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Market Commentary

A Review of the Markets and a Look into the Future

An Exciting New Year

Weep not that the world changes - did it keep a stable changeless state, it were cause indeed to weep.

- William Cullen Bryant

Somewhere in the heart of the English countryside, Lucy Pevensie entered the enchanted world of Narnia through a magical wardrobe. You see, Lucy, the youngest of four children, had come across the large piece of furniture as she explored the house in which she was staying. She peered curiously into the wardrobe to observe its contents, but was surprised to see the glow of a dim light coming somewhere from deep within the clothes that resided there. As she followed the light, the clothes gradually turned into trees and her surroundings became a whole new world. The light she had followed turned out to be an ordinary light post. However, the world of Narnia turned out to be anything but ordinary. This magical land she found, complete with a great lion and a wicked White Witch, was full of suspense and excitement and ultimately much deeper meaning.

As goes this classic story by C.S. Lewis, *The Lion, the Witch, and the Wardrobe*, so goes the beginning of each new year we experience in the 'real world' of investing. There is always a mixture of hope and anxiety as we collectively anticipate what lies ahead. At first, we think we know what to expect, but in keeping with C.S. Lewis' beautiful allegory, as we move deeper and deeper into the 'wardrobe' we often end up in a world far different than we anticipated. It is how we position ourselves prior to, and ultimately respond to these surprises that determines our degree of success in investing.

Of the many surprises each new year holds, some are big and some are trivial. One of last year's big surprises was the height to which oil prices could rise in a relatively short period of time given the right conditions. Hurricanes Katrina and Rita slammed into the coast wiping out most of New Orleans and exposing a dearth of excess refining capacity in the U.S. and an obvious over-concentration of refineries in the Gulf of Mexico area. Another surprise was how well the economy held up in spite of these shocks to the financial system.

Peering into 2006's 'Wardrobe'

The Economy: When the final numbers are in, it is likely the U.S. economy grew at a strong 3.6% in 2005. Growth estimates for 2006 tend to range from modestly slower rates than in 2005 (3% - 3.5%), as we expect, to modestly stronger rates just under 4%. It is probable that the generally anticipated weaker housing and consumer spending will be offset somewhat by hurricane Katrina reconstruction costs and strong capital spending, especially early in the year.

Global growth will likely be similar to the estimated 4 - 4.5% growth experienced in 2005. This makes the third year of above trend growth for the world. Developed economies will likely grow on average about 3%

and emerging economies will grow around 6.5% - 7%. Japan's economy will probably expand at more than 2% for a third consecutive year - the first time since 1989-91.

Potential Witches in the Wardrobe: If monetary policy becomes too restrictive or oil prices rise too much, then the stock market could suffer along with economic growth. However, even if weaker housing and higher energy prices fail to slow the economy, the Fed ultimately will be successful. The best scenario, and we think the most likely, is the Fed orchestrates a soft landing, thereby avoiding the common boom bust cycle. This could result in an extended economic expansion providing reasonable earnings growth with low inflation and an excellent environment for both stocks and bonds.

Inflation: The Consumer Price Index (CPI) measurement of inflation will likely decelerate as the year progresses from its recent five-year high of 3.4%, benefiting from more stable oil prices and a moderating economy. Core CPI, excluding the more volatile food and energy components, rose 2.2% last year, the same as in 2004. This year, the rate will likely remain around 2%. Productivity, surplus cheap labor (from a global perspective) and consumers' reluctance to pay much higher prices is keeping core inflation relatively subdued. Last year, unit labor costs appear to have grown at less than 2% - a pace consistent with tame inflation. This is very important since wage costs account for about 70% of overall production costs in the economy. The Fed would be very happy with that same pace going forward, but would consider it a negative surprise if it accelerates.

Potential Witches: With such tight oil supplies, any additional supply disruptions could create price spikes that would almost certainly spell trouble for both the economy and the markets. Furthermore, we think it would be problematic if the rate-of-change in core inflation climbed above 2.5%. This would indicate the Fed's work is not done.

Oil: According to the Energy Information Administration (EIA), "Despite strong projected growth in demand, world spare oil production capacity is projected to increase during 2006 and 2007 as non-OPEC and OPEC supplies increase. This increase in spare capacity is expected to ease the current tightness in world oil markets and moderate the world oil price increases seen during the past year." To the extent the EIA's prediction is accurate; this should be good news for the economy. However, trends in energy supply and demand are affected by a large number of factors that are difficult to predict, such as the impact of higher energy prices on demand, U.S. economic growth, advances in technologies, changes in weather patterns, and future public policy decisions. With those caveats in mind, we expect oil prices to range

from \$55 to \$70 in the first half of the year and gradually improve to the \$50-\$60 range in the second half as the economy slows and more productive capacity comes online. In the meantime, it will pay to keep a watchful eye on developments in the oil patch until supplies improve quite a bit more.

Domestic Equities: Stable, albeit slowing, economic growth and low core inflation suggests the likelihood of a gradual uptrend in stocks. We favor stocks over bonds in the near-term from a valuation perspective and would overweight them where appropriate. The expected slowdown in earnings growth rates may be more than offset by an expansion in price-to-earnings multiples, as is common whenever the Fed completes a tightening phase. Based upon year-ahead earnings projections for the S&P 500 and a stable PE ratio, we have a current year-end target of 1,390 for the S&P 500 index, a 9% advance from current levels and 11% from year-end 2005. Contributing to our expectation of higher stock prices is a projected 1.3 trillion surge in merger and acquisition activity, as predicted by Morgan Stanley - reaching 10% of GDP in 2006. The rush of companies to buy will be driven by peaking margins and the availability of relatively cheap financing. Further supporting this trend, is the fact that corporate America currently has nearly 10% of its assets in cash and short-term investments and knows it must actively seek new ways to add value for its shareholders.

We believe large-cap growth stocks will do well in 2006. Record corporate profitability means companies will have cash to spend on technology in order to continue their trends of rising productivity and profit margins. Global business spending is expected to grow a solid 5-10% during 2006 and this should help technology companies post strong earnings gains. Small-cap stocks, which have performed well for several years now, may take a back seat to their larger company counterparts for a while. It is common for small-cap stocks to lag large-caps as an economic expansion slows.

Since consumer spending is generally expected to slow in 2006, it may be wise to avoid companies exposed to consumer spending. Large oil companies will continue to spend increasing amounts of their large cash hoards on exploration - helping the exploration and oil service companies.

Potential Witches in the Wardrobe: Among others, further sustained increases in energy prices, weakness in the labor market or a sharper rise in long-term interest rates pose downside risks to our S&P 500 forecast.

Interest Rates/Bonds: Ten-year Treasury yields will likely move modestly higher to the 4.5% - 5% range from 4.3% currently. In spite of an almost doubling of short-term rates in 2005, long-term rates have remained within a relatively narrow range. The main reasons for this stability appear to be strong foreign demand for U.S. bonds (foreigners now own approximately 40% of long-term Treasuries) combined with strong confidence domestically in the Fed's ability to orchestrate a soft landing. Fortunately, steady long-term rates have provided an important stabilizing affect to real estate which has been showing early signs of weakness. Even though the economy is expected to soften modestly, which would normally promote lower yields, we believe yields may rise due to an anticipated drop-off in the increasingly important foreign buying of U.S. bonds. The good news is the Fed may soon be at the end of its tightening phase. They meet next on the 31st of January and again on March 28th (Ben Bernanke's first as Chairman). There is a good chance for a quarter point rise in the Fed Funds rate at each meeting - but we are hopeful this completes their tightening phase. Generally, after the Fed is through, long-term bond yields usually drop. It may be different this time since they never really rose like they have tended to do in previous cycles.

International Equities: Foreign equities, as a class, will likely produce moderately better returns in the coming year than domestic equities. A

strong world economy, reasonable valuations and double-digit earnings growth should generally provide for good performance from most of the emerging markets. In spite of strong gains in 2005, the MSCI Emerging Market Index is selling at just 10.8 times forward earnings estimates. Emerging market economies continue to increase their share of the world output, driving up demand for commodities and mitigating core inflation in developing countries. Helping to support these favorable dynamics is China's powerful growth rate that will likely continue for several years to come, reminiscent of Japan's strong economic growth rates from the 1960s through the 1980s.

We currently like the outlook for Japan's economy and stock market. After a 13 year bear market that saw the Nikkei 225 average drop 80% from its high, the Nikkei began a stock market rally in April of 2003 that has carried it considerably higher. In spite of this rise, Japanese stocks are still very reasonable. Japan's economic recovery seems well established and stock investors will likely be rewarded.

Gold: Steady demand from Asia and from oil producing countries seeking to diversify their holdings has lifted gold prices to levels not seen since 1981. Historically a rising price trend has been a harbinger of future inflation - now it seems to be a combination of practical demand and a hedge against currency devaluation. China, Korea and Taiwan currently have a little more than 1% of their country's reserves held in gold, while the world average is 8.7%. If these countries decided to raise their reserves to 5% gold, it would require purchases of roughly three years worth of production of all newly mined gold in the world.

Dollar: The dollar is unlikely to repeat its surprisingly strong performance of 2005. As the U.S. economy slows, the dollar should exhibit weakness in the coming months relative to most of our trading partners. This will be especially true to the extent economies remain strong in Japan and Europe, reducing their needs to keep their currencies weak in relation to the dollar.

Real Estate: House prices rose 9.6% last year. According to Standard and Poors, prices will likely appreciate 2.9% this year. Home prices are 21% above their 40-year trend according to Wachovia Securities Investment Strategy Group. This may set the stage for a prolonged period of home price stagnation in real terms.

While it may not be the surefire investment of recent years, carefully chosen real estate investments still make sense as part of a diversified investment portfolio. According to Cohen and Steers, a large manager of mutual funds investing in Real Estate Investment Trusts (REITS), operating fundamentals continue to improve for most REITS. Earnings should grow in the high single digits for 2006. Moderating economic growth in a relatively tame inflationary environment should provide a stable outlook for REITS. REITS may reinvent again once the Fed has finished their tightening phase.

Conclusions

As we make our journey deeper into the 'wardrobe' of 2006, we are thankful you have chosen us to be the ones to watch out for the 'Witches' along the way. Hopefully, any feelings of anxiety you may have about the journey will ultimately be replaced with the satisfaction of a successful trip. 🐾

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