



MARKET OUTLOOK

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Stocks unexpectedly reach five-year highs

As 2005 was nearing a close, technical indicators seemed to be pointing to a correction at the beginning of 2006. Instead, stocks rallied and major indices reached the highest levels in more than five years.

As I began writing this commentary, the weather outside my window was sunny. It was a warm winter day with temperatures in the mid-40s. Weather forecasters warned that the day would be wet with up to an inch of rain in the valleys and two feet of snow in the mountains.

The storm they predicted never made it this far south. We ended up getting a little rain and sleet, but not nearly the amount that was predicted.

It isn't unusual for the weather forecast to be wrong. In fact, my wife chooses to ignore weather forecasts because of their inaccuracies. I tend to think the forecasts are right most of the time. I also spend a lot of time in outdoor activities. So if any sort of a storm is forecast, I err on the side of caution and make certain I am equipped for whatever might occur.

Forecasts about market activity are less accurate than weather forecasts. In fact, being wrong is

so common that there are sentiment indicators that assume the majority opinion of what stocks will do will be wrong. One of these is the AAll Index. AAll stands for American Association of Independent Investors.

In a recent weekly market commentary, Tobin Smith forecasted a continuing major rally, based partly on a bearish sentiment reading from this indicator. (You can sign up for his free weekly email newsletter at: www.changewave.com.)

Here is how he assessed the situation:

"To put this into context, after following this index for 15 years, my research shows that when the index gets to 60%+ bullish and less than 10% bearish, the market hits a sentiment top -- that is, all who CAN buy stocks HAVE bought stocks. Last week's reading was the lowest bullish sentiment of the last 36 months! Maybe this explains the \$3 trillion sitting in money market funds and accounts in the U.S.

"RALLY ON

"I used to corroborate this sentiment gauge with the broker/dealer margin. (When margin hits record highs and the AAll

index is at a 50-point or more surplus of bulls to bears, watch out below!) But hedge fund margin usage clouds this statistic somewhat these days. The other sentiment metric that works almost as well is mutual fund cash flows as reported by TrimTabs -- and there, too, instead of record highs we see record lows in equity funds going into U.S. stocks.

"Given the following factors:

- *Huge underperformance of U.S. buy-and-hold stock indexes to foreign indexes (excluding energy and Internet stocks, that is).*
- *Horrid sentiment of individual investors.*
- *Accuracy of the "as goes the first five days of January, so goes the market for the year" statistics (87.5% of the time equaling an "up" year).*
- *Underinvestment in U.S. equities by foreign investors.*
- *Falling dollar (which allows foreign buyers to get more bang for their euro, yen or other currency).*

"This rally looks to have long, luxurious legs ... I'm talking Brooke Shields legs.

"Me likee!

"What could change my forecast?"



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- *China choosing to drastically change its U.S. treasury portfolio, sparking a 200-basis-point crash in 10-year T-bills.*
- *A big crack in U.S. residential housing prices on a Fed tightening past 5% short-term rates.*
- *An Arab energy embargo as a result of Israeli-led destruction of Iranian nuclear fuel enrichment assets (and the complete destruction of the Iranian Air Force and missile silos to protect Israel from retaliation) and \$75 oil for six months or more.*

"What's the likelihood of these three market killers happening this year?"

"About the same as Fox News Channel getting an exclusive interview with Hillary Clinton."

In contrast, there are currently many other experts who believe stocks are on the verge of a significant bear market correction. I'm borrowing some comments today from Tim Chapman, who is a consultant for Strategis Financial Group's Asset Commitment strategies.

"No one can accurately predict the future but there are some interesting things to watch for in

2006. As always it is easy to find an 'expert' pontificating on either side of the issues so I will give you both sides of the three arguments I hear most often:

"1. Pessimists (realists?) point out that the current bull market is now 39 months old if you measure from the October 2002 low, or 34 months old if measured from the March 2003 low. In either case it is getting long in the tooth when one considers the average bull market since World War II lasted for 38 months. Optimists agree but are quick to add that the typical bull market advance is 80% and the current advance has only been 61%, therefore they believe there is still some upside left. If the Bulls are right it would mean an additional gain in the S&P 500 of about 10%.

"2. The Fed raised short-term rates 14 times during the past few years and in the last week of December the yield curve inverted. That means short-term rates were higher than long-term rates. For example, right now T-bills pay a higher interest rate than 10-year bonds, which is unusual because typically investors demand a higher yield in exchange for tying up their money over a longer period. Bears know that inverted yield curves have historically been a

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bad sign for our economy, signaling a coming recession. The last time the yield curve inverted was early 2000, right before the last bear market began. The Bulls agree that inverted yield curves have been a precursor to bad times in the past but they believe this time is different primarily because of the foreign demand for U.S. bonds.

"3. Bears point out that the market is now overvalued or at least fairly valued based a current Price-to-Earnings (P/E) ratio of 17.8, which is slightly above historical levels and well above P/E levels one would expect at the beginning of a sustainable rally. Bulls believe that historically low inflation rates, with no apparent threat of increased inflation on the horizon make the realistic market P/E much higher. Plus they believe 2006 will bring continued strong growth in corporate earnings. For 2005, S&P 500 earnings was about \$70 and analysts projections for 2006 put earnings

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in the \$75-80 range. If earnings do reach \$80 and P/E ratios stay at 17.8 it would mean an S&P 500 index value of 1424, which is 14% above the 2005 closing price.

"What Does It All Mean?"

"What it means is no one really knows what will happen in the next 12 months. There is validity to the argument put forward on both sides. That is why we do not go into the year with a predetermined mindset and we think it is a huge mistake for a client to position his or her portfolio in such a way that it can only be successful with one specific scenario. If you get locked into the Bulls argument, you win if they are right but risk suffering big losses if they are wrong. If you blindly side with the Bears, you might miss rewarding returns that could be needed to meet your long-term retirement goals. In closing, it is important to be ready to react not quick to predict."

I have to agree with Tim Chapman. I have no idea what the market will be doing for the next 12 months. But if your portfolio is correctly allocated, that should not matter.

When I mention allocation, I am not talking about traditional allocation models espoused by Modern Portfolio Theory (MPT). (Is it still accurate to call it Modern Portfolio Theory when the theory is now more than 50 years old?)

Instead, I am referring to an active allocation approach. Rather than divide our portfolio among several asset categories and then just passively wait to see what will occur, we want to actively allocate our assets among the strongest sectors, indices and

other investment vehicles at any given time. At the same time, we always need to be concerned with risk and its management.

When MPT was first introduced, investing was still primarily an activity for the wealthy. There were no sector funds or exchange-traded funds (ETFs). There were no short funds or enhanced beta funds. Stocks trades had to go through a broker and there were hefty commissions. The simplest investment transaction of merely selling one position and buying another often took more than a week to clear. A long-term, buy-and-hold approach to investing made sense primarily because there was no good alternative.

Today we live in a world of cell phones, personal computers, and wireless transactions. In spite of all the advancements of the past 50 years, many people still adhere to investment practices that were developed when their grandparents were entering the work force.

Today individual investors have tools and instruments that were unimagined even a decade ago. Many of these allow investors to profit in both up and down markets. By learning how to use these tools and investments we can lower the cost of investing and find other ways to help stack the odds in our favor.

—Flint Stephens

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What is Fueling the Housing Market?

Have you ever driven past a new housing development in your town and wondered "where are all these people coming from?"

Perhaps even more bewildering to me is the number of expensive homes being built. When I see a new neighborhood of high-end homes, I often ask myself how so many people can afford such pricey homes. It reminds me of the recent television commercial where a beaming father is showing off his new house, car, country club membership, etc, and proudly proclaims "and you know how I can afford it? I am in debt up to my eyeballs."

I have always suspected that the fuel for the housing market has been excessive household debt. Federal Reserve Chairman Alan Greenspan confirmed my suspicion when he told Congress on June 9 that "the apparent froth in housing markets may have spilled over into mortgage markets".

Consider mortgage markets like San Diego's, in which 47% of all mortgages are interest only (source: BusinessWeek Online). For those of you who are not familiar with interest-only mortgages, here is how they work. The borrower pays only the interest that accrues on the loan balance each month.

Because each payment goes toward interest, the outstanding balance of the loan does not decline with each payment. Also, because the loan payment does not include any portion to reduce principal and because interest rates fluctuate, the initial payments are much, much lower than a traditional fixed 15 or 30-year

mortgage. (After some time horizon, i.e. 10 years, the loan begins to amortize like a traditional loan).

Interest-only mortgages have some great advantages. Ideally, the lower payments allow you to invest the savings over a traditional mortgage at a theoretically high rate of return than you earn by paying down your mortgage. Unfortunately, most people that take out interest-only loans do so because that is the only way they can afford to purchase the home.

I recently spoke to a friend who is in the real estate business in Los Angeles. He commented that not a single client of his has taken out a traditional loan in the last year. I don't think it's a stretch to presume most people taking out interest-only loans are doing so to buy a bigger home, or to have more money to spend elsewhere (cars, vacations, etc.). Mortgage refinancing alone contributed over \$600 billion of consumer spending last year.

Unfortunately, interest-only loans carry a tremendous amount of

risk. By making payments of interest only, the only way to build home equity is through market appreciation. If home prices decline modestly, borrowers might become "upside down" in their loans.

If prices should fail to increase during the interest-only period, and if the borrower needs to sell the home, he could potentially be on the hook for thousands of dollars in sales costs which would need to be paid out of whatever equity (in the form of the down payment) he started with. According to the National Association of Realtors, typical down payments have fallen from 10% in 1990 to about 3% in 1999, so it's obvious that borrowers are courting trouble.

Perhaps an even greater risk to the interest-only borrower is rising interest rates, which have become a reality. Alan Greenspan has raised rates 11 times, from 1% to 3.75%. Holders of interest-only loans saw their monthly payments skyrocket during the last year.

The purpose of this newsletter is

not to provide mortgage advice or critique those who have taken out interest-only mortgages. The moral of the story is that a serious, economic threat looms on the horizon that could have a significant impact on the stock market and your retirement investments.

Consumer spending provides fuel for increasing stock prices. As rates continue to rise, consumers have less money to spend or save. The average American household savings rate is now zero. Energy prices have increased dramatically, further compounding the problem.

During the last 10 years, the number of new, single family homes being built each year has more than doubled. And the average size and price of homes is increasing almost as quickly. I think it is fair to say that America has an epidemic problem of people spending too much and living beyond their means, and at some point this will be reflected in depressed stock prices. Which is why interest-only mortgages affect your investments.

When do we think this will effect the stock market? Hopefully, you know us better than to think we are going to make a prediction. Our goal is to be in a position to react if and when the market begins to decline as a result. We are always ready to move to a protective position because we do not know which decline in the market will be the onset of the next bear market. We do know, however, that every bear market starts with a small decline.

—**Jud Doherty, CFA**

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