



Could a slowdown in global economic activity be a good thing? Equity and bond investors apparently believe so, as evidenced by the manner in which they bid up prices during the third quarter of 2006. Investors have been willing to overlook slowing corporate profit growth, a softening labor market, and slowing housing activity. Instead they have chosen to focus on the positive implications that slower growth has on inflation, Federal Reserve policy, and energy and commodity prices. Their optimism, of course, rests on the hope that the economy only slows and does not transition into a recession.

### **Economy**

U.S. economic growth continued to slow during the third quarter of 2006. Real gross domestic product (GDP) is estimated to have expanded at a 2.5% annual rate in the third quarter, a deceleration from last quarter's 2.6% growth rate and below the economy's long-term trend rate of 3.0%. Evidence of a slowdown is apparent in consumer spending, industrial production, job growth, and the housing market.

A positive implication of slowing economic growth is a much-needed moderation in inflationary pressures. Last quarter, economists were worried that a spike in the core consumer price index (CPI), which excludes the volatile food and energy components, meant the return of stagflation (i.e., high inflation coupled with slow economic growth). Nevertheless, March's CPI reading appears to represent the high-water mark for inflation, with the monthly percentage change in CPI falling from 0.34% in March to a low of 0.19% in July.

Commodity prices have declined, which will serve to alleviate inflationary pressures. Oil declined nearly 15% during the third quarter and continues to fall below \$60 per barrel. Industrial metals (e.g., copper, zinc, aluminum, lead, and nickel) fell by more than 20% during the quarter. Clearly, slowing growth is having an effect on commodity prices.

The Federal Reserve surprised no one by halting its two-year-old rate tightening campaign. With inflation fears receding and the economy slowing, the members of the Federal Open Market Committee (FOMC) thought it best to step back and allow the previous 17 interest rate hikes to work their way through the economy. The Fed has stated that future actions will "depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." We believe that the Fed will remain on hold for the time being and that the next change in interest rates is most likely to be a reduction.

Arguably, the greatest area of weakness in the U.S. economy is concentrated in housing. Nearly all key measures of activity are down precipitously, and inventories of unsold homes reside at an all-time high in excess of 4.5 million units. The housing boom boosted U.S. economic growth considerably over the past

few years, and its collapse is expected to dampen growth going forward. According to Fed Chairman Ben Bernanke, a housing correction could shave about a percentage point from second half 2006 real GDP growth because of the impact housing has on consumer spending, job creation, consumer finances, and the banking system.

In our last letter, we were concerned about the effects higher energy costs, rising interest rates, and a softening housing sector would have on consumer spending. Whereas the housing market continues to weaken, the outlook for interest rates and energy costs have improved. This has strengthened our conviction that the economy will only slow and not fall into a recession.

The U.S. has been the primary engine of growth for the global economy over the past several years. It should be expected, therefore, that any slowdown in the U.S. economy will be felt abroad. Compounding matters are efforts by China, which has been the other pillar of global economic growth, to curb investment spending. The economies of Europe and Japan are much more dependent on exports than that of the U.S. and, as such, we would not expect these economies to outgrow the U.S. economy in a material way in the near future.

### **Equity Market**

The U.S. equity market performed well, recording its strongest third quarter performance since 1997. Investors cheered slower economic growth as it inspired a significant decline in bond yields. Lower interest rates are generally conducive to a rising stock market, all else being equal.

The third quarter was notable for the major shift in equity leadership that occurred. The energy, materials and industrials sectors, long the leaders of this bull market, were the three worst performing sectors, while laggards such as health care and information technology significantly outperformed. Furthermore, large-cap stocks outperformed small- and mid-cap stocks after underperforming for the past six years. Similarly, the U.S. equity market outperformed international equities after underperforming for more than five years. We view this leadership change as validation that the economy has reached an inflection point.

Typically at this point in the economic cycle, investors look towards high quality companies that deliver steady and predictable growth in earnings. We expect these emergent leaders to continue to do well over the remainder of 2006. Large-cap stocks should continue to outperform small- and mid-cap stocks, and domestic equities should outperform international equities; although we still believe a proper exposure to all categories is appropriate in the context of a diversified portfolio. Corporate profits are set to slow after twelve consecutive quarters of double-digit growth. We believe, however, that the market's valuation, as measured by the price-to-earnings multiple, should expand on the back of lower interest rates and declining inflation.

### **Fixed Income Market**

The third quarter of 2006 witnessed a major rally in the U.S. fixed income market, with the benchmark 10-year Treasury rallying from a 5.13% yield at the end of the second quarter to 4.63% at the end of the third quarter. As with equities, the rally was in large part driven by slower economic growth, falling commodity prices, the Fed's decision to pause its rate hike campaign, and expectations of a Federal Funds Rate reduction in early 2007. Though inflation continues to be above the Fed's announced range of 1-2%, the market expects that the slowing housing market and the drop in commodity prices, particularly for energy, will result in a moderation of inflation. Our expectation is that yields will continue to trend down, although this forecast would be at risk if economic statistics showed higher than expected economic growth or inflation.

The Treasury yield curve remains inverted, with the Federal Funds Rate at 5.25% and the 2-year Treasury at 4.69%. Historically, an inverted yield curve is indicative of tight monetary policy that is designed to

slow economic growth and to reduce overall inflation. The fixed income market believes that the Fed will achieve its objectives and successfully orchestrate a soft landing. The bond market is at a favorable point in the credit cycle, as evidenced by the 12-month default rate for speculative bonds at a cyclical low of 1.0% versus an average default rate of 4.6% since 1981. Currently, high-yield corporate spreads are historically tight, at +364 basis points versus the +660 basis points reached in August 2000, just prior to the March 2001 recession. We continue to be concerned with event risk in the corporate bond market, as the pace of mergers and acquisitions, leverage buyouts, and recapitalizations picks up.

The municipal market yield curve, unlike the Treasury yield curve, is flat, with the difference between 1-year and 5-year municipal yields a scant 1 basis point (3.46% vs. 3.47%). Historically, municipal yields are low relative to Treasuries. Ten-year municipal bonds offer yields at 79% of the 10-year Treasury versus the historical average of 87%.

### **Outlook**

The economy has reached an inflection point, and, accordingly, the financial markets should continue to churn. Investors thus far have been emboldened by the slowing economy, bidding up both the fixed income and equity markets. The Dow Jones Industrial Average recently set a new all-time high, surpassing its old record set in January of 2000. This exuberance may prove a bit premature.

The equity market is vulnerable to concerns about inflation giving way to fears about a hard economic landing (i.e., a recession). Fears of a recession are likely to intensify as the housing downturn causes consumers to cut back on spending. Nonetheless, we believe a recession is not likely, given that the Fed should be finished raising rates and may even cut rates. The stage would then be set for the continuation of this equity bull market both here and abroad.

Bond investors believe that a Fed rate cut by the end of this year or in early 2007 is probable. Any strength exhibited by future economic data could cause a sell off in bonds, sending interest rates higher. Furthermore, spreads for risk assets are at historically tight levels and reflect a continuation of the current benign environment. Overall, we believe the potential for major capital appreciation from the fixed income market is limited at prevailing interest rate levels. That said, if the economy has a soft landing, as we expect, the prospects for further gradual declines in yields are good.