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Market Commentary

A Review of the Markets and a Look into the Future

Slow Start - Strong Finish?

"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today."

- Laurence J. Peter, US educator & writer (1919 - 1988)

As we advance beyond mid-year, stocks are struggling to stay positive. This is not surprising considering the major headwinds deterring their progress. Most notably, oil prices have risen more than 40% over the last year. During the same period, the Fed has hiked interest rates more than 9 times. And if the war in Iraq were not enough, geopolitical concerns have become elevated once again as the London subway terrorist bombings of July 7th and July 21st have served to remind investors of the ease with which terrorist events can occur. Finally, the ongoing boom in housing prices taking place in numerous cities across the country is raising suspicions by many people that a real estate bubble is developing and may eventually burst. Considering all these factors, it is actually quite impressive stocks have held their own.

Contributing to the resiliency of stocks are growing corporate profits that have continued to increase in spite of the headwinds. For 2005, S&P 500 operating earnings are expected to rise over 11% - slower than last years 22% rise, yet still very healthy. As a consequence, the S&P 500's price-to-earnings multiple has been declining as the year has progressed. During the same period, long-term bond rates have remained stubbornly low, much to the surprise of Alan Greenspan. This dichotomy is providing a compelling valuation trade-off between stocks and bonds. Currently the earnings yield on the S&P 500 is 6.2% (measured by dividing the year-ahead forecasted earnings for the S&P 500 by the index itself). This compares with the current yield of 4.3% on ten-year Treasury bonds. Historically, differences of this magnitude have augured well for the future performance of stocks.

So What are Economists Saying about the Outlook?

It has been said that God created economists in order to make weather forecasters look good. True to form, economists seem to be all over the map in their

predictions. As they collectively see it, there are numerous scenarios that could play out in the coming months and years.

A number of economists have voiced their beliefs the Fed will soon end its tightening cycle without causing any meaningful disruption to the economy or stocks. The presumption here is the short-term interest rate increases induced by the Fed over the last year will work their magic and moderate any inflationary pressures without causing a meaningful economic downturn. This is often described as a 'Goldilocks Economy' where low inflation and moderate economic growth prevail, providing a "not too hot and not too cold - but just right" environment for stocks.

Other economists are suggesting strong global growth, especially in China and India, is bringing about secular changes to the world economy that will be reflected in rising commodity prices for years to come. They point out that China alone accounted for 31% of the increase in demand for oil last year - and this may be just the beginning. History suggests that as emerging economies grow and begin to industrialize, oil consumption per capita tends to rise rapidly. The U.S., Japan and South Korea followed this pattern as they industrialized their economies. China's per capita consumption of oil per year is only 1.7 barrels currently compared to 28 barrels in the U.S. This portends potential huge increases in the demand for oil and other industrial commodities from China's massive population in the coming years. If new discoveries of oil and gas or alternative energy sources fail to keep pace with these demands, increasing inflationary pressures may lead to a secular rise in interest rates that could herald a more difficult period for the stock market.

Still other economists are predicting the current swell of investment capital flowing into China will lead to

overbuilding and significant excess capacity in factories and production equipment. This is what happened during the technology bubble and ultimately resulted in a bear market accompanied by significant deflationary pressures.

These and other economic scenarios presented by respected economists are certainly very plausible. Nevertheless, we have to be careful not to get bogged down by all of the economic possibilities and lose sight of the main focus we should have with the management of our portfolios. The following Aesop's fable illustrates my point:

A traveler rented a donkey to take him to a distant place. The day was very hot and the traveler eventually stopped to rest under the shadow of the donkey. As the donkey's shadow was only large enough for one person, and the traveler and the owner of the donkey both claimed it, a violent dispute arose between them as to which one had the right to the shadow. The owner maintained that he had rented the donkey only, and not his shadow. The traveler asserted that he was, with the rental of the donkey, entitled to his shadow also. The quarrel proceeded from words to blows, and while the men fought, the donkey galloped off.

The moral of the story: Don't let the debate over the direction of the economy allow you to lose your "donkey".

What Are Your Economic Expectations?

Before I answer this question, it is important everyone understand the First Law of Economics: 'For every economist, there exists an equal and opposite economist'. As a portfolio manager, my perspective is quite different from an economist's. Every decision I make potentially has very real near-term ramifications to my clients' portfolios. As such, I am more concerned with the consequences to the portfolio of being wrong than I am with the possibilities of being right.

Longer-term secular economic trends are important, but these factors are sometimes overwhelmed in the short-term by other influences. That's why I keep my eyes on the objectives of our portfolios and don't get lost in the debate. Our objectives at Green Investment Management vary somewhat from one portfolio allocation to the next. But in general our objective is to produce better risk adjusted returns than a similarly allocated passive portfolio. While we cannot guarantee success in this endeavor, we do stay focused on our objectives. As it relates to the stock market, there are two low probability, but potentially damaging economic scenarios that could

produce a very difficult environment for stocks. One would be a significant pick-up in inflation from our current modest levels. The other would be a considerable downturn in economic activity that results in a deflationary environment. Either one of these events would result in a significant compression in current price-to-earnings multiples of stocks and much lower prices. Again, these events appear to have a low probability of occurring at the present time.

The most probable economic scenario presently seems to be the 'Goldilocks Economy' where low inflation and moderate economic growth continue to prevail. However, since we are well into an economic expansion with low unemployment and increasing capacity utilization, we want to watch carefully for any signs of increasing inflation – especially in wages. So far, most of the surprises have been to the downside. In the absence of meaningful inflationary pressures, the Fed may soon be through raising rates.

What is the Outlook for Domestic Stocks and Bonds?

If the Goldilocks scenario continues to play out like we expect, it will be hard not to be bullish on stocks - especially if there is some reprieve offered by falling oil prices and/or indications that the Fed is finished raising rates. Seasonally, the third quarter is often the most difficult period of the year, but this one may be an exception. Based on relative valuations and continued earnings improvements, it is probable that stocks will outperform Treasuries in the next few months.

This should also be a favorable environment for corporate bonds to outperform Treasuries. Credit spreads have widened since their lows in March of this year, providing an added incentive to own corporates. A slight bump in the road to the outlook for bonds is the scheduled retirement of Fed Chairman Alan Greenspan, who is scheduled to step down in January 2006. The markets may be a little more volatile in the early going of the new chairmanship until they gain comfort with his or her new credentials and style.

In closing, we send thanks to those of you that are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. 🐾

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