



<u>Full Year 2005</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	10,717	↓0.61%
Standard & Poor's 500 Index:	1248	↑3.00%
10-Year Treasury Yield:	4.39%	

## **Investment Outlook** **December 31, 2005**

Dear Investors,

From the perspective of U.S. stock and bond investors, 2005 was a ho-hum year. The S&P 500 Index managed a measly 3% gain, and the Dow Jones Industrial Average did about as close to nothing as possible. In its flattest year since the end of World War II, the Dow was down 0.61% for the year. Long-term U.S. Treasury bonds were also basically flat despite a string of short-term interest rates increases by the Federal Reserve.

One of the most notable events to occur during 2005 happened in the final week of trading when the U.S. Treasury yield curve “inverted.” An inverted yield curve simply means that short-term fixed income securities are paying a higher interest rate than long-term bonds. This is not the normal state of affairs. Normally long-term bonds pay more than their short-term brethren to compensate for the risk of inflation and other adverse events that could occur over their longer maturities. But as the Federal Reserve has pushed short-term interest rates higher, long-term rates—which are decided in the markets and are thus not under the direct control of the Fed—have stayed put. Why is this event important? Because an inverted yield curve has been a harbinger of our last five recessions, though the economic conditions prevailing before each of those recessions were quite different from the conditions of today. In any case, the Fed seems determined to put the brakes on this economy—the big question for 2006 is whether or not it stomps too hard on the pedal.

When corporations post their results for the fourth quarter of 2005 in the next few weeks, they are likely to continue their improbable, two-and-a-half-year long streak of consecutive quarters of double-digit profit growth. Profits for the fourth quarter of 2005 are estimated to have risen by a sharp 13% over the same quarter last year. Such a streak of strong earnings growth has only happened in the U.S. three times since the 1950s. Much of the consistency and magnitude of the recent earnings strength can be traced to the energy sector, however, which over the past three years has enjoyed a very high level of profitability as well as a fast rate of earnings growth. Investors should bear in mind, however, that higher profits for energy companies portend a tougher time for the purchasers of energy—namely, everyone else.

Generally speaking, corporations continue to be in excellent financial shape despite high energy prices, rising short-term interest rates, and a slowing real estate market. Judging by their actions, however, they do not seem to be ebullient about the near-term future of our economy. They have not

begun to make significant capital investments with the large amount of cash that they have accumulated over the past several years. Instead, they are using this cash to increase their dividends and to buy back their own stock. These two later courses of action do bode well for future stock market returns, but the reluctance of companies to invest aggressively in their own futures does not.

Overseas, the story of the year for global financial markets has to be Japan. After struggling for two decades since its property and stock market bubbles burst in the late 1980s, Japan is rising anew. There are signs that the deflation that has vexed the Japanese economy for years is now beginning to abate. The benchmark Nikkei 225 Index was up 40.2 percent for the year, notching its biggest rise in 19 years. Japanese investors, severely burned by the unraveling of their bubbles, have for the most part remained on the sidelines while international investors have enjoyed the gains. Most other international markets also performed well. The Dow Jones World Index (ex U.S.) was up 17.1% for the year, trouncing the domestic market.

In 2006, the major issue for investors around the world is how much effect the Fed's 13 consecutive interest rate increases have on slowing the U.S. economy. In the bearish scenario, long-term rates will finally start to rise, putting a crimp on the housing market and causing consumers to reel in their discretionary spending. In the bullish scenario, the economy will slow enough for inflation to remain tame and the economy will continue to grow at about 3% per annum. The U.S. stock market, which has pretty much gone nowhere for the past year despite solid increases in corporate profits, is now looking relatively more attractive than other asset classes—particularly long-term U.S. Treasury bonds, in my opinion.

I look forward to working with all of you to make 2006 a prosperous year. As usual, I welcome your comments and feedback.

Best Regards,

Peter

Peter C. Thoms, CFA  
Orion Capital Management LLC  
1330 Orange Ave. Suite 302  
Coronado, CA 92118  
Tel: 619-435-1701 Fax: 619-435-1706  
[www.orioncapitalmgmt.com](http://www.orioncapitalmgmt.com)