Year End 2005: Review and Preview

In my year end 2004 report I stated, "With a plethora of working parts within this macro-economic puzzle, one investment stands out in all such likely outcomes: precious metals. In the debate between such inflationary or deflationary scenarios, real wealth accumulation, which is nobody's obligation but rather a pure asset, stands to benefit in either scenario."

In hindsight, this statement certainly sounds prescient as precious metals (gold and silver) reached prices not seen in nearly two decades. They were truly one of few big winners in an otherwise stagnant market, and your exposure to this group performed extremely well.

But that is about all that I can pat myself on the back for. In last year's report, I continued, "The 'wild-card' in all this is how investor psychology affects the U.S. dollar and the broad stock market averages. For these reasons, and as a result of not knowing exactly how long the current trends will persist, I continue to recommend a combination of precious metals and foreign currency investments. For those who wish to also hedge against the shift in investor psychology, a portion of assets in investments that capitalize on a weak stock market should also be implemented. Obviously, each investor has unique circumstances from which these allocations should be made, but I continue to believe that a mix of these assets will outperform the broad stock market averages over the coming years."

In 2005, the current trend (a stagnant market) did in fact persist, as the market remained stable, and some losses were recorded in inverse mutual fund investments. This was a poor recommendation, as portfolio performance would have been quite good without it. The dollar also was stable, rebounding a bit from the previous three years of decline. The large yield in these foreign currency investments was enough to offset the decline in principle value, causing roughly break-even total returns, but the fact remains that these two components of my three-component investment strategy for 2005, did not perform nearly as well as I had expected. So all said and done, my recommendations for 2005 were simply average, performing only in line with the broad averages, which posted flat returns.

I therefore give my performance a "C" grade. While the general theme played out as expected, psychology did not shift in 2005, causing failing marks in my recommendation for inverse mutual funds. The performance in foreign currencies was just average, and the precious metals performance was top notch. However, all combined, 2005 performance was a struggle simply to maintain performance in the plus column.

You may be asking yourself, "how can flat returns be considered as 'good' as average?" Simply put, there were little returns to be made most anywhere you look. The Dow Jones Industrial Average recorded the tightest one year trading range in it's history (and the first ever down year for a year ending in "5"), with a modest one half percent decline from 10,783.01 to 10,717.50. The S&P 500 did manage to post a positive year, up 3.0%,

but as I had stated in a previous note, this performance would have been negative if it wasn't for the huge performance in energy stocks, which benefited nicely from the surging price of oil. Lastly, the Nasdaq, which also benefited from the large market run in November, was able to squeak out a positive gain as well, by about 1.5%.

Certainly, there are always a few select areas that performed extremely well (namely precious metals, the aforementioned energy sector, and some individual stocks like Google), but the vast majority of stocks simply went nowhere, and made money market investments look exciting. Psychology held up enough to keep the economy and markets stable, but it still was not powerful enough to propel anything better than muted gains across the broad asset classes.

I had been thinking, at the end of 2004, that the already historic extremes in investor psychology was due to reverse. At the end of last year, investor psychology (based on consensus reports) had remained overtly bullish for two straight years, without a single week where bearish advisors outpaced bullish advisors. Since this data began being tracked four decades ago, this had never before happened, not even during the dramatic rise through the late 1990's. One year later, the streak continues, more than doubling the previous record of the number of consecutive weeks in which bullish advisors outpaced their bearish counterparts (an exceedingly bearish portent).

Typically, such lopsided sentiment, at a minimum, causes a correction in the stock market, as there is little money left to flow into equities to propel them higher. While that risk remains (and arguably has increased much more), psychology remains extremely buoyant, and has helped keep the stock market and value of the U.S. dollar stable through 2005.

So 2005 rounds out the second straight year of dull performance across all broad asset classes, and without this shift in psychology happening, my recommendations only performed in-line with the markets. Such tepid returns have been frustrating for all market participants, but Bulls and Bears alike are now in agreement in simply hoping that a larger sustainable trend in the stock market will emerge soon.

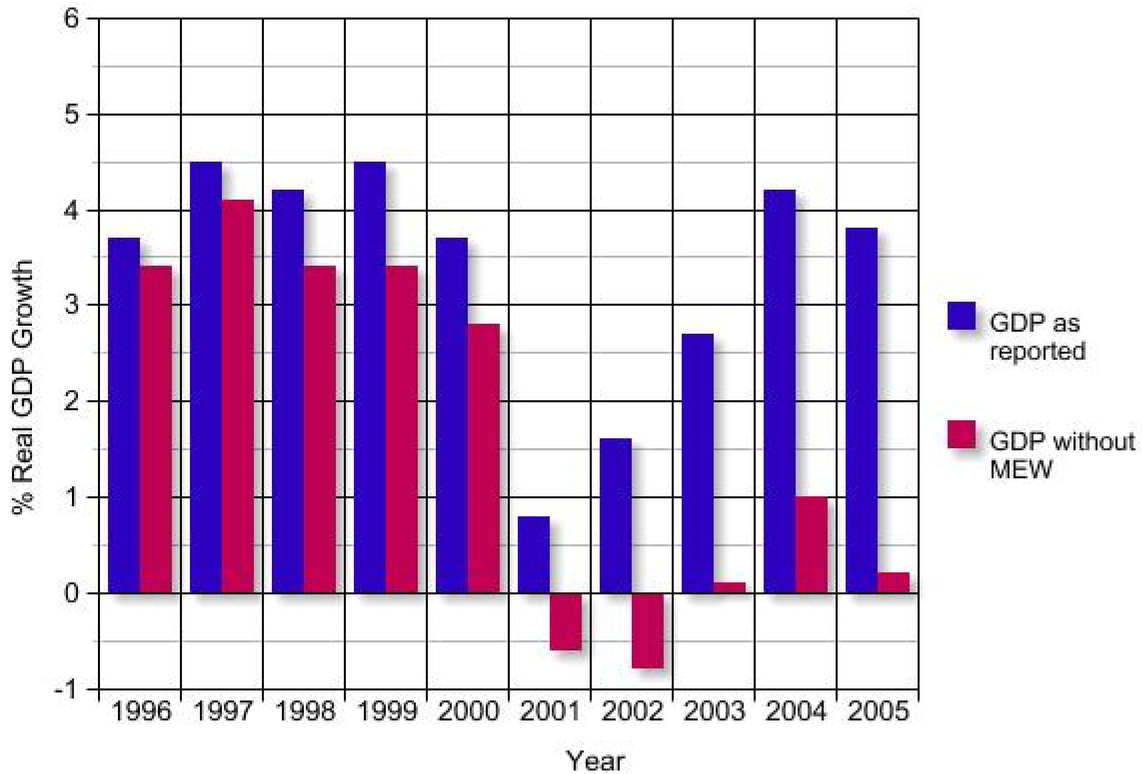
And this brings us to what we might be able to expect in 2006.

I wish that I had some exciting and profound predictions for the coming year, but unfortunately, I expect much of the same. The key determinant for performance in 2006 will likely remain psychology. So long as psychology continues to hold firm, we are likely to see a stable economy driven by debt-induced consumption.

As you can see in the graph on the following page, our economy may well have been in and out of recession since 2001 if not for the ability of the average consumer to continue to cash out the equity from rising home prices. This is a main component of the Fed's reluctance to raise interest rates to a level more proportionate to the actual inflationary levels in prices of goods and services that we all see affecting our pocketbooks. By

keeping the Fed Funds Rate below the "real" level of inflation, they are providing continued liquidity to help keep the economy stable.

This remains a rather precarious situation. Certainly, it helps to provide a growing economy, but it comes at the cost of ever increasing debt and leverage. I won't go into the details on this scenario again at this time, as I have discussed this topic in detail previously, but suffice to say that this is just fine… *until* we either reach the point of saturation or unless the aforementioned extremes in investor psychology shifts, whereby consumers would tighten up their purse strings and begin paying off debt.



I cannot stress enough how important the "psychology" factor remains. It is the continued assumption among the average U.S. consumer (as well as the government) that ever increasing debt payments can be maintained simply by taking on more debt to pay them.

This process can continue (and so far has) for far longer than many would expect. As a result, it would be futile to assume right now that 2006 will be the year that this begins to matter (although it could at any time). Thus, my current working assumption for 2006 is based on the premise that the economy continues to muddle along in the same manner it is currently going.

For financial markets, so long as this continues, will likely result in mid-single digit returns again in the stock market, and consequently a continued increase in inflationary pressures. It is this inflationary pressure that has helped boost commodity prices, and I continue to believe that precious metals and energy investments will perform well should this environment continue. So precious metals will remain a central investment theme, and should the energy sector "come in" enough to provide a good entry point, I will likely recommend adding exposure to the group.

I also believe that interest rates on the middle and long end of the yield curve will remain stable. However, since the yield curve is "flat," there is little to gain by taking on longer dated maturities, so money market and short to intermediate-term bond funds offer nearly the same yield as longer dated maturities, with far less risk. Given that these types of investments offer yields nearly as high as what one might expect as potential upside from the stock market (should it continue to muddle along), these investments also remain attractive in the current environment.

Lastly, foreign currency investments look to remain attractive for the foreseeable future. I would expect the dollar to remain stable through at least the first half of the year, and has potential to rise by as much as 10% in 2006. However, even if this should occur (which would be a negative for foreign currency investments), with some foreign currency funds trading at around a 6% discount to the net asset value of the fund, and offering yields as high as 7%, I believe the total performance of these foreign currency funds should, at worst, be near break-even (as happened in 2005). Yet, these investments still provides 5% to 15% per annum potential returns should the dollar resume it's decline (as I expect it to within the next 12 months). So despite my near term negative outlook on the foreign currencies, the risk/reward is still extremely attractive from a long-term investment standpoint.

We currently remain in a period of sluggish economic growth based on debt-induced consumption, as has been the case for about two straight years. I believe that this is likely to continue through at least the first quarter or two of 2006. So long as this remains, trying to achieve mid-single digit annual returns looks like all investors are likely to achieve, regardless of which asset class they may prefer. While I believe this is the upside in the equity markets, I continue to believe investments through precious metals, foreign currency investments, and money market and short-term bond funds look to offer the same potential as the stock market, but with far less risk.

Obviously, it is no bold prediction that a stagnant trend that has been in place for a couple years may well continue for the near term. So I remain on watch for any signals that a more sustainable (and therefore more lucrative) trend may finally be in the offing. The following are just a few of a long list of potential indications that a more sustainable trend may be emerging:

1. The S&P 500 and Dow Jones Industrials both trade and sustain above 1278 and 11,000, respectively, indicating a more bullish near-term market.

2. Real Estate continues to appreciate at a rapid pace, making the average consumer feel wealthier, and therefore continue to spend.
3. Corporate America continues to spend on mergers and acquisitions to limit competition and increase profitability.
4. The dollar continues to remain stable or increase from current levels, making foreign goods more affordable and increasing consumption.
5. The yield curve goes from flat to inverted, crimping lending in the economy and signaling that a slowdown in the economy is likely. (This would likely be followed shortly thereafter by the new Federal Reserve Chairman, Ben Bernanke, lowering the Fed Funds Rate for the first time in years.)
6. Troubling news from some large blue-chip companies (like Fannie Mae or General Motors) begin to "matter," starting or aiding a shift in the extreme bullish investor sentiment.
7. Home equity extraction slows, crimping the consumer, either from a rise in interest rates and/or a slowdown in real estate speculation.
8. An oil shock occurs (i.e. another Gulf coast hurricane or major oil field is destroyed), causing another large spike in oil prices.

These are not predictions per se, as the first four are bullish in nature, while the last four portend a more bearish outcome, and clearly they cannot all happen. However, I hope it gives you a sense of what types of activity are likely to occur before a more sustainable trend emerges. Recently, many such situations have done little to dampen or aid the already extreme investor psychology. Until such time as a dramatic shift in psychology changes (either even more bullish or a reversal to a more bearish standpoint), we are likely to continue to see much more of the same muted action as the last two years.

As always, I will do my best to keep trying to identify any change as it occurs, and will recommend portfolio adjustments accordingly. In the meantime, and as always, should you have any questions or comments about these or any other topics related to your financial situation, please do not hesitate to let me know.

I want to wish you all a happy and healthy New Year. I hope that your holiday season was as fulfilling as mine. I recently read a quote which stated, "It shouldn't take something horrible to make one realize how fortunate they really are," which helped me to reflect on just how blessed I truly am. I am quite fortunate to have a supportive family, loyal friends, and wonderful clients. I greatly appreciate your continued confidence and support. I wish you all a prosperous and healthy New Year, and look forward to working with you to make 2006 as wonderful a year as you deserve.

Sincerely,

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