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Market Commentary

A Review of the Markets and a Look into the Future

A Guising We Will Go

(A good portfolio) is a balanced whole, providing the investor with protections and opportunities with respect to a wide range of contingencies.

- Harry Markowitz

The U.S. stock market has made a nice rebound from the summer lows, boldly embracing the infamously gloomy months of September and October - as if to proclaim they have lost their authority over the markets. The question now is, "Will the stock market continue to rally from these levels, temporarily succumb to profit taking before resuming its uptrend or begin a decline that will mark the recent highs as the apex of the year?" This is a difficult question to answer without examining both the factors that have allowed the market to rise to these levels and those that may carry the market even higher.

Let's first examine how we have gotten here. In spite of a 14% decline in the sale of new homes over the last year, there does not appear to be any related fallout to consumer spending as of yet. Strong labor markets, accelerating income growth and advancing wealth have all provided a strong underpinning to consumer spending and allowed it to advance from 2.6% growth in the second quarter of 2006 to 3.1% in the third. An appreciable decline in gasoline prices has served to enhance consumer confidence and supported this rebound in consumer spending.

While the consumer has held up remarkably well, weak housing markets have taken their toll on economic growth. The Gross Domestic Product (GDP) growth rate has fallen from 2.6% in the second quarter of 2006 to 1.6% in the third. This weakness has induced yields on ten-year Treasuries to fall from 5.2% in early July to 4.6% today. Also, the combination of moderating energy costs along with the slowing economic growth has combined to allow core inflation, as measured by the core PCE deflator, to decelerate from 2.7% in the second quarter to 2.3% in the third. After having paused initially on September 20th, these improving inflation numbers accompanied by more moderate economic growth permitted the Federal Open

Market Committee (FOMC) to maintain its federal funds rate at 5.25% again at its meeting on October 25. It has also increased the likelihood they will be able to stay on hold for a while longer.

Looking forward, what can we expect the stock market to do in the remaining months of the year? The stock market's strength has been surprisingly persistent since the summer lows. So far the economy seems to be accomplishing the perfect balancing act by slowing enough to moderate inflationary pressures without inducing a recession. This is impressive, yet a concern from these levels is whether this same equilibrium can be maintained going forward. Since an assumed "soft landing" seems to be baked into the price of stocks currently, any information that challenges this rosy scenario could make the market vulnerable to a correction. The current environment makes the

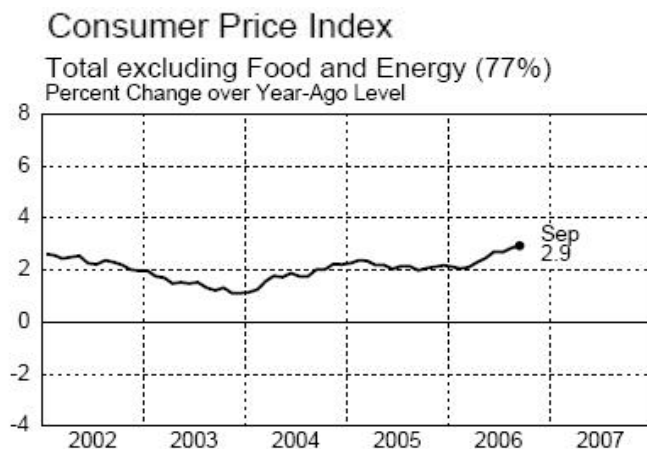
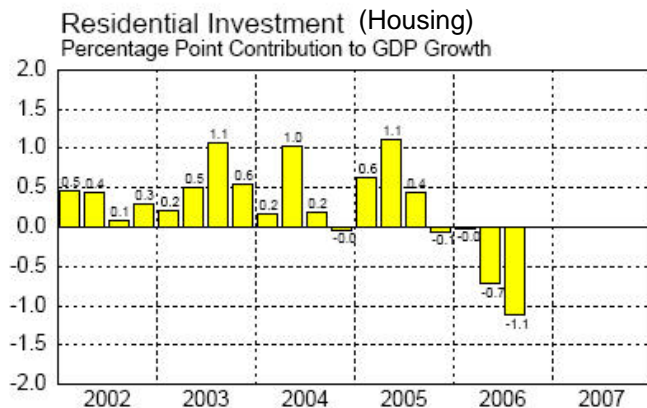
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"I'm North Korea. He's Iran."

maintenance of equilibrium particularly dicey. Reigning in inflation at this stage of the economic cycle is difficult because productivity growth tends to slow at the same time wages are beginning to rise at an accelerated rate, in this case climbing 4.9% in the last 12 months. This forces corporations to choose between passing along cost increases to consumers or letting their profits get squeezed. Ordinarily, the pace of inflation diminishes when the consumer finally slows their spending, forcing companies to reduce their prices to maintain sales. But right now the consumer continues to be resilient. This may make it more difficult to reign in core inflationary pressures in the coming months, especially if economic growth rebounds as expected. According to Goldman Sachs, *"History suggests that a disinflation sufficient to return core inflation to the Fed's 'comfort zone' by early 2008 would require growth to remain below trend for another year or so."* (*Disinflation is Hard To Do*, Goldman Sachs' U.S. Research Group, October 27, 2006). Below trend growth for the next year may prove a little challenging to corporate earnings comparisons. On the other hand, reaccelerating growth presents problems of its own.

In the near-term, the good news that has driven the market to current levels may carry the market higher. Even the elections are unlikely to derail the advance. Only one-third of the 100 seats in the Senate are up for re-election and Republicans are expected to maintain their majority there.



The outcome in the House is less certain. But without any major shift of power in Congress, the elections are not likely to have any significant impact on stocks.

Only time will tell with certainty whether the FOMC will navigate us through to a soft landing. We expect they will ultimately be successful. Special vigilance is required in the meantime to monitor the pulse of the economy and inflation and their potential affects on the market. However, we do anticipate a prosperous conclusion to 2006.

Bonds

As we mentioned above, third quarter growth was weak and housing data continue to point to an economic slowdown. Additionally, inflation still remains an issue. If a soft landing does unfold in the coming months, we would expect to see ten year Treasury rates (currently 4.56%) inch back up to around the 5% level. In this environment, short-term rates would likely decline. The net effect would be positive for the economy, since a steeper yield curve (as opposed to the current inverted curve) would signal improving growth ahead. In the meantime, we favor short to intermediate maturities, avoiding long-dated bonds.

In the high yield debt arena we are presently cautious. Credit spreads (speculative yield premiums over Treasuries) have narrowed recently because of historically low default rates. Low default rates are positive for the high yield market except that if they were to expand in the future, investors would not be adequately compensated for the added risk. At this stage of the credit cycle any slowdown in growth could impair corporate profits and negatively affect credit quality in the process. But as soon as the Fed is prepared to cut short-term rates, we would expect much more exciting opportunities to develop in the high yield market.

In closing, we believe our approach to disciplined asset allocation will be especially rewarded in the environment we see immediately ahead. We are very grateful to those of you who have entrusted us to manage your money. We will do our best to reward that trust. 🐕

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