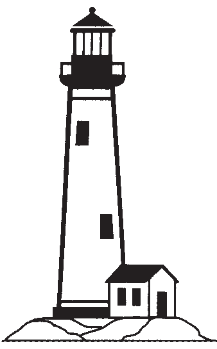

Lighthouse Beacon

A Guide in the 21st Century

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Lighthouse Investment Commentary

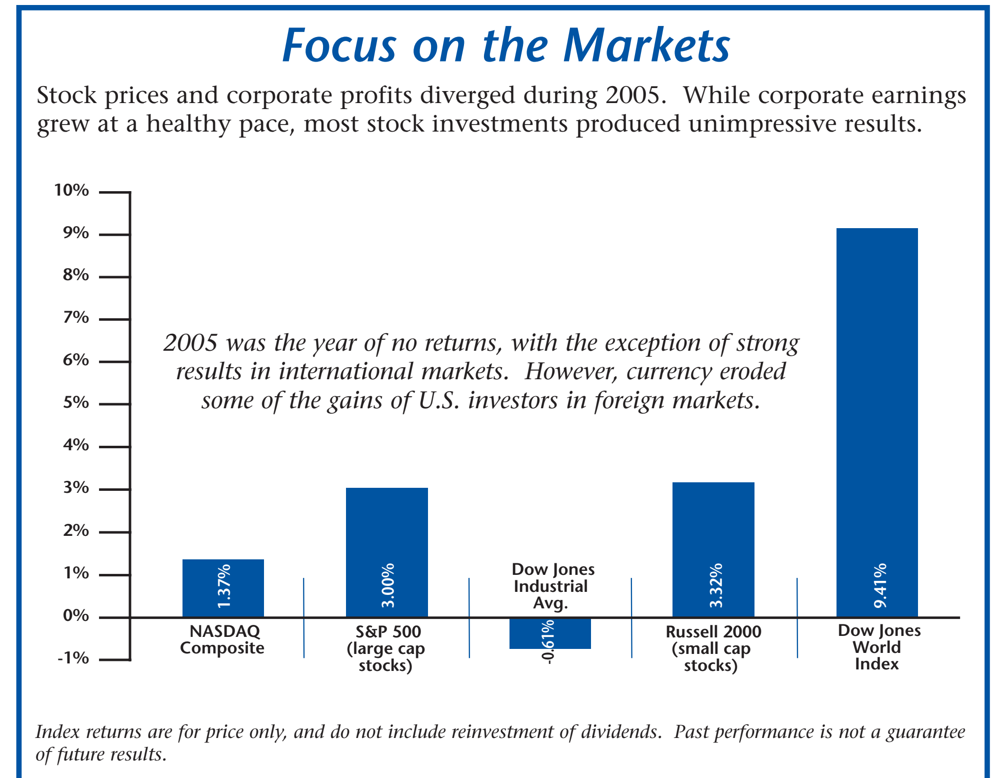
What's Wrong with the Market? Wrong Question!

Whew. 2005 was quite a year. Just think of the natural disasters alone! The year began in the immediate aftermath of the horrific tsunami in the Asian Pacific, continued with the persistent famine in Africa and the devastating hurricanes in the Gulf Region of the United States, and ended with the tragic earthquake in Pakistan. Oh, yes, there were the avian flu threat, the difficulties of waging an increasingly unpopular war in Iraq, new political scandals in Washington and the uncertainty of a Supreme Court in transition. All of these were external factors potentially affecting the economy. Add to these were rapidly rising interest rates and $3 dollar-a-gallon gasoline and one would be forgiven for thinking that we had a recipe for a stock market collapse.

Only, the stock market didn't collapse. It showed remarkable resiliency, actually producing modest, positive results during a 12-month span when everything seemed to be going wrong. Actually, everything wasn't going wrong.

Focus on the Markets

Stock prices and corporate profits diverged during 2005. While corporate earnings grew at a healthy pace, most stock investments produced unimpressive results.



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

The economy kept chugging along. Gross domestic product, for example, expanded at a very robust annualized rate of 4.1% in the third quarter, despite Hurricanes Katrina and Rita. Corporate earnings continued to grow at a double-digit pace and corporate profit margins were the best they have been since the 1960s.

Healthy Balance Sheets

With the high-profile exceptions of the automotive and airline industries, American corporations in general were in excellent condition. Backed by healthy balance sheets with more than $2 trillion in cash holdings, U.S. companies have been increasing their dividends, buying back stock, investing in new plants and equipment or making strategic acquisitions. Corporate productivity continued to improve throughout the year. The nation's unemployment rate fell to just 5% as both jobs and personal incomes kept growing.

Despite these relatively robust numbers, overall inflation remained constrained, notwithstanding gyrating energy prices. The Consumer Price Index rose by just 3.5% for the 12 months through November. As a result, consumers felt confident enough to sustain their spending habits.

Inflation Threat Reduced

The Federal Reserve apparently has been successful in its effort to reduce inflationary pressures without stalling the economy. By the end of 2005, the Fed had raised the key short-term interest rate –the fed funds rate—13 times in just 18 months. What the fed has done is bring rates back from the extraordinary low levels to which they had fallen by early 2004. At a level of 4.25% at year's end, the fed funds rate still was considered to be only neutral, rather than restrictive, with respect to economic growth.

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Anxieties Over Rates

However, the succession of repeated rate hikes over the year-and-a-half has been somewhat unsettling to investors, who began wondering if the rate increases would ever end. The fear is that the Fed would raise rates so far that interest rates would pull the economy down, into a recession. Those fears may be abated somewhat, though, by the Federal Reserve Board's commentary after it raised rates in December. In that commentary, board members hinted that they may be getting near the end of this cycle of rate increases. The markets should take encouragement from this hint, which strongly indicates that the Fed wants to avoid going too far in tightening monetary policy. Moreover, a new Fed chairman takes office in 2006 and the last thing that Ben Bernanke wants to do is begin his stewardship by pushing the economy into a recession.

As we enter this new year, the most probably scenario is that the economy should be able to sustain its upward momentum, but probably at a somewhat slower growth rate than we saw in 2005. With this backdrop of a steadily expanding economy, business profits should continue to rise and corporations should be able to keep raising their dividends.

Reasonable Stock Prices

At the same time, stock prices are reasonable by historical standards. For two successive years, corporate profits have risen much faster than have corporate valuations —stock prices. As a consequence, the average stock in the Standard & Poor's 500 Index entered 2006 with a price/earnings ratio of about 15, relative to estimated 2006 earnings. That's a very attractive price in an environment in which corporate earnings are rising, inflation is constrained and interest rates still are not a problem. We would argue that the stock market is undervalued.

We believe stock prices and corporate profits diverged during 2004 and 2005 because of the rising interest rate environment and the exogenous considerations that we enumerated at the beginning of this review –natural disasters, political uncertainties and geopolitical worries. The constant media attention on problems created anxieties that unsettled investors and distracted them from the underlying economic fundamentals.

The Right Question

While exogenous problems are real and in many cases tragic, the truth is that the economy remains healthy and it is the economy which will drive stock market performance over the longer term.

As we have written before, emotions may influence the market in the short term, but economic fundamentals drive the market's performance over the longer term.

With such positive economic fundamentals, it's time to think about opportunities in the market rather than problems. What's wrong with the market? That's the wrong question! We should be asking, "Where are the best investment opportunities?"

Lighthouse Guides

Q: With the international markets having done so well in 2005, why not put your money into foreign stocks?

A: It's true that the Morgan Stanley Capital International (MSCI) EAFE Index, which measures the performance of the markets in major industrialized foreign markets, produced a much greater return than the S&P 500 in 2005. And, it's also true that the emerging markets, as reflected by the MSCI Emerging Markets Index, did even better.

But that's not enough reason to reallocate all your money into the international markets –unless you have an unquenchable thirst for risk and a bottomless supply of stomach antacids.

First, you should never chase last year's biggest investment winners –they just may turn into next year's biggest disappointments. Secondly, you should not allocate a large percentage of your money to the riskier areas of the investment world. Diversification is especially important when you are talking about risky assets.

And, speaking of risk, international investing carries one extra risk: currency. Relative currency values can be very volatile. During 2005, the U.S. dollar was very strong against many major foreign currencies, including the euro and the yen. As a consequence, when the values of foreign investments were translated back into U.S. dollars, much of the gains were wiped out because of the strong dollar.

Certainly, foreign securities can be part of a well diversified portfolio. But think twice before you over overcommit to such a potentially volatile segment of the market because of last year's results.

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