

MARKET NEWS

Keeping our Clients Informed

Second Quarter 2006



July 14, 2006

Reversal of Fortunes

In our last newsletter we stated that investors' enthusiasm for stocks during the first quarter could be entirely attributed to the belief that the Federal Reserve was finally coming to the end of their interest rate hike campaign. We also noted that there was little consensus as to what to expect from the Fed after their May meeting.

As it turned out, all indications after the May meeting and resulting 25 basis point rate increase, were that the Fed was far from finished. Just as the prospect of stable interest rates led to healthy gains for stocks in the first quarter, the expectation now of still higher rates over the remainder of the year has tanked stock prices this quarter.

This change in attitude erased over half of the gains in stocks within weeks of the Fed's May meeting. The decline stabilized somewhat by the end of June but then continued through mid-July, essentially wiping out all of the first quarter's gains.

Adding to investors' concerns, oil prices have renewed their march to record highs. The per-barrel price of oil crossed over \$78 for the first time ever within recent weeks. The initial jump in oil prices resulted from concerns over Iran's nuclear program and pending referral to the U.N. Security Council. Iran has threatened to disrupt their oil exports should the U.N. impose sanctions on that country.

Adding more pressure to the situation, armed conflict has broken out in south Lebanon between the Israelis and Hezbollah. While none of the parties directly involved are oil producing nations, Hezbollah is recognized as a proxy for the Syrian and Iranian governments in Lebanon. This is the most serious fighting that has taken place between Israel and the Palestinians in many years and it is still unclear what effect this will have on the overall region.

An especially troubling aspect of the conflict is the timing of Hezbollah's actions that have led to this situation. The initial attacks corresponded closely with a deadline for an Iranian response to U.N. nuclear mandates.

Add to all of this the crazy ranting of Venezuela's president, escalating hostilities by Nigerian rebels and the beginning of the hurricane season, and it is easy to see that higher oil prices aren't going away anytime soon.

2006 Part 2

We still believe that when all is said and done 2006 will have been a good year for stocks. We think that most of the pessimism priced into the market is for "headline risk", as opposed to a fundamental deterioration of valuations.

Earnings growth within the S&P 500 still remains strong even though energy costs are higher. Despite the Fed's actions, long-term interest rates are no higher now than at the end of last year. Additionally, with potentially two or more rate hikes ahead, it is unlikely that long-term rates will increase over the year.

We believe that there are three obstacles facing the market right now that need to be successfully concluded by the year's end. First and foremost, the Fed needs to reach an end to its rate hike campaign. Second, there needs to be some resolution to the conflict over Iran's nuclear program. And finally, we need to make it through the hurricane season without a major event.

Should the economy successfully navigate these issues, we see no reason for equities not to regain their first quarter returns and then some. Until then, we expect to see continued volatility, especially next quarter.

Why Interest Rates Matter

As we mentioned earlier, the volatility (both good and bad) in the equities market this year has been largely driven by the expectations of the Fed's outlook of inflation and monetary policy. During this quarter we've seen the Dow Jones Industrial Average move by as much as 200 points in a day based simply on a statement made by the Fed chairman Ben Bernanke. Why is it that changes in the bond market greatly affect the stock market? And why do people that own stocks care so much about what interest rates do?

First, it is important to understand what a stock price is supposed to represent. In theory, a stock's price is the net present value of the company's future earnings per share discounted back using an appropriate interest rate. For those who like math the formula looks like this:

$$NPV = \sum_{t=0}^N \frac{C_t}{(1+i)^t}$$

Where:

C = the cash flow (earnings per share) per year

i = the interest rate

t = the year

As you can see from the formula, there are really only two variables that matter. The first, and most obvious variable, is the earnings. The second variable, which is less obvious, is the interest rate.

The interest rate used should be the sum of a risk-free rate of borrowing, inflation and a proper risk premium for the company. Since the long-term treasury rate encompasses both the cost of borrowing and inflation, the stock market places great emphasis on changes in treasury yields.

As long-term treasury yields increase, the discount rate used to calculate stock prices also increases. Because i , the interest rate, is in the denominator of the equation, it reduces the value of a company's future earnings per share and drives the stock's price down. Because inflation is the most dynamic component of treasury yields, it is a significant factor in stock price volatility.

Inflation is defined as *an increase in the volume of money and credit in circulation relative to available goods and services resulting in a continuing rise in the general price level*. In accordance with the laws of supply and demand, an oversupply of currency in circulation decreases the value of money (or, more accurately, increases the prices of goods and services).

Rising inflation essentially means a reduction in the purchasing power of the dollar.

Short-term bond yields rise in anticipation of possible rate hikes by the Federal Reserve's Open Market Committee (FOMC). Raising interest rates makes it more expensive to borrow money, thereby reducing borrowing. When the general public reduces their borrowing habits, they also ease their spending habits. This in turn helps to curb inflationary pressure because it makes it harder for producers to raise prices on goods and services.

Yields on long-term bonds (for example, bonds with a 30-year maturity), however, are market-driven. The FOMC has no *direct* control over the long-term yields; they rise and fall as a result of the level of expected future inflation. However, through the FOMC's use of monetary policy on short-term interest rates, long-term bond yields *are* affected. When inflationary fears are high, long-term yields rise. Since forecasts for future inflation are based on what is currently taking place in the economy, slowing current economic activity can lower future inflationary concerns. That is why boosting short-term interest rates can actually lower long-term rates.

Not all stocks are as sensitive to changes in monetary policy as others. The extent to which a stock is affected is based upon the earnings multiple at which that stock is currently trading. Typically, the higher the stock's price-to-earnings (P/E) ratio, the more sensitive its price to changes in expected inflation.

Imagine a company with annual earnings of \$10, while its stock traded for \$100 per share. That would mean the company had a P/E ratio of 10, or an earnings yield (earnings divided by share price) of 10 percent. If the annual inflation rate were 2 percent, the "real" or after-inflation earnings yield would be 8 percent, which is still very strong.

But suppose the stock price were \$300 per share, with earnings remaining at \$10. The P/E ratio suddenly jumps to 30 to 1, and the earnings yield drops to 3 percent. With annual inflation of 2 percent, the real, after-inflation earnings yield would be only 1 percent. If inflation rose only slightly to 3 percent, this company's after-inflation earnings yield would be reduced to 0.

There is obviously more to stock analysis than this. However, this is the foundation to calculating a stock's "fair value". From here analysts would make adjustments for other factor such as book value, dividend payments, etc. But the fact remains that changes in earnings and interest rates are the main driving force behind a stock's price movement.