



<u>First Quarter 2006</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	11,109.32	↑3.66%
Standard & Poor's 500 Index:	1294.83	↑3.73%
10-Year Treasury Yield:	4.86%	

## **Investment Outlook**

### **March 31, 2006**

Dear Investors,

U.S. and global stock markets rallied strongly in the first quarter of 2006 to get the year off to a good start. After a slow 2005, the Dow finally showed some energy and gained 3.66% in the quarter while the S&P 500 Index tacked on 3.73%. This was the highest one-quarter gain registered by the broad U.S. market since the fourth quarter of 2004. The story was the opposite for bonds, however, which suffered as interest rates continued to move higher. (When interest rates go up, bond prices go down—and vice versa.) The benchmark 10-year U.S. Treasury note lost 2.88% of its value for the quarter as the Federal Reserve Bank maintained its program of raising short-term rates. The Fed Funds rate now stands at 4.75% and it is likely to go to at least 5.00% before the Fed takes a break.

U.S. companies have begun to report their financial results for the first quarter. By and large, these results should be strong. The broad consensus among strategists is that the S&P 500 companies will post earnings growth of 11.2% over last year's first quarter. This is a strong rate of growth by historical standards—the average earnings growth rate since the 1980s is about 7% per year—and it ought to continue a now years-long streak of double-digit earnings increases for the largest U.S. companies. As in most recent quarters, energy and other commodity companies are enjoying more than their normal percentage of the gains.

While corporate earnings are strong, U.S. investors are worrying about the effect that the 15 consecutive Fed interest rate increases will have on an economy that is very used to cheap money. As the Fed pushes up short rates, credit card interest rates and other short-term interest rates move higher as well, increasing costs for consumers and companies. Furthermore, long-term rates, which are determined in the markets and are thus not under the direct control of the Fed, have finally started to move higher. Former Fed Chairman Greenspan called it a "conundrum" that the Fed had raised short-term rates considerably in 2004 and 2005 without seeing any substantial movement in long-term rates. Now, however, this movement has begun. As I write this, 10-year U.S. Treasury note yields are above 5% for the first time in about four years. Higher long-term rates will likely prove to be a significant burden to consumers with large adjustable-rate mortgages that are due to be reset to higher market rates in the near future. At the moment there are about \$2 trillion worth of adjustable-rate loans that are due to reset in 2006 and 2007. This is no inconsequential sum.

Overseas stock markets are continuing their strong performances. In Asia, China continues to grow rapidly and Japan's economy, while still weak relative to its neighbors in East Asia, has improved to the point where the Bank of Japan is thinking of raising interest rates for the first time in a long time. Numerous countries in Western Europe, even though their stock markets have performed well of late, continue to be beset by an inability to bring change to their rigid economies so that they can cope with the new realities of the global economy. In France, workers recently staged rallies to protest a proposed law that would have made it easier for employers to hire and fire workers. (The workers succeeded, and the bill was scrapped.) In Italy, a country suffering from declining competitiveness and five years of economic stagnation, a contentious election will likely bring to power a Romano Prodi central-left government that will probably have no power at all to legislate meaningful changes in an economy that desperately needs them. Eastern Europe is a different story, however. Capital inflows to the region have been strong, valuations are reasonable and the economic environment continues to be broadly positive.

For the balance of 2006, investors are certainly concerned about the Fed's determination to douse any signs of inflation. But another potential issue which may prove to be more important than the Fed is the potential for avian influenza, or bird flu, to make its appearance in the U.S. In fact, it is highly likely that the H5N1 virus will be identified here in the U.S. sometime this spring or summer as wild birds migrate from Siberia over to Alaska and move south from there. What is less sure, however, is the impact that bird flu will have on the U.S. economy. So far instances of bird flu in humans are relatively rare—there have only been about 200 confirmed human cases worldwide—but the bad news is that it kills about half of those it infects. So far humans have only been able to get bird flu from birds, and not from one other. The really big question about bird flu is whether or not the virus mutates to allow human-to-human transmission. If this does happen, and bird flu spreads widely, our economy will certainly be roiled. This is an issue I will be monitoring closely.

As is the case this time each year, my investment advisor registration (Form ADV) has been updated. Please let me know if you would like to receive a copy. As usual, I welcome your comments and feedback.

Best Regards,

Peter

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