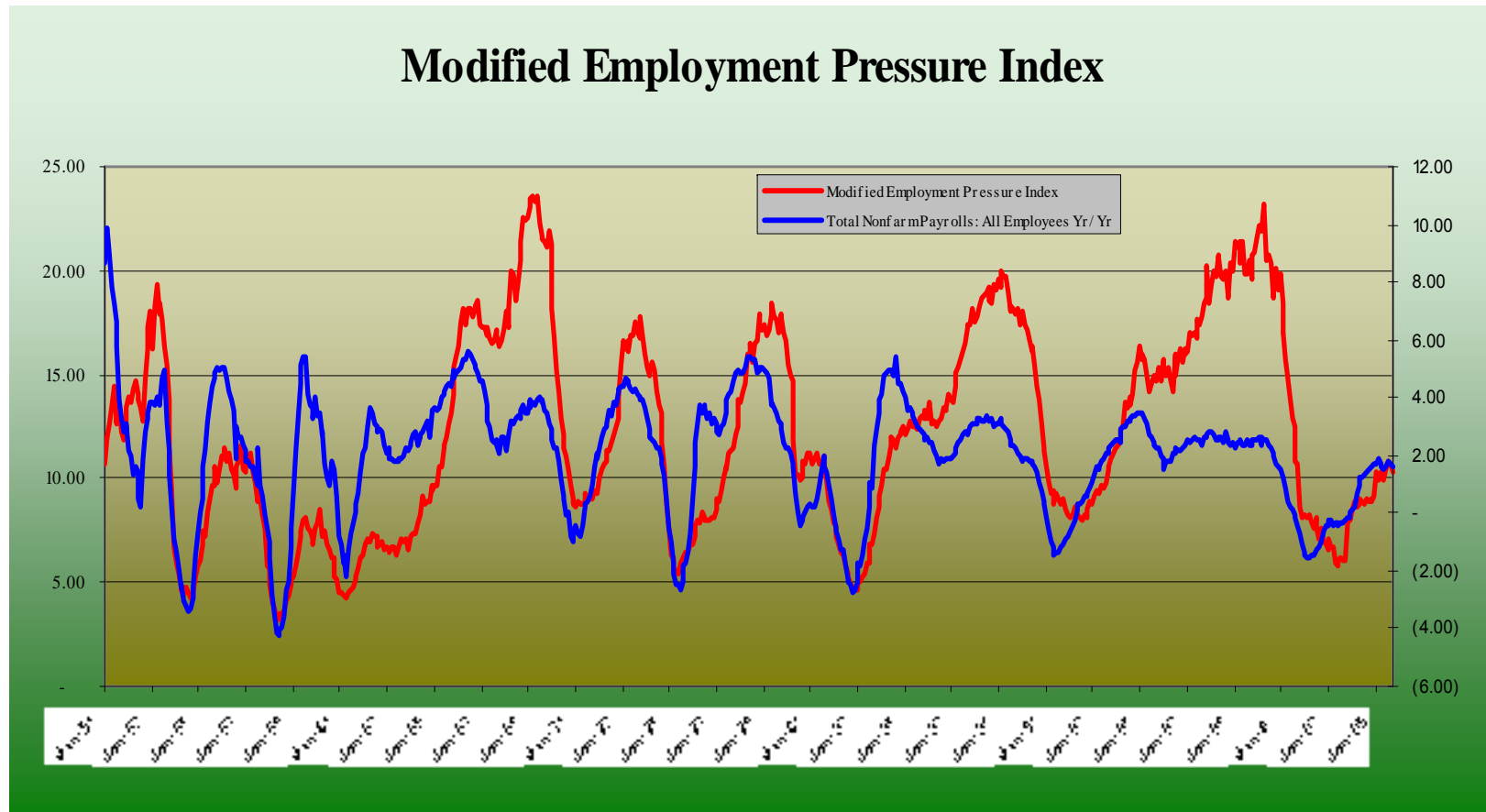
Commodity prices appear to be in a new bull market, but they could just be playing catch up. The CRB deflated by the CPI is just back to the trendline.

## Macro-economic Research



The yield curve hasn't just flattened here recently, it has *collapsed*. Borrowing short and lending long to print money (or earnings) is fast drying up. Many are saying, "the yield curve doesn't work anymore." Whoa. Wait a minute. Let's wait and see. Either inflation and short rates fall, or growth is going to slow, or perhaps all three.

## Macro-economic Research



We still contend that what the market perceives as slow labor market growth has kept a lid on interest rates.

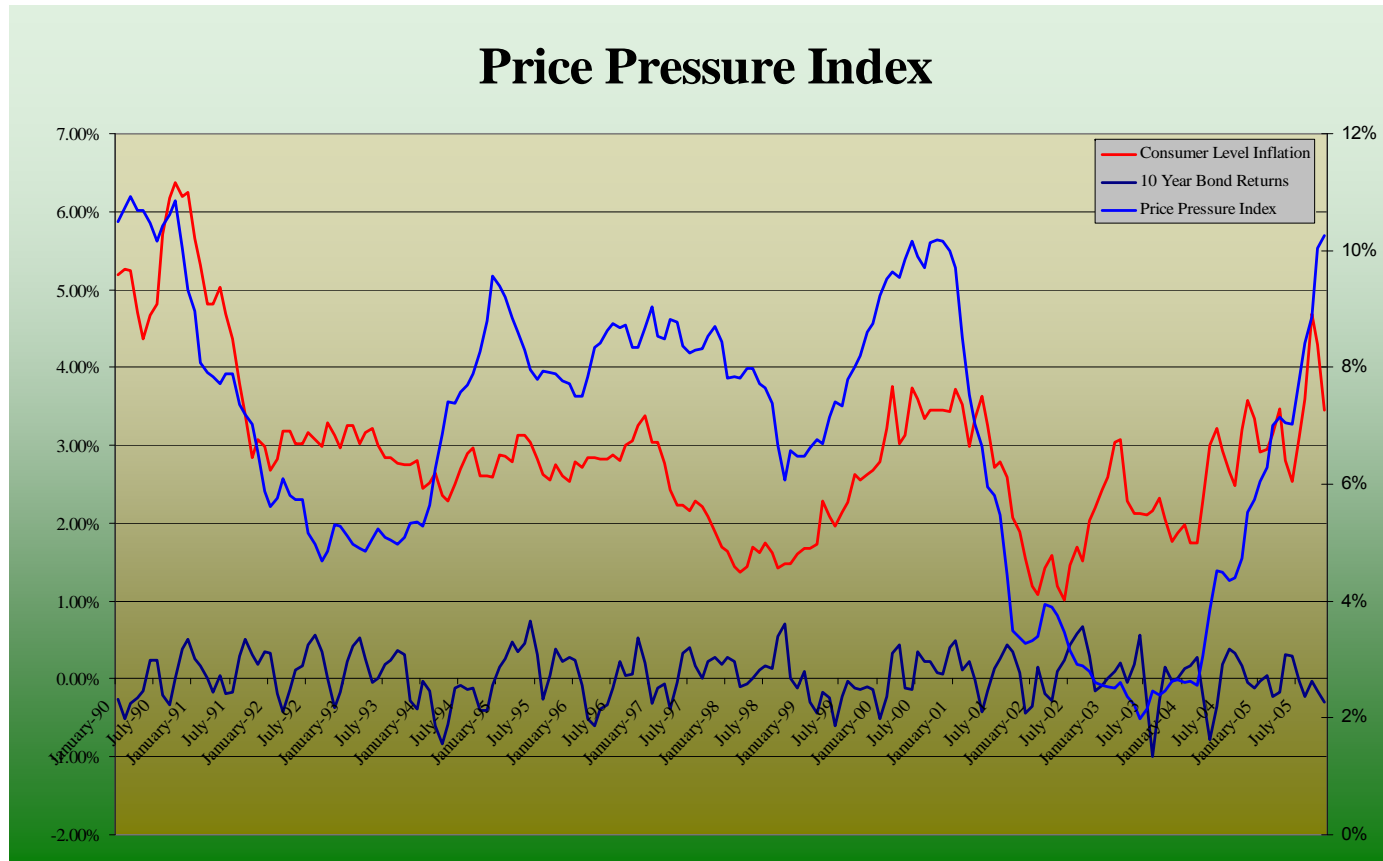
# Capital Markets Expectations

| Index                        | Current        | Forecast             |          | Range               | Time Frame           |
|------------------------------|----------------|----------------------|----------|---------------------|----------------------|
| <b>S&amp;P 500</b>           | <b>1248.40</b> | <b>Trading range</b> | <b>↔</b> | <b>1120-1275</b>    | <b>Next 6 months</b> |
| <b>Ten Year Treasury</b>     | <b>4.37%</b>   | <b>4.62%</b>         | <b>↓</b> | <b>4.25 - 5.00%</b> | <b>6 months</b>      |
| <b>Inflation (all Urban)</b> | <b>3.45%</b>   | <b>3.22%</b>         | <b>↑</b> | <b>3.00 – 4.00%</b> | <b>6 months</b>      |
| <b>Fed Funds</b>             | <b>4.25%</b>   | <b>4.50%</b>         | <b>↑</b> | <b>4.25 – 4.75%</b> | <b>3 months</b>      |
| <b>S&amp;P 500 Earnings</b>  | <b>\$66.81</b> | <b>\$69.31</b>       | <b>↑</b> | <b>\$67 - \$71</b>  | <b>1Q 2006</b>       |
|                              |                |                      |          |                     |                      |
|                              | Legend:        | ↑ Higher             | ↓ Lower  | ↔ Indifferent       |                      |

# Inflation expectations

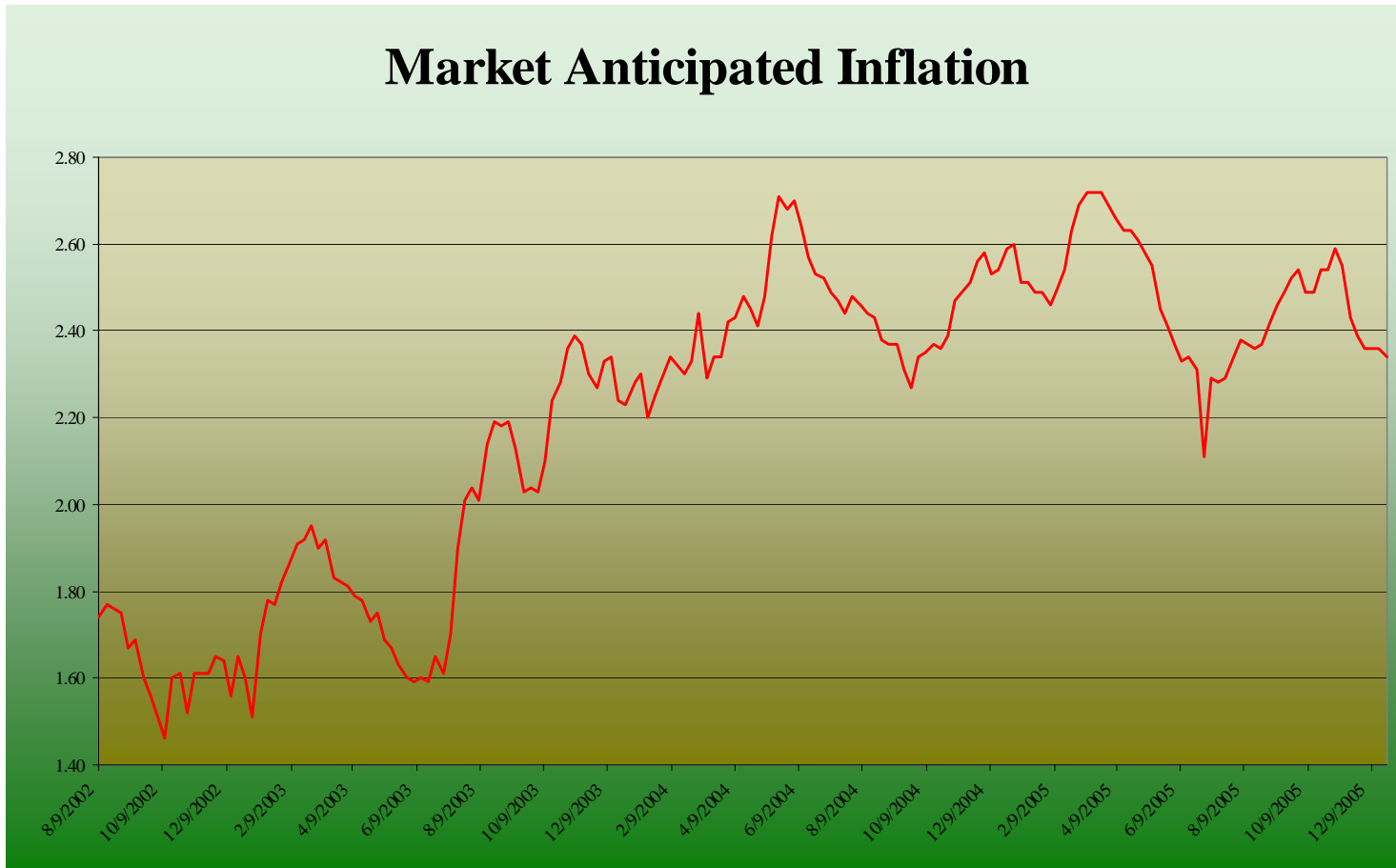
Moderating energy prices alone will not take the inflation issue off the table. Continued strength in the labor markets may present the Fed with a problem.

## *Inflation Expectations*



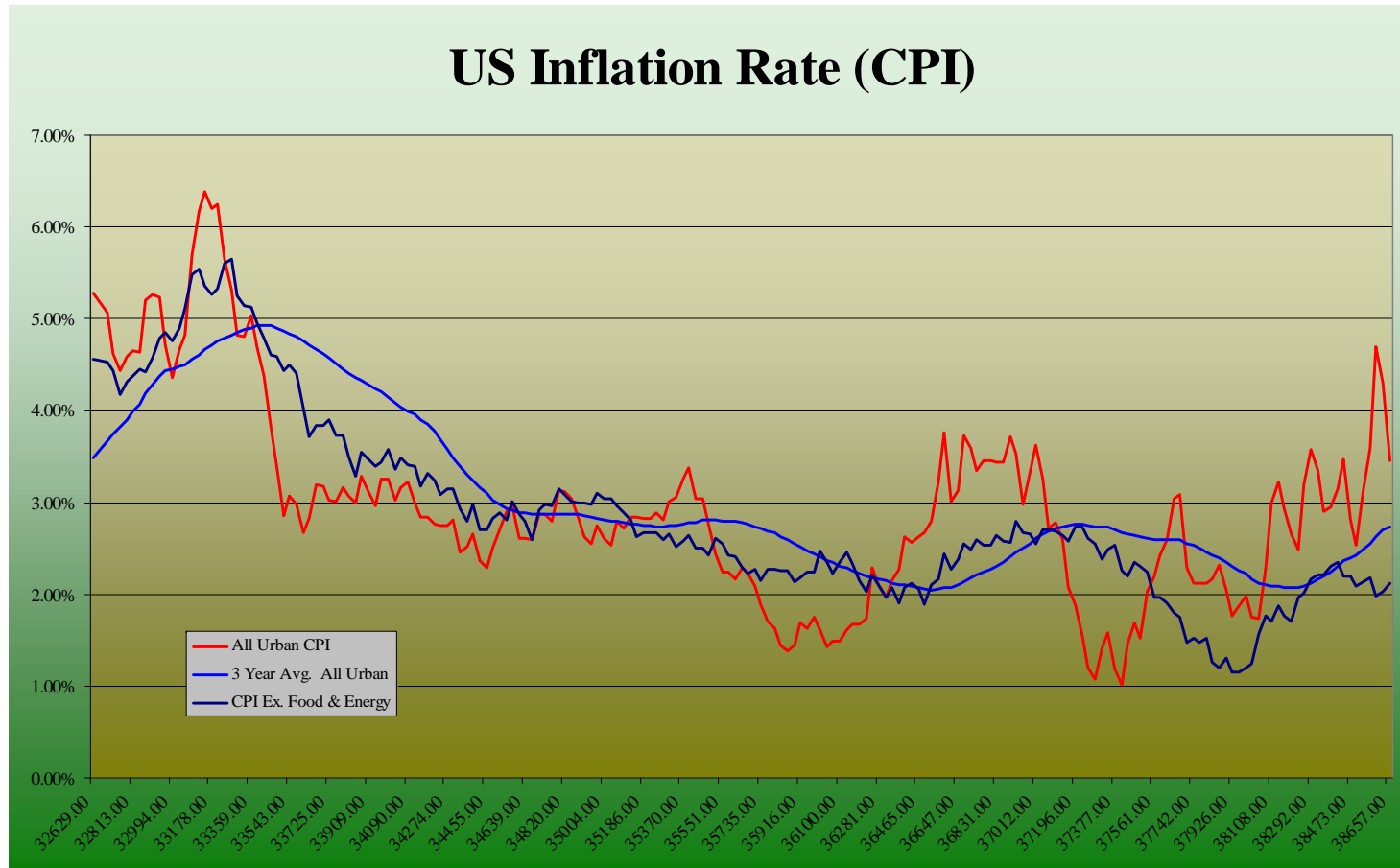
The Price Pressure Index continues to march higher. Though falling crude oil cooled consumer prices for a month, it is hard to see the price pressure index moderating without much slower growth.

## *Inflation Expectations*



Decomposing the TIPS spread to get an implied inflation rate, the markets anticipate long term inflation of just 2.34%.

## *Inflation Expectations*



Funny how the market ignored the core rate in this past month's data release. "Good news, good news, I only want to see the good news!"

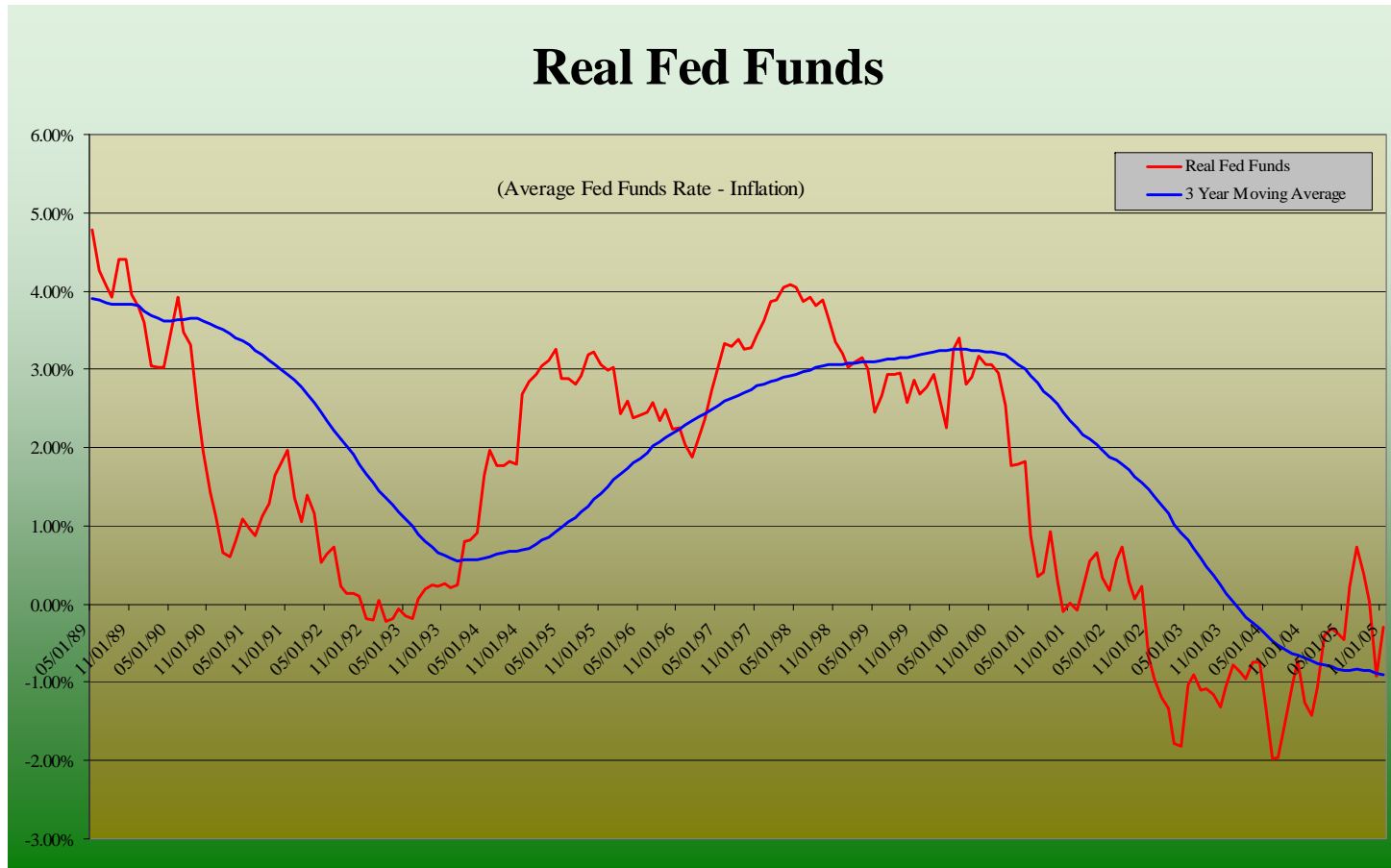
## Federal Reserve Watch

The markets expect one, perhaps two more 1/4 Fed Funds rate increases. After that, we are off to the races.

Granted, the end is soon near, and it just depends on what kind of tone the Bernanke Fed wants to set. If Dr. Ben wants to show that there is a new sheriff in town, watch out!

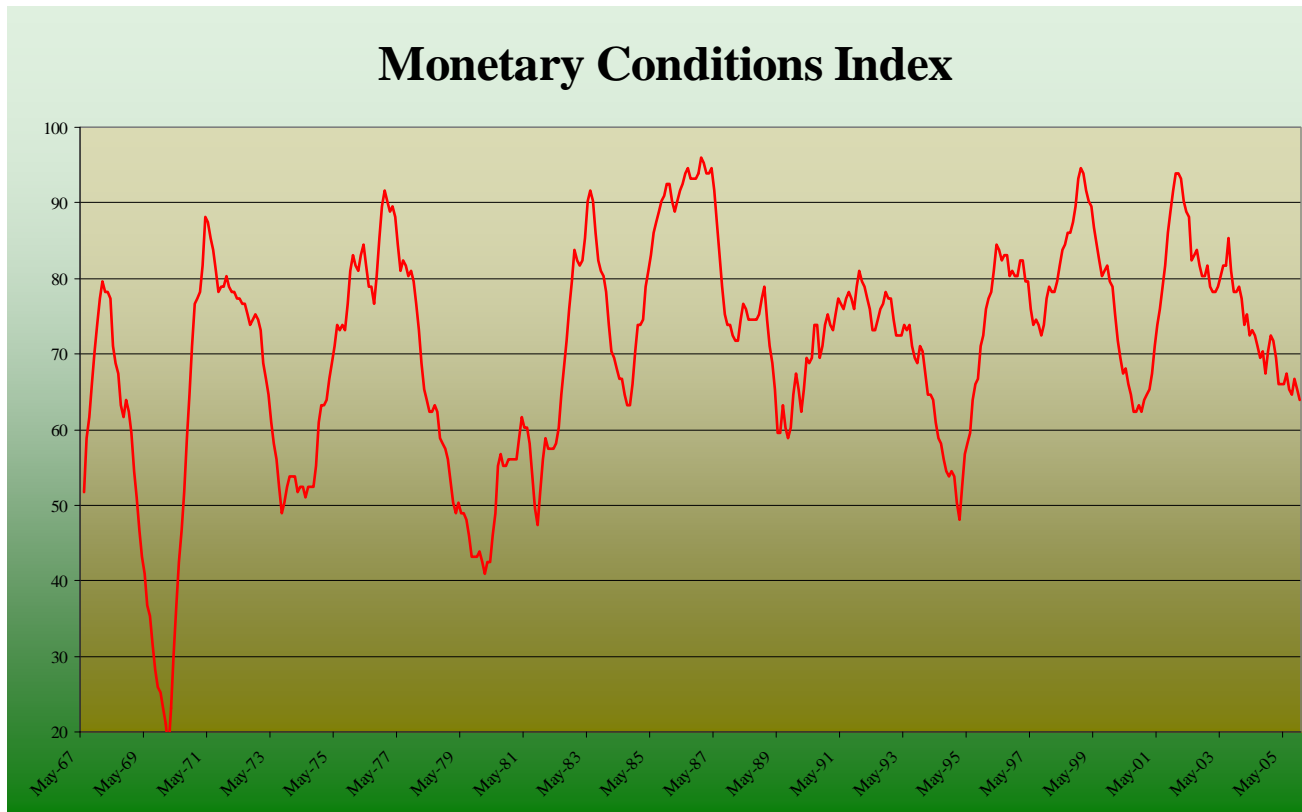
Historically the Fed has kept on tightening until something breaks, so far, we only see cracks, nothing broken.

# Federal Reserve Watch



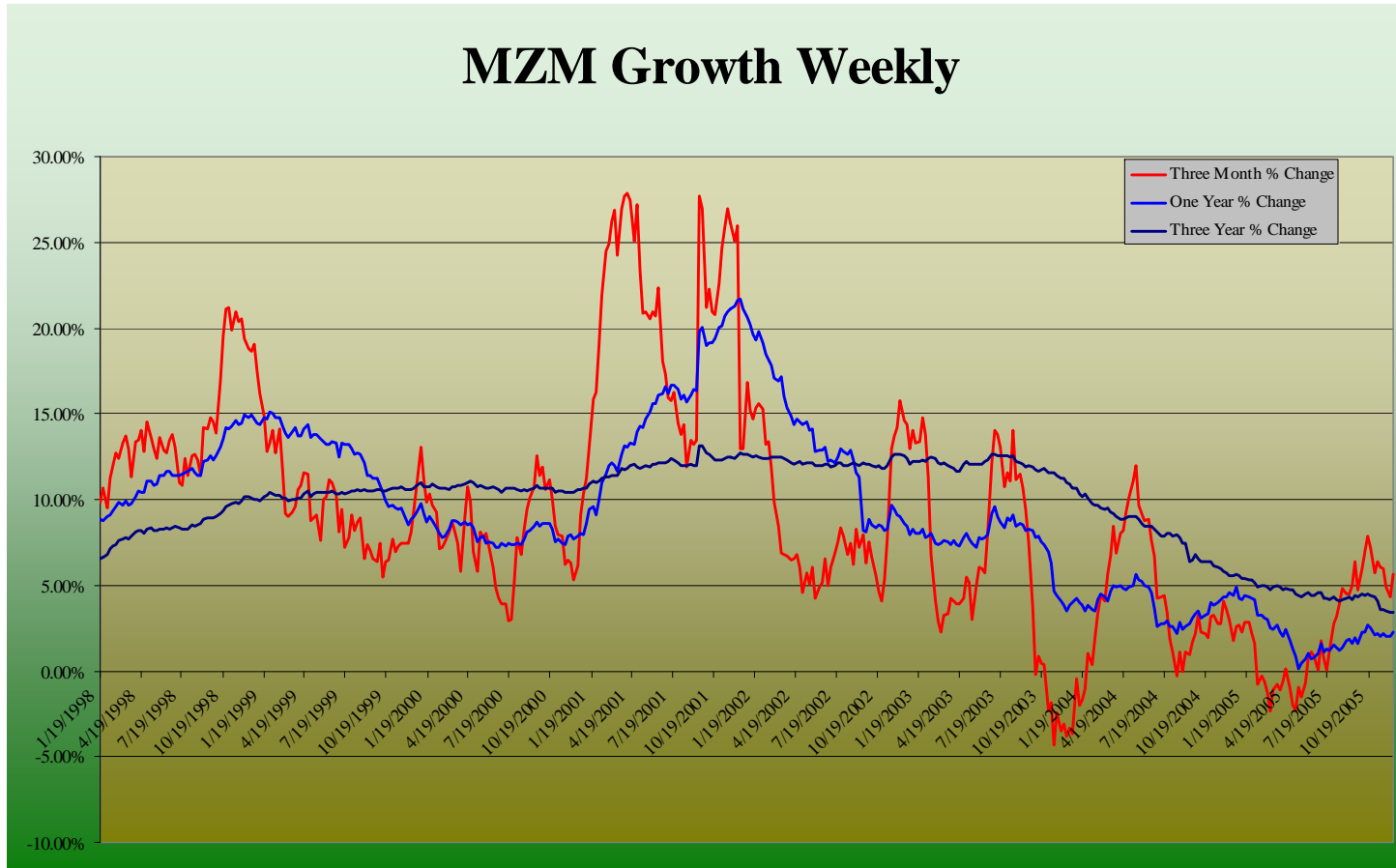
Still negative, not even close to neutral.

## Federal Reserve Watch



Lending isn't tight and that might be the only reason this decline has not been painful.

## Federal Reserve Watch



MZM growth has defied the moves in short term rates, liquidity growth continues. It is worth noting that the 1 and 3 year averages are well below their norm.

# Outlook

We see abnormally low long term interest rates versus present inflation continuing, a range-bound S&P 500, moderating energy and overall inflation.

To be bearish you have to bet against GDP and employment growth; to be bullish, you are betting on them.