

Stock Volatility Erupts

The fact that financial markets go up and down in value should be of no surprise to anyone. *When* the markets go up and down is the surprise. And in the past quarter, investors were surprised. How big a surprise depended on how frequently an investor looked at his or her account. If you only look at your account at each quarter's end, you will likely see a small decline in the value of your account. If you looked at it more frequently, there was something of a roller coaster ride—particularly in the foreign markets.

Between mid-May and mid-June, large cap stocks lost 7% of their value. It was the worst intra-month drop since February 2003, the month prior to the Iraq invasion. Small cap and international stocks fell by 13-15% from their peaks, their deepest decline since the corporate governance scandals of autumn 2002. Emerging market stocks fell by over 24%, their worst showing since the Russian default crisis of 1998. However, by quarter-end, many stocks had managed to recover most of their losses, leaving investors shaken, but relatively unharmed.

Why did the stock market decline, and so quickly?

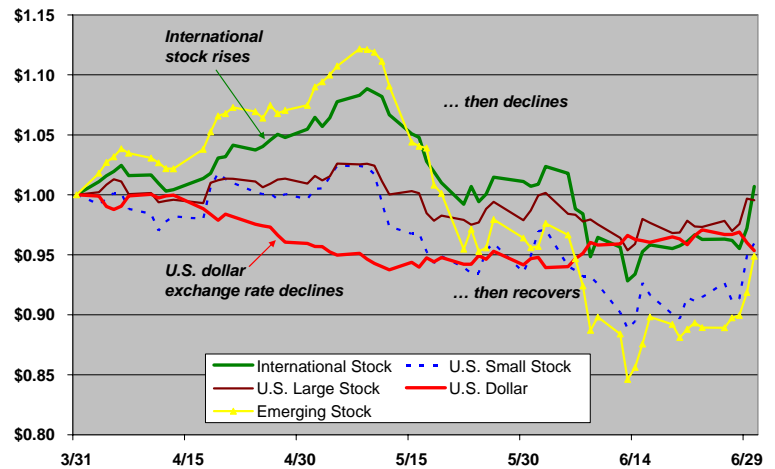
The sharp movements in stock prices were sparked by a sharp downturn in the value of the U.S. dollar on global currency markets.

Concerns about the U.S. dollar's attractiveness intensified when, on April 27th, Federal Reserve Chairman Bernanke testified before Congress that "at some point in the future, the committee may decide to take no action at one or more meetings." Stocks rallied on the suggestion that a pause in interest rate hikes was possible, but the exchange value of the U.S. dollar fell as the prospect of a lower-yielding dollar drove overseas bond investors to direct their investments elsewhere.

As investors abandoned the greenback, inflation hedges and non-dollar assets appreciated. Gold skyrocketed to a record \$730 per ounce, and international stocks rose sharply (see chart). By mid-May, the exchange value of the U.S. dollar had fallen by over 6%.

The dollar eventually found buyers as reports began to trickle out that global finance ministers were holding behind-the-scenes talks to tackle imbalances in the

Growth of \$1.00 Invested March 31, 2006



global economy and address the dollar sell-off. In the weeks that followed, central bankers and government representatives assured the public that higher interest rates were forthcoming.

It was bitter medicine, but it worked. The U.S. dollar recovered – but not without triggering sharp volatility in global stock markets.

Is this weak stock trend likely to continue?

While it's difficult to predict day-to-day market movements with any degree of reliability, we have more confidence in our longer-term views. We believe the U.S. stock market is most likely to deliver below-average, "real returns" (net of inflation) during the next 12 months. Our analytic models indicate that rising oil prices and cash yields are two factors likely to constrain economic growth and to reduce the attractiveness of financial assets.

Rising oil prices can adversely affect the economy in a number of ways. The cost of goods increase, if only due to transportation costs. This is inflationary and negatively impacts corporate profitability. Consumers have to spend a larger percentage of their income at the pump rather than on goods and services, putting a noticeable drag on the economy.

In order to keep inflation contained, the Federal Reserve has been gradually raising interest rates. This has raised the cost of borrowing, causing economic growth to slow, a negative factor for stocks.

With rising short-term yields in excess of 5%—attractive cash yield levels not seen since year 2000—

short-term investments are seen as an increasingly attractive alternative to riskier assets such as stocks.

We're also troubled by some harder-to-quantify factors. Ongoing wars in Iraq and Afghanistan and dicey nuclear standoffs with Iran and North Korea raise serious economic and security risks. On the home front, imbalances in trade, budget, and pension funding, and slowdowns in housing and auto manufacturing pose challenges to financial markets in the months to come.

Notwithstanding this most recent quarter, stock volatility has been abnormally low over the past three years. We view the recent up-tick in volatility as a move towards market normalcy. Investors, chastened by the discipline imposed by global currency markets, have begun to re-evaluate the risks inherent in their strategies. This results in a higher "risk premium" for stocks and has the effect of depressing stock prices.

The U.S. dollar, temporarily revived by higher interest rates, remains under watch. We would like to see the greenback regain its footing without resorting to promises of future rate hikes. Until that happens, international securities (both bonds and stocks) and domestic cash equivalents will appear relatively attractive.

Do I need to change my investment strategy?

As the market's performance this past quarter attests, there's no such thing as a "sure thing" in investing. While coming months may bring more volatility than investors have recently been accustomed to, long-term investors can still profit by owning a full range of asset classes within a diversified portfolio.

Investment success does not require that you have advance knowledge of when the markets will be going higher or lower. Investment success depends on your ability to maintain a *sound* investment strategy through the *inevitable* ups and downs of the financial markets.

A sound investment strategy is one that is structured to suit your risk tolerance, return objectives, and spending needs over your investment horizon, utilizing an appropriately diversified allocation of asset classes and funding vehicles. If you feel that your portfolio is not appropriately structured, then a change would certainly be required. And our role is to help you sort through the factors that would determine an appropriate allocation. Please contact our office if you would like to discuss your current investment strategy.

If your investment strategy is sound, the recent decline in the markets is not a reason alone to make a change. After all, a sound investment strategy assumes there will be the inevitable market decline. Money is made in the financial markets *because* of risk, not *despite* the risk.

Investment Committee
Northwest Capital Management, Inc.
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