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Market Commentary

A Review of the Markets and a Look into the Future

Partly Sunny with Increasing Cloudiness

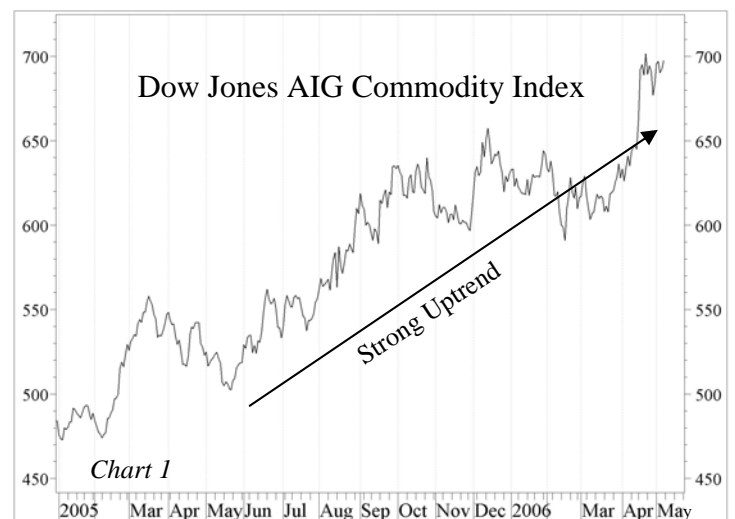
The trouble with weather forecasting is that it's right too often for us to ignore it and wrong too often for us to rely on it.

- Patrick Young

When you are growing up it is common to have several different visions of what you want to be when you get older. For me, there was a brief point in time when I contemplated being a weatherman. It seemed like such a straightforward job, because you just analyze a few weather patterns, check out the humidity, barometer, temperature and a few other things and then you would be able to guide everyone as they made their important plans for the week. People would look to me as they deliberated their possible camping trips, outdoor projects or sought the latest information regarding potentially life threatening weather, such as tornados, hurricanes and the like. I would be providing vital information to people at some of the most important times of their lives. It seemed like such a noble job. Then, I began to think about how my forecasts might affect their lives if I was wrong. After all, the winds can change very abruptly and instability in the atmosphere can make it anybody's guess as to what the weather may do. It was really a much more complex and intriguing occupation than I initially imagined.

Needless to say, my life took quite a different path than my early imaginings. As I reflect on some of the aspects of weather forecasting that were especially intriguing to me, I realize in many ways I am doing the same types of things today. Instead of forecasting the weather, I gather the various economic forecasts of some of the best economists in the country along with other market specific data and then try to deduce the likely impact to your portfolio - making changes when necessary. Just like forecasting the weather, there are times when strong crosswinds make the predicting job much more difficult.

Take for example the current economic environment, investors are currently very focused on how much longer Chairman Ben Bernake and the Federal Open Market Committee (FOMC) will raise short-term rates. They have already raised rates 3.75% over the last 23 months with 15 consecutive 1/4% steps. More recently, ten-year Treasury rates have also begun to rise, reaching a five year high of over 5.1%. The Fed has suggested that a pause in rate increases may be in the offing, but recently a spate of strong economic data suggest the economy may be much more robust than originally anticipated. Data this impressive in the face of strong headwinds from a strong surge in oil and other commodity prices (*see Chart 1 below*) leaves the question of how long the Fed can afford to pause, if at all. These higher input costs will eventually affect corporate profit margins negatively or be passed through to the consumer in the form of increased inflation. The conundrum for the stock market is that persistently strong economic growth may continue to



force the Fed's hand on interest rates; conversely, the objective of the Fed's rate hikes may eventually result in an economic slowdown that would make future earnings comparisons difficult and stock market performance more uncertain.

In weather terms, unstable conditions such as these warrant keeping a watchful eye on the horizon. In spite of this increasingly challenging environment, strong corporate earnings growth in the first quarter has enabled the stock market to work its way to a new five-year high. Earnings for the companies in the S&P 500 Index will probably post a rise of about 14% when all the data is finally in. According to Goldman Sachs in its *1Q 2006 Earnings Focus*, "*Fewer negative surprises have occurred in 1Q 2006 than any quarter since 1996.*" They went on to say, "*Profit margins for nearly all stocks are at record highs, yet analysts currently expect 2007 margins will exceed 2006 levels in every sector.*" Goldman Sachs indicated concerns that profit margins would not be able to expand beyond these peak levels indefinitely. At some point, margins will disappoint. This is especially likely considering the strong recent increase in input costs mentioned above.

So What's the Weather Forecast for the Financial Markets?

While the current economic conditions are somewhat challenging for making high probability estimates of the returns to expect from various asset classes, one thing is clear, financial assets have been driven by a strong preference for higher risk, lower quality assets for the last 3 1/2 years. This is reflected by the superior performance of small and mid-cap stocks over their large-cap counterparts, emerging market equity and debt over developed markets, high yield bonds over Treasuries, and the very strong performance of commodities. It is common for these types of assets to perform better in the recovery and early expansion stages of the business cycle. However, as the expansion matures, it is also common for investors to begin to seek the greater relative stability of higher quality, more liquid issues. This is logical, since higher risk, lower quality assets are no longer the relative bargain they were at the beginning of the recovery. It is possible these assets will continue to outperform for a while longer, but I believe it is prudent to be a little more cautious at this juncture.

In our Fixed Income Allocation we are closely monitoring the direction of interest rates, credit spreads,



forecasted default rates and price trends of our high yield positions. In some cases, we have begun to increase our exposure to short and intermediate higher quality bond positions, such as corporate and Treasury bonds and reduce our allocation to high yield bonds. To the extent the economy begins to slow, this transition will be continued.

I believe that an overweighting to the equities of foreign developed markets is called for in this environment. The U.S. is currently experiencing both record trade imbalances and strong fiscal deficits. There are a lot of factors that determine the demand for the dollar, but current economic imbalances certainly contribute to the risk of a continued weaker dollar (*see Chart 2 above*). To the extent this happens, investments denominated in foreign currencies would tend to perform better than their U.S. counterparts.

Conclusions

I chose quite a different path for my career than I originally contemplated. However, there is one thing I can say I have learned from my local weatherman, regardless of the forecast, always keep an umbrella handy. That same philosophy has served me well in the investment markets, too.



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