Lighthouse Beacon

A Guide in the 21st Century

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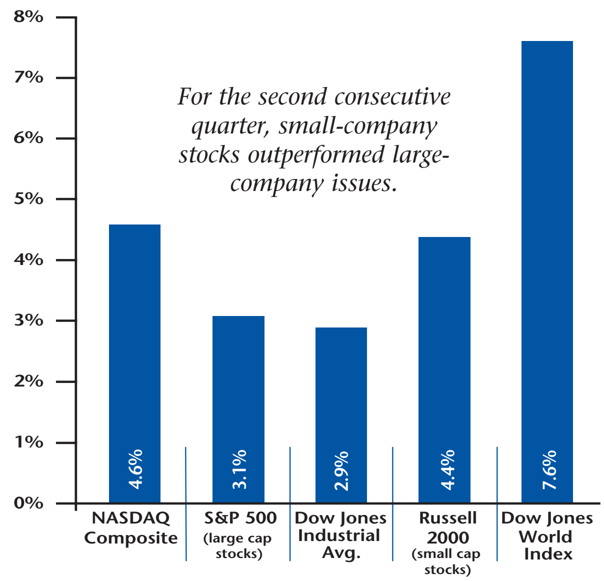
Lighthouse Investment Commentary

Economy Perseveres in Face of Natural Disasters

Focus on the Markets

A late-September rally brought moderate gains across the spectrum of the U.S. equity market during the third quarter of 2005.



Index returns are for price only, and do not include reinvestment of dividends. Past performance is not a guarantee of future results.

The back-to-back hurricanes Katrina and Rita certainly inflicted horrific human suffering and widespread property devastation on the Gulf Coast, especially in the storied city of New Orleans. But their effects on the nation's economy and the capital markets may be far less significant than first feared.

Stock market averages initially retreated in the immediate aftermath of Katrina's fury and again after Rita struck. But each time the markets declined, they subsequently rebounded after investors were able to make more realistic, sober assessments of the real impacts. The markets were again fighting their way back.

The damage to the Gulf region's oil refineries was serious and caused a sudden, dramatic impact on gasoline and home heating prices. Those impacts that we have seen at the gasoline pump are almost certainly going to affect us for a while. Most refineries are expected to be back on line fairly soon. It will take longer to repair and replace the buildings, community infrastructures, and schools, homes and workplaces. But that also will be accomplished, given the regional and national commitment to restoration and reconstruction on the Gulf Coast. Indeed, the restoration effort itself almost certainly will have a stimulative effect on the overall economy, not just in the region but in the nation as a whole.

Recognizing this, investors again were bidding up the prices of stocks only days after the hurricanes.

The economy –and the stock market—are proving once again how resilient they are.

Don't forget, we had ended the second quarter in June with the economy and the markets in reasonably good shape. Economic growth, reflected in gross domestic product, rose an annualized rate of 3.3% for the second quarter, and both corporations and consumers appeared to be accelerating their spending as the third quarter began. The economy appeared heading toward a robust annual growth rate of about 4% before the hurricanes.

In the wakes of Katrina and Rita, it is likely that GDP growth in the third quarter will fall somewhat short of the 4% rate. Growth in the fourth quarter of 2005 also could be adversely affected as discretionary consumer spending is constrained by the effects of higher fuel costs that squeeze many family budgets.

We should, however, expect to see a re-acceleration of growth in early 2006 as the rebuilding of the Gulf Coast begins in earnest. Any shortfall in consumer spending may well be made up by government and corporate spending.

The two hurricanes were the latest of a series of extraordinary events that have caused shocks to our collective consciousness and have brought short-term setbacks to the economy and the stock market. These short-term setbacks typically capture the attention of our major media institutions and can cause consumer sentiment to take a dip. Indeed consumer confidence benchmarks fell sharply in the weeks after Katrina, to their lowest point in 15 years, in reaction to higher fuel prices.

But consumer confidence measures historically have proven to be poor –even terrible— predictive measures of the future direction of either the economy or the stock market. Major temporary

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declines in consumer confidence have not always translated into major declines in long-term consumer spending. Shocks that cause quick, emotional reactions have a tendency to be short-lived.

None of this discussion is intended in any way to minimize or downplay the terrible human suffering that has occurred in the Gulf Region. On a personal level, we believe that all of us who are more fortunate should help the victims of Katrina and Rita. But as professionals, we also need to use our analytical tools and assess the total impact that the hurricanes are likely to have.

The stock market, after all, is forward-looking. Stock prices reflect an anticipation, or discounting, of expected future trends and events. When investing, we need to be forward-looking as well.

As we look at the overall economy, we continue to see a fairly broad-based expansion, with earnings and dividends growth each quarter. If anything, stock market valuations have not kept pace with corporate earnings trends.

In the face of short-term events –however shocking—we still need to keep focused on these longer term trends. While prudence and care are always necessary, we still see opportunities in the markets.

Lighthouse Spotlight

Inflation Rates Resist Pressure from Energy Prices

The world price of oil has almost doubled in the past year, breaking through the $70-per-barrel barrier in the days after Katrina. That has had a direct effect on the gasoline prices we all have been paying and on the heating costs we will endure this winter, but it has had less impact on our overall cost of living.

That can be puzzling when we recall the spike in energy prices in the early 1970s and its effects on inflation rates then. However, energy costs have become much less of an influence on the overall economy than they were three decades ago. All nations –not just the United States— have become much more productive since the 70s, in large part due to technology. Moreover, in an era of keen competition, companies are less able automatically to pass on to their customers their higher energy costs.

The causes of the fluctuations in energy prices will be studied and debated for years to come. Even the experts are confounded. While oil is a commodity, its price movements can't always be easily explained. Certainly, some of the price fluctuations in oil can be traced to the actions and strategies of oil traders, rather than any fundamental economic principles such as supply and demand. We do know that we don't have supply shortages, as we did in the 1970s. And, while demand has been increasing over the longer term, steadily rising demand can't explain the sharp surges in oil prices that we have witnessed over the past 12 months.

We are not suggesting that $3-a-gallon gasoline won't have an impact. It will have its effects, especially in the short term and particularly in those businesses that rely on discretionary consumer outlays. While higher energy costs are burdensome, we can derive some consolation from the fact that they have less impact on the overall economy than they did 30 years ago.

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Q: Why have long-term interest rates remained so stable despite the actions of the Federal Reserve to raise short-term rates?

A: Short-term rates, by any historical measure, were at extraordinarily low levels in June 2004 when the Fed started its round of rate hikes. The Federal Reserve had kept rates at 1.00% to assure that the economy would come back from recession. In less than 18 months, the fed funds rate has risen from 1.00% to 3.75%, but longer-term rates have hardly moved. That means that the key rates affecting consumers and businesses –such as mortgage lending rates—are still low. Several factors are responsible:

- Short-term rates, which had been kept artificially low, only now are returning to normal levels;
- Inflation rates, which have a greater impact on longer-term rates, still are under control due to increasing worldwide economic competitiveness and the continued growth in productivity because of advances in technology;
- Continued demand for U.S. bonds by foreign investors, who regard the United States as the world's strongest and safest economy.

A change in any of these factors could move longer-term interest rates higher. Indeed, we expect longer-term rates eventually will move up, but to lower levels than many observers had been predicting.

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