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Market Commentary

A Review of the Markets and a Look into the Future

A Haunted October

At first cock-crow the ghosts must go
Back to their quiet graves below.
~Theodosia Garrison

The last few weeks have been difficult for both stocks and bonds—you might say they have been a little spooked. Rising energy prices and tight refining capacity, as exposed by hurricanes Rita and Katrina, have intensified fears that the ensuing months could bring accelerating core inflation. Meanwhile, the Fed has continued to push short-term interest rates higher toward the obscure 'neutral' rate, described as the level of interest rates that are neither accommodative nor restrictive. All told, investors seem to be waiting for more clarity regarding both inflation and the Fed's path with interest rates before they commit new funds to the markets.

Fears that the oil induced spurt in the Consumer Price Index (CPI) could trickle down into the important core inflation rate are a very valid concern. The core rate omits the more volatile food and energy components from the baseline CPI and is considered a more accurate measure of the underlying rate of inflation. Bond investors want to know what to expect from this measure before they are willing to aggressively buy bonds at current levels. Core CPI is also important to stock investors who are concerned about how far the Fed will raise short-term rates in order to stem growing inflationary pressures. It is our expectation that the Fed will not pause until it is convinced that economic growth has downshifted enough for the recently revived inflation expectations to dissipate. The higher it is perceived the Fed will need to raise rates, the more concerned investors will become about the potential for a recession.

Economic data releases and Fed actions and comments in the coming days and weeks will begin to add greater clarity to these concerns. If the core rate does begin to

rise above current expectations, the Fed may be forced to raise interest rates beyond their 'neutral' range of 4-5% into more restrictive higher rates. This could cause greater difficulty to both the bond and stock markets.

The good news is that in spite of the recently reported 14 year high CPI rate of 4.7% and warnings from various surveys about the broadening out of pricing leverage by companies, there has been no validation of those concerns reflected in the core CPI as of yet, which stands at 2% currently. It may be that the very open global trade that prevails today is containing the inflationary spillover effects that might have occurred in the past. In terms of broad gauges of US prices, inflationary pressures appear to be narrow for now. This is especially surprising since the economy grew at a robust 3.8% in the third quarter, its eighth quarter of growth at 3% or above and the longest streak since World War II.

S&P 500 third quarter operating earnings are expected to set an all-time high and register a new record with its 14th consecutive quarter of double-digit, year-over-year gains. The S&P 500's price-to-earnings ratio has fallen to 14.7 times the year-ahead earnings expectations - the lowest P/E multiple in 15 years (the average P/E since 1988 has been 19.9). In other terms, its earnings yield is 6.8% (S&P500 Earnings/S&P500 Price) as compared to the current yield of 4.5% on the ten-year Treasury bond. On this basis, stocks are presently 30% undervalued relative to bonds - providing a good valuation underpinning to the market. Because of that undervaluation, when the Federal Reserve is finally perceived to be almost finished raising rates, this should provide the catalyst the market needs to break out of its recent lethargic state.

The Outlook for Bonds

We have generally favored high yield corporate bonds above treasuries over the last three years. We were especially attracted to this sector in late 2002 when credit spreads were providing almost a 10% yield premium to Treasuries. Since then, surging corporate profitability, low default rates, subdued inflation and accommodative monetary policy have all contributed to increased investor confidence and lower credit spreads, reaching their nadir of 2.9% in March of this year. Since then spreads have widened to 3.7%, reflecting changes in inflation expectations and a reduction in monetary accommodation by the Fed. Additionally, rising short-term rates are causing investors to be less motivated to seek out higher yielding investments. This status could change quickly if inflation expectations are reduced or credit spreads widen further. In the meantime, Treasury prices have also been weak - equally preoccupied by the possibilities of higher inflation. As a result, we maintain a cautious stance in the credit markets until the conditions that expose the economy to increased inflationary risk subside.

Observations

The strong GDP growth reported for the third quarter reveals a resilient economy in spite of the hurricanes and higher energy prices. So far, consumer spending has held up well and business investment has been strong. As short-term rates continue to rise, we expect the search for yield theme that has become dominant in the last two or three years to dissipate from recent elevated levels. Higher rates are causing yield hungry investors to be less motivated to seek returns from riskier assets. The fashionable 'carry trades' (the purchase of a higher yielding asset funded by the sale of a lower yielding one) are finding their returns compressed and its followers waning. As a result, we expect the continuation of a trend toward the unwinding of commitments to these types of strategies as investors begin to question the need to take on additional risk with increasingly smaller returns. In this environment, we expect equity investors to begin to focus more and more on growth themes and less on income themes.

With the Fed's continued actions, economic growth should begin to slow in the coming months. In this type of environment it is common for growth styles of investing to gain interest. Investors that have been focused on cyclical stocks that do best in strong economies will begin to gravitate toward growth industries, such as technology and healthcare companies

that are likely to perform well even in a slow growth environment. According to Ned Davis Research, there are other compelling reasons to have interest in growth stocks. Namely, the NASDAQ Composite index, comprised of nearly 50% technology stocks, is now priced at a P/E multiple of 13.2 (excluding companies with negative earnings), well below the 60 level of five years ago and back to its 1986-1995 range. Investors now have the opportunity to buy growth stocks at the cheapest prices relative to earnings in ten years.

The fundamental outlook for technology stocks continues to be favorable. Corporate finances are generally strong and with increasingly tight labor markets companies are seeking ways to improve their efficiency. These trends are evident in the 3rd quarter GDP report that showed business spending surging at an 8.9% rate following the 10.9% reported in the second quarter.

Another trend worth noting is that the five year dominance of small capitalization stocks over their larger cap counterparts may be coming to an end. Larger companies appear to be taking over the leadership role. Valuations no longer significantly favor small caps and large caps traditionally perform better in a late expansion, rising interest rate environment.

The bottom line for investors is to be patient. In the last year stocks and bonds have weathered an election, a war in Iraq, significantly rising interest rates and oil prices, and several major hurricanes - and held up remarkably well. But because corporate earnings growth has been so outstanding, stock valuations are at their most attractive level in years. In the days and weeks ahead we are likely to be transitioning to a more moderate growth economy that should temper inflationary concerns. It is from this type of environment that both stocks and bonds may be able to shake off the imaginary spooks of October and once again look forward to the real treats the markets have historically provided investors.



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