Lighthouse Beacon

A Guide in the 21st Century

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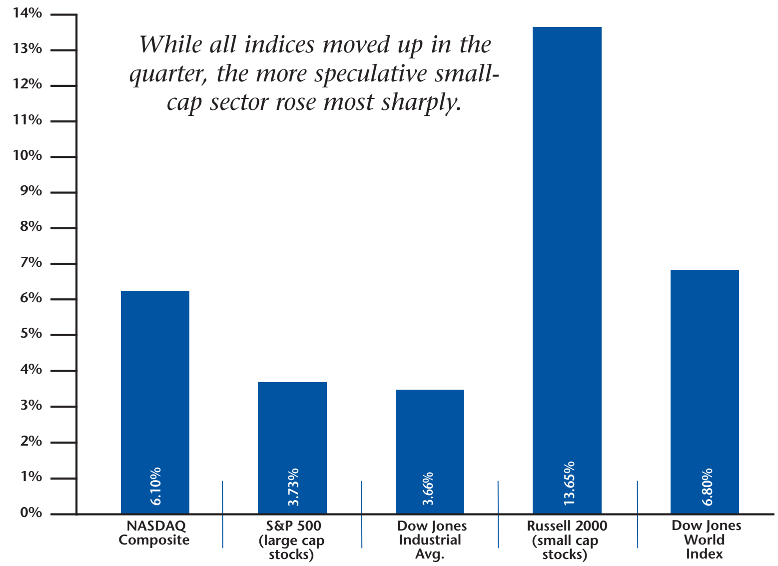
Lighthouse Investment Commentary

Market Advances Despite Fears, Conflicting Crosscurrents

Focus on the Markets

Equities got off to a strong start in the first quarter of 2006, with many domestic stock indices rising more than in all of 2005.



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

Score one for economics.

In the face of the continuing struggle between strong economic fundamentals on the one hand and anxieties about world events on the other, investors in the first months of 2006 focused on the impressive underpinnings of the economy.

As a result, domestic stock markets generated healthy returns for the first quarter of the year, in many cases outperforming the full year in 2005.

The reasons were hardly mysterious: economic growth was re-accelerating; corporations were reporting improved profits; stock dividends were rising; jobs were increasing; and inflation remained under control.

Not even a moderation in gross domestic product (GDP) growth for the final quarter of 2005 could sway the markets, as the general consensus of economists was that growth was accelerating again in the first quarter of the new year.

These favorable trends countered the unease created by the volatile nature of oil prices, which climbed late in the quarter despite reports that crude oil inventories were at seven-year highs. Much of this volatility appeared to arise from gasoline prices, which were affected by tight refinery capacity and the renewed tightening of environmental standards which had been relaxed after Hurricane Katrina. Further complicating the energy picture has been the heightening of international tensions over Iran's moves to enrich uranium as part of its nuclear program.

Interest rates also made headlines on an almost daily basis. From June 2004 through the latest meeting of the Federal Reserve's Open Market Committee on March 28, the Fed has raised short-term interest rates 15 successive times. This tightening of credit has led to fears that the Fed may go too far and cause a recession. However, each rate hike was widely anticipated. Many investors were disappointed that the new Federal Reserve Chairman, Ben Bernanke, would offer more specific guidance about when the rate increases might end. He did not.

We do not view the lack of clarity on the potential for further rate hikes as a negative, as it seems reasonable that the new Fed chief would want to keep options open. While the date of the end of the

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rate increases may not be certain, it is becoming evident that is we are getting very close to the end of the increases. When that happens, the markets will breathe a collective sigh of relief.

The tragedy of Iraq continues to be worrisome and certainly contributes to the unease by investors as well as for the general American public. Unfortunately, as of this writing, there appeared to be little on the immediate horizon to alleviate these tensions.

And so, the markets keep being buffeted by many cross-currents. As we have pointed out many times, the media tends to focus on the potential negatives rather than the positives. The legendary investor "wall of worry" remains firm. The most recent worry has been that spending by the American consumer may be starting to slow after being the lynchpin of the economic recovery for several years.

While a slowdown in the growth of consumer outlays is possible, a new engine of growth has appeared: corporate spending. With robust profit growth and strong balance sheets, corporations are awash in cash. In fact, U.S. corporations currently hold more than $2 trillion in cash. Microsoft and ExxonMobil, together, account for more than $60 billion. With reserves like that, corporate spending could easily pick up any slack caused by a slowdown in consumer spending. Little wonder that business investment grew at a pace of 16% in the fourth quarter of 2005, the fastest rate in a year-and-a-half.

In the first three months of 2006, corporate profits grew at a double-digit pace. That was the sixteenth consecutive quarter that this has occurred. This steady growth in earnings has outpaced the returns from stock prices. As a consequence, price/earnings ratios have contracted –you get more earnings for every dollar you invest. And, corporations have kept increasing their dividends.

Stocks now represent very real investment value, whether you judge them by historical standards or relative to alternative asset classes.

What's the right strategy? We may be repeating ourselves, but the message bears repeating. Invest in quality, reasonably priced stocks of companies with good earnings and dividends prospects. Diversify your holdings so you are not overexposed to one part of the market. If you need income, look at high quality preferred stocks and bonds with short-to-intermediate term maturities.

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Q: Could the slowing of the housing market lead to an erosion of consumer confidence and a weakening of the economy?

A: Some observers have feared that the end of the surge in home prices could have a psychological impact on consumers by affecting their sense of "wealth." To be sure, the dramatic appreciation in home prices in recent years has been one of the drivers of the growth in consumer spending and prices are not appreciating they way they were several months ago.

However, we are a long way from seeing any collapse in the housing market. Rather, we seem to be witnessing a slowdown in speculation in the housing market. Rapidly rising prices had lured speculators into the market. They were acquiring properties in hopes of being able to "flip" them over quickly and reap outsized short-term profits. That kind of speculation was particularly evident in red-hot markets, including parts of Florida, California and Arizona. This overheated speculation now seems to be slowing and the overall rate of increase in housing has come down.

We don't see a collapse in the general housing market, however. While price increases have moderated and sale prices in some markets even have slipped, demand for housing certainly has not disappeared.

We may see fewer home equity loans as interest rates rise, and this may have an impact on consumer spending. But the economy is strong and resilient and business investment already has started to increase sharply, providing a new source of stimulation to the economy. And, interestingly, in late March consumer sentiment actually improved.

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