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Market Commentary March 2006

1st Quarter 2006 Market Commentary

Despite a growing number of articles in the financial press about small cap and foreign equities ceding their market leadership to large cap US companies, these two sectors dramatically outperformed large cap US stocks in the first quarter. The MSCI EAFE index of international stocks returned 9.47% while small caps, represented by the Russell 2000 returned 13.94%. The S&P 500, by comparison, returned a respectable but relatively paltry 4.21%. Within the US market low quality stocks outperformed high quality by a large margin - A rated stocks returned 3.7% compared to 7.8% for B and over 10.0% for C and D stocks. Value beat growth in the large cap space but growth dominated among small cap stocks. The emerging markets continue to outperform. The MSCI emerging market index returned 12.0% for the quarter. The hot BRIC countries (they are so hot they have become a new acronym pronounced "brick" that stands for Brazil, Russia, India and China) have returned 22.7% so far this year. These markets have been the recipient of large flows of capital in recent months, and likely these numbers will attract even more "hot money" chasing this performance. Perhaps one can appreciate the irony of the acronym in advance of a potential decline of these markets should the flow of capital reverse directions. After a lackluster 2005, hedge funds came back to life in the first quarter with the HFR Fund of Funds index returning 4.81% for the quarter.

The Federal Reserve recently indicated it is letting up on its tightening stance in response to several indications that the economy is slowing and inflation is moderating. Inflation is a rate of change in prices, not an absolute price level. So if energy prices going forward remain at more or less current rates, the sector will have little or no impact on inflation rates. The US housing market delivered a 16% year over year decline in new home sales, its worst since the 1994-1995 period. Last year approximately $600 billion or 6.5% of personal disposable income was extracted in home equity loans. Consumer spending rates actually exceeded after-tax income due to this phenomenon. While unemployment has declined in the twelve month period ending February 28 from 5.4% to 4.8% and there has been a modest rise in wages, it may not be enough to counteract the effects of higher interest rates and energy prices coupled with the disappearance of home equity loans as a marginal driver of consumer spending. Increased business capital spending may help compensate for a reduction in consumer spending, but according to Northern Trust economist Paul Kasriel it would take a 15.2% increase in capital spending to offset a 1 percentage point reduction in consumer spending. At its peak in the 1990's year over year growth in capital spending did not exceed 12.1%. Furthermore, anecdotal evidence suggests that a significant portion of new capital expenditures by American companies may be in Asia and other developing markets. This will help corporate profits, but will lack the secondary stimulative effects associated with domestic investment.

A recent article in Grant's Interest Rate Observer notes that the most heavily shorted stocks by hedge funds have actually delivered higher returns than the S&P 500 since 2001. As hedge funds typically target weak companies with poor financials for short sales, this observation matches some of the

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work we have done on equity quality ratings as driver of equity performance. To illustrate, the article points to a stock with declining revenues, lawsuits from franchisees and deteriorating market share that is currently trading at 26 times earnings. The author, a hedge fund manager, opines that this is evidence of a "value bubble", defined as when too much money is looking for cheap stocks and then winds up stretching the definition of cheap until it has no relevant meaning. A similar situation occurred in early 1998. The chart below plots the P/E ratio of the Russell 2000 Value Index from January 1992 through December 1998. Notice the peak P/E ratio in the first half of 1998 of almost 24. Remember these are value stocks and are not supposed to grow much. That 24 P/E translates into an earnings yield of just over 4%. The subsequent sharp decline in the P/E ratio reflects the 14% decline the index had in the last three quarters of 1998. Fast forward to today and the P/E ratio of the Russell 2000 Value is at 24.3.

The second half of 1998 saw the Russian default and the collapse of Long Term Capital Management. The phrase coined to describe the market environment was a 'flight to quality". With record amounts of money flowing into hedge funds, emerging markets and aggressively leveraged non-investment grade debt structures combined with record low market volatility, it is not difficult to hypothesize that something somewhere may spark, if not a historical repeat of 1998, at least a market environment that rhymes with it.

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