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Follow the Leader?

The Third Quarter

Domestic big-cap stocks, a powerful component of the Dow Jones Industrial Average and the S&P 500 Index, did very well in the third quarter, reclaiming market leadership from small and mid-cap stocks which had led the equity rally for the last four years. The S&P500 was up 5.7% (for the quarter) versus small and mid-cap growth stocks which were down 2.7% and 1.2%, respectively.[1]

For the U.S. equity allocation of a portfolio, we correctly recommended emphasizing big-cap stocks. See, "Patience and Uncertainty" July 2006 (www.avaloncapital.com). The shift in leadership resulted from lower oil prices, lower interest rates, a quieting of geopolitical turmoil and unexpectedly strong 3rd quarter earnings (Q3 profits are now on track to climb 17.4% above a year earlier, the best gains since the second quarter of 2004).[2] The large-caps have a powerful international component to earnings. For the Dow Industrials, almost 50% of the companies' sales are international and international growth remains very strong. In contrast, less than 10% of small cap earnings come from overseas.[3] As the U.S. economy slows, these large-cap stocks can keep making money from strength in international economies versus smaller companies where earnings are almost exclusively dependent on economic activity inside the U.S.

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Current Economy

United States Economy

The Federal Reserve looks likely to get the soft landing it has been trying to engineer. The Commerce Department reported that Gross Domestic Product (GDP) expanded at a 1.6% annual rate in the third quarter, down from the 2.6% rate in the second quarter and 5.6% in the first.[4] Q3 should be the low point for growth in this economic cycle. We expect the economy to gradually improve from now until the end of the year. In the third quarter, housing construction was the main drag, plunging 17.4%, the worst drop since the first quarter of 1991.[5] Housing's worst is likely occurring now: builders' sentiment about market conditions is at an extremely low level and may have bottomed in September. Sentiment edged up in October for the first time in a year and sales of new homes rose in September for a second straight month.[6]

Recently the Fed said: "going forward, the economy seems likely to expand at a moderate pace. Significantly lower energy prices, sustained increases in labor income and favorable labor market conditions were anticipated to support expansion."[7] However, the Fed also highlighted its continuing concern with potential inflation while announcing it was keeping interest rates steady for the third straight time. The Fed hopes a more moderate economic expansion will gradually cool down inflation. We believe inflation may prove stickier than the Fed, which is expecting 2 percent to 2-1/4 percent next year.[8] Core inflation rose by only 0.2% in September, but the year-over-year CPI rose 2.9%.[9] While many investors are expecting the Fed to ease in the coming months, we think it is more likely they will keep rates steady for some time to come.

World Economy

Aggregate world economic growth should post a positive 5.1% in 2006 and 5.0% in 2007. Virtually every region is forecast to grow by over 3% in 2006: China (11.3%), India (9.3%), South Asia and the Indian Subcontinent (8.5%), Russia and Eastern Europe (6.6%), the Middle East/North Africa (6.2%), and the Far East (7.6%). North America (which includes the U.S.) should increase by 3.5% in 2006, while Latin America is growing by 4.7%. Even long-depressed Sub-Saharan Africa is growing at 4.7% and Japan is expected to continue its structural reforms to renewed economic health with growth of 3.2%. Only the Euro-zone continues to lag global performance, forecast to grow at a sub-par 2.1%.[10] Nearly universal positive growth rates demonstrate the unprecedented breadth and strength of the worldwide economic expansion. A significant consequence of this economic surge will be the increasing demand for limited worldwide supplies of natural resources. However, in the absence of an actual disruption in the supply of oil or an intensification of the deteriorating geopolitical situation, there is very little evidence from a pure economic outlook that would support a slowdown next year.

4-Year Cycle Low - Are We There??

We argued that a 4-year cycle low was due over the coming months and that this decline would set the stage for a new bull cycle. Now that the major averages are hitting new cycle highs where does that leave the 4-year cycle? The cycle low typically occurs in the fall, around the month of October, but it has occurred as early as six months before October and as late as five months after October.

This is significant because from that low point forward, the market has averaged double-digit gains over the next two to three years without any significant intervening setbacks. We expect the rally that began in July has seen most of its gains for now. We expect some decline into the first quarter of 2007, as the 4-year cycle bottoming process completes. Big cap stocks might test their July lows and some small and mid-cap stocks may well decline below July's levels to lower lows. In 2002, the previous 4-year cycle low, stocks bottomed in October, but forfeited many of the gains by the first quarter of 2003. However, that decline marked the last best opportunity to buy stocks for the strong bull market that carried over the next four years. As then, investors need to psychologically prepare themselves that any downside movement between now and Q1 2007 offers a buying opportunity for the next bull market, which could carry beyond 2008.

Investment Outlook - United States Equities

On paper, the third quarter was triumphant for investors. Not only did the Dow flirt with its record high but the S&P 500 had its best quarter in nine years. Yet the quarter's gains were much more modest than the major "headline" indices would indicate. While the S&P 500 delivered a total return of 5.7% in the three months ended September 30, the average U.S. diversified equity fund rose just 2.23% for the 3rd quarter and 5.59% YTD versus the YTD return of 8.53% for the S&P.[11] Leadership shifted notably during the summer months from the winners of the last six years, such as small and mid-cap stocks and natural resources, to the large, stable blue-chip companies whose shares had been ignored for several years.

In diversified portfolios, the positive performance of the big-cap U.S. stocks, which represent a portion of the overall asset allocation, was overwhelmed by other sectors: Small-cap growth -2.7%, mid-cap growth -1.2%, natural resources -8.4%, pacific region +1.6% and Japan -2.0%.[12] Our recommended weightings in health care, high technology, telecommunications and bank stocks did very well during the quarter but for the overall portfolio gains were reduced by the dismal -8.4% return in the natural resource area.

Now, in the 4th quarter, the advance is spreading out. Average new highs on the NYSE reached 290 in October versus 150 in September.[13] Our favorite secular themes, including natural resources, international big-cap and emerging markets are performing well along with U.S. big-cap stocks, boosting overall portfolio performance.

Asset Allocation

U.S. Bonds and Stocks

As we expect the Fed to do nothing for many months to come and the economy to surprise investors with its upside strength, we also expect interest rates could remain flat or even rise over the next four to six months. In a rising interest rate environment we favor cash and short-term bonds in the fixed income portfolio. Near term, we may lighten up on U.S. equities as this current intermediate rally tops out, waiting for the next entry point sometime in the spring, at the 4-year cycle bottom. We favor big-cap issues over small and mid-cap stocks. We also favor health care, high technology, telecommunications and selective consumer stocks.

International

We have scaled back from a heavier over weighting in international equities, though we continue to recommend this area. We are sticking with core international mutual funds and big-cap international equities as it is too early to be aggressive buyers in emerging markets. We also think international bond funds make sense for many investors given our outlook for a weaker US dollar.

Natural Resources and Energy

Wow - what a difference a few months make! In July, oil prices were just shy of $80 per barrel. Since then the price of oil has sunk almost 30% and natural resource stocks right along with it. Has the natural resource "bubble" burst? We don't think so. Oil may get to $50 before it begins another substantial up move, but we believe investors should maintain their exposure in this area and buy more on price declines. From a long-term perspective, the Thomson Energy Funds have had an annualized return over the last five years of 21.2%, including the -8.4% 3rd quarter return.[14] Even a secular leader like energy will have short-term setbacks from time to time.

Charlie Maxwell, who was routinely lauded as the number one oil analyst throughout the 'Seventies and 'Eighties, was recently interviewed by Barron's.[15] It is well worth a read. He outlined four huge impediments to expanding oil production keeping pace with growing global demand. The first, dubbed "Hubbert's Peak" says that oil production will peak on a global basis, a factor that may dominate the outlook by 2015 or 2020. The second, and biggest problem near-term, is that 75% of the world's production of oil today is lifted by national oil companies and they are not re-investing back into oil production, choosing instead to redirect the proceeds to their national treasuries and political constituencies. Thirdly multinational oil companies have not been willing to spend significant money on new production either. The fourth potential impediment is that Middle East producers, having only recently become aware of Hubbert's Peak, may replace the mantra "produce more and faster" with "produce optimally over a longer period of time", further constraining supplies. Charlie Maxwell's estimates for the price of oil are $85 (2010), $180 (2015) and $300 (2020). We are maintaining our over weight position in natural resources and energy.

Real Estate

We have been REIT-shy for months and they continue to surprise us with their strength. REIT mutual funds returned 8.4% in the 3rd quarter.[16] We recommend under weighting this asset class due to historic overvaluation.

Summary

Though we forecast an intermediate rally starting in July, its concentration and duration surprised us. Near term, the market should begin an intermediate decline carrying into the 4-year cycle low and the next market entry for the subsequent bull market. At which point we would emphasize buying U.S. big cap stocks, natural resources and the international area.

Dave Rahn **Clara Basile** **Bill Oberman**

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1 Thomson.com
2 Investors.com
3 Williamoneil.com
4 Commerce.gov
5 Realtors.org
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