



NOVEMBER 2005 — MARKET REPORT

FALSE SENSE OF BOREDOM

So far this year the stock market has had moments of strength, only to lose steam and fall back down. The S&P 500 Index began 2005 at 1211.92 and as of the end of October, it stands at 1207.01. The markets have been in a tight 110 point trading range during the year. This small range for the market has left the casual index investor uninspired. On the other hand, our portfolios have done much better than the S&P 500.

In reality, however, the markets have been faced with many issues: Changes in the Supreme Court and the head of the Federal Reserve; the continued war in Iraq; weather related tragedies and huge clean up costs; rising oil prices; continued quarter point interest rate hikes by the Federal Reserve, and a possible Avian Flu pandemic. Each of these issues infuses uncertainty into the minds of investors. Uncertainty causes some investors to either stay away or to stop any activity "until the smoke clears." As the average investor focuses on the non-fundamental issues that rarely have long lasting effects on the market, we focus on companies that are positioned for long term growth.

So far, we have yet to see the much advertised soft patch and stagflation. The economic expansion has been remarkably robust with real GDP exceeding 3% consistently each of the past 10 quarters and GDP inflation measures remaining amazingly subdued despite the jump in energy costs. Looking forward, we expect some slowing in consumer spending during the next two quarters as suggested by the drop in consumer confidence during September and October. Real GDP may not slow as much since inventories fell during Q3 and will probably increase in Q4 and next year. We look for real GDP will be up roughly 2%-2.5% during Q4 and Q1, and then continue to grow by 3% or more during Q2-Q4 2006. There is some talk out there about a consumer-led recession in 2006, which is the most obvious risk to our relatively optimistic forecast for next year. The key to the consumer outlook is employment. Jobless claims are back down after spiking following the hurricanes. Just as important is real compensation per worker, which should continue to grow along with productivity. Furthermore, gasoline prices are falling, which might help to revive consumer confidence. In any case, we will continue to monitor the consumer very closely.

Should one be impressed by the economy? Absolutely! Despite all the grim talk from the nabobs of pessimism, real GDP has exceeded 3% for 10 straight quarters, the best performance since the 13-quarter string ending Q1 1986. Consumer spending may slow for a couple of quarters during the winter, but the outlook for tech-led capital spending looks good, and so does the prospect for some inventory rebuilding. GDP inflation remains amazingly subdued. Be optimistic!!

Labor cost pressures are rising. The Q3 Employment Cost Index (ECI) report showed that employment costs were up only 3.3% year-over-year, the lowest in six years and much less labor cost inflation than the non-farm hourly compensation measure, which includes stock options. The ECI also shows wages rising 2.2% vs. 2.7% for average hourly earnings. Union workers are leading the big drop in year-over-year benefit costs, and will continue to do so.



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Money does buy happiness. In October, families with incomes over \$50K were about 14 percentage points happier than those with lower incomes according to the Consumer Sentiment Index. However, both were equally depressed in October compared to how they felt about the present and expected situations a couple of months earlier. Car and home buying attitudes were depressed for everyone.

As we have shown over the 21 months of the extended trading range, focusing on specific company fundamentals and constantly looking long-term beyond the media noise will result in superior portfolio performance.