

## Third Quarter 2006 Market Commentary

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Two things happened last quarter that have not happened at the same time in 3½ years: The performance of U.S. Large Cap stocks was better than that of the other major stock asset classes, and intermediate-term bonds (as measured by the Lehman Intermediate Gov't/Credit index) outperformed cash.

U.S. Large Cap stocks had their best performance in nearly two years while bonds had their best performance in four years. Last quarter's performance of U.S. Large Caps is all the more notable since this asset class has, over the past six years, underperformed the majority, if not all of the major stock asset classes, two-thirds of the time.

U.S. Mid Cap stocks had negative performance in the recent quarter and U.S. Small Cap stocks barely broke even. International markets had a good quarter but trailed U.S. Large Cap stocks.

We think this is characteristic of a “flight to quality.”

***So what does this mean for investors, and specifically, for decisions that must be made in their portfolios?***

Over seventeen consecutive meetings, the Fed had systematically raised overnight borrowing rates from 1% to 5¼%, but paused at the August 8 meeting. There was certainly sufficient evidence that economic growth was slowing and that additional rate increases would not be required to slow the economy further. (A slowing economy can be an antidote for inflationary trends, the Fed's primary policy concern.) The minutes of the August 8 FOMC meeting revealed that the Fed's staff was forecasting six quarters of below-potential growth starting in the third quarter of 2006. Unfortunately, the staff did not specify what that “below-potential” rate of growth would be. Let it suffice for the purposes of this discussion that everyone agrees the economy will be slowing. Any differences in opinion will focus on the future rate of that slow growth.

Investors need to think like Goldilocks: *Will the economy be too hot? Too cold? Or just right?* We think there is almost no chance the economy will be ‘too hot.’ ‘Just right’ means the Fed has engineered a soft landing—raising interest rates just enough to take the air gently out of the housing bubble and to

cool rising commodity prices without causing the economy to slip into a recession. (A recession is “too cold”.) The hope for a soft landing, coupled with the recent drop in oil prices, has prompted the recent rally in U.S. Large Cap stocks.

With longer-term rates lower than short-term rates (an inverted yield curve), the “bet” is on that the Fed will soon be forced to lower interest rates—and we think this prognostication will prove correct. Whereas some within the FOMC had unsuccessfully argued for an earlier pause in interest rate increases or for an actual rate cut, it is likely that the FOMC needs to see convincing deceleration of core inflation data before it will cut interest rates. But for a dramatic downturn in economic data, such a rate cut is unlikely until December of this year at the earliest. The Fed needs to appear unwavering in its resolve to combat inflation.

There is ample evidence that residential housing is in a recession. In the recent years of the current economic expansion, housing related expenditures and personal consumption expenditures have accounted for about 76% of real Gross Domestic Product (GDP) activity. A slowdown in personal consumption expenditures and housing should allow the Fed to cut interest rates.

During September, the year-over-year increase in the median price of single-family homes fell for the first time since April 1995. (Since statistics on housing prices were first kept starting in January 1968, such a monthly decline has only occurred on five other occasions.)

In August, the inventory of unsold existing homes rose 37.9%. There is now a 7.5-month supply of unsold existing homes compared to a 4.7-month supply in August 2005. Given such a large increase in inventories, would it be a surprise to see additional pricing declines? We think not.

Foreclosures of residential mortgages are 53% higher than a year earlier. Can this be in part because of rising payments on adjustable-rate mortgages (which have a low introductory rate that increases after an initial period regardless of the movement in interest rates)? Studies conclude that the increases in the reset for adjustable rate mortgages range between \$300 and \$500 per month depending on the total value of the mortgage. (And you thought \$3 a gallon gasoline was a drain on your budget!) Homeowners can often refinance or sell



their homes before foreclosure, but how feasible is that in a market environment of declining home prices and a build-up of inventory?

The accommodative monetary policy of the Fed has resulted in a housing boom for the past six years. Mortgage money was cheap and more Americans could afford to purchase homes. Many owners profited from increasing home prices, either through sales, the reduction in monthly mortgage expenses through refinancing at lower rates, or the access to increasing equity via a second mortgage—all of which helped to propel consumer spending, one of the pillars of a strong stock market. As home price appreciation slows and households feel less wealthy, are consumers likely to save and cut back on spending? Just as consumer spending was a significant contributor to recent GDP growth, will a slowdown in such spending imply lower GDP growth?

Housing starts, permits issued and permit extensions have fallen in excess of 23%. What ripple effect will a housing slowdown have on the economy? Housing and related sectors have made up a third of all non-farm employment over the past five years.

We do not think that the housing slowdown is good news for the economy. Those betting on a Fed interest rate cut win whether the economy ends up being ‘too cold’ or ‘just right.’ Either way, a Fed rate cut is coming. Investors with stock portfolios whose bets are on a ‘soft landing’ stand to lose *short term* if the economy turns out to be ‘too cold’.

The rally in stocks seems contradictory. *If the Fed’s forecast for a slowing economy proves accurate, won’t that translate into lower corporate profits? And shouldn’t lower corporate profits mean lower stock prices?* The stock market is forward-looking. Valuations often hinge on what the market thinks might happen in six months versus what is happening today.

If Goldilocks gets her way, then the economy is “just right.” Stable and/or declining prices in housing and oil, if sustained, could relieve inflationary pressures, allowing the Fed to lay claim to a “soft landing.” The 3<sup>rd</sup> Quarter’s performance of U.S. Large Cap stocks would just be a prelude to sustained growth and prosperity. In this best-case scenario, we could see a powerful stock market rally through 2007.

But what if the economy proves to be ‘too cold’? For example, housing could experience a ‘hard landing’ causing economic growth to fall more sharply than

planned, cutting into corporate profits and stock prices. Or, a bad turn of geopolitical events could cause energy prices to increase appreciably, reducing the discretionary spending of consumers.

As the Fed-guided economic slowdown gains momentum, U.S. financial markets may become increasingly sensitive and vulnerable to destabilizing risks. It is our view that market risks will be elevated in coming months. However, we also believe that the opportunities for capital growth will remain strong over the long-term. Our key task, therefore, will be to manage and tolerate short-term risks in order to realize longer-term performance.

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We were tempted to cast Fed Chairman Ben Bernanke as another character in our analogy of Goldilocks. But to somehow insinuate Fed Chairman *Bear*-nanke might be less than bullish on the economy did not resonate with us. After all, the Fed is the one who has long thought the U.S. economy was too hot!

We do not think that we can characterize ourselves as bearish despite our concerns the economy might become too cool to suit Goldilocks’ taste. For the longer term, we are bullish. But our tastes are similar to that of Goldilocks. We like things to be ‘just right’. We do, however, prefer to act a little more cautiously than Goldilocks had when she fell asleep in Baby Bear’s bed. Don’t forget when she woke up and was confronted with a bear, she jumped out of the window! Had oil prices not dropped recently, it is unlikely U.S. Large Cap stocks would have rallied. We think it prudent to hold some cash reserves while we wait out events that, should they unfold in the 4<sup>th</sup> Quarter, will determine just how hard or soft the bed is that the Fed has prepared for us.

Investment Committee  
Northwest Capital Management, Inc.  
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