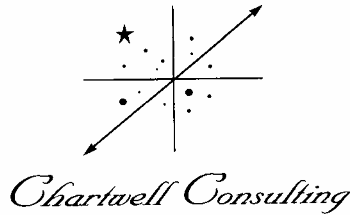

CHARTWELL REVIEW

January 2006 **FOURTH QUARTER 2005** Volume XII, Issue No.4

TWO-HANDED MARKETS

Our title theme this quarter is something of a back-handed swipe at the endearing(?) habit most economists and market strategists, plus a few investment managers and (perish the thought!) investment consultants, have of seeing every issue as a half-empty and half-full glass, *at the same time*. Isn't anything clearcut in this business?

Well, not really. We're all, investment principals and their myriad agents/advisors alike, trying to peer into the future. And, as the footnotes always remind us, "past performance is no guarantee of future results". What they don't say, but should, is that this applies to each and every global economy and global investment market, *in addition to* the investment portfolios created to take advantage of them. There are very few purely one-way markets, or "one-decision" investments, for very long.

So it was in the 4th quarter, and indeed all of 2005. For example, consumer prices in the *3rd* quarter had finally began to reflect the massive and relentless upswing in hard commodity (including energy) prices. The year/year increase was 4.7% (highest in years). So, of course, overall prices declined this past quarter, as did those of most hard commodities. Well, fine, but that means expectations about future inflation diminished, and interest rates went down, right? Nope.

Okay, then. But, if year-over-year inflation in the U.S. is rising faster than elsewhere (it is), then the exchange value of our currency must be under pressure – especially since our trade balance is so negative. Right? Wrong. Dollar was up last quarter, and last year (BIG).

Sometimes markets are two-handed.

Table 1. Index Benchmarks

Market Index	Q4 2005	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	2.1	4.9	14.4	0.6	9.1
U.S. Large-cap Stocks	2.0	3.8	12.5	(1.4)	8.4
U.S. Mid-cap Stocks	2.4	12.7	23.8	8.5	12.5
U.S. Small-cap Stocks	1.1	4.6	22.1	8.2	9.3
International Stocks	4.1	14.0	24.2	4.9	6.1
T-bills (3 month)	0.6	2.7	1.7	2.2	3.7
1-3 Year Treasuries	0.7	1.7	1.5	3.7	4.8
Aggregate Bonds	0.6	2.4	3.6	5.9	6.2
High Yield Bonds	0.4	2.1	13.7	8.8	6.7
Global Bonds, ½ hedged	(0.6)	(1.1)	4.8	6.1	5.9
CPI, annualized	(4.0)	3.4	2.9	2.5	2.5
DJ Commodity Index	(3.1)	21.4	18.0	10.7	9.0

* Annualized trailing returns for periods ending 12/31/05.

Table 2. Average Mutual Fund Returns

Fund Category	Q4 2005	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	2.5	6.3	14.7	0.6	8.6
U.S. Mid-cap	2.7	10.1	20.7	5.3	10.8
U.S. Small-cap	1.4	6.9	22.2	8.7	11.3
International Lg. Cap	4.6	15.0	23.3	5.2	7.9
International Sm. Cap	6.1	23.2	33.9	13.4	13.1
Emerg. Mkt. Equity	5.9	30.2	36.2	18.2	8.1
Balanced/Hybrid	1.6	5.3	10.8	3.6	7.7
General Bond	0.5	2.1	4.5	5.9	5.9
Government Bond	0.6	2.9	3.3	5.3	5.6
High Yield Bond	0.9	2.7	12.0	7.4	5.7
Hedge Funds - Broad	*1.9*	*8.6*	*12.5*	*8.0*	*11.0*

* Annualized trailing returns for periods ending 12/31/05.

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The Domestic Economy - "on the one hand . . . ."

You'll recall that real GDP advanced at an annual rate of 4.1% in the 3rd quarter, and was up 7.6% in current dollar terms. This was a surprise to investors and economists, who had predicted a real gain of 3.5%.

The government released its advance estimate of 4th quarter GDP growth just as we wrapped up this *Review*. It estimated the domestic economy grew at just a 1.1% annualized rate in the 4th quarter, which was also quite a surprise (the "whisper" number had been 2.7%). Table 3 reflects the major contributing factors.

Table 3. Contributions to Fourth Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**0.79%**	**1.1%**
Fixed Investment	**1.95**	**12.2**
(- by Businesses	*0.30*	*2.8)*
(- by Consumers	*0.21*	*3.5)*
(- Change in Inventories	***1.45***	*??)*
Exports	**0.25**	**2.4**
Imports	**(1.42)**	**9.1**
Government Spending	**(0.45)**	**(2.4)**
Real GDP Growth	**1.1%**	
Gross Domestic Purchases Price Deflator		***3.4%***

When you look at the report, what jumps out at you are –

- Personal consumption spending was punk in the quarter, just as we had expected it would be. Gasoline hit $3.00, and people stopped buying cars;
- Real disposable personal income jumped 7% in the quarter, rebounding from the third quarter impact of Hurricanes Katrina and Rita;
- Fixed investment growth, especially by businesses, slowed noticeably in the quarter. It grew at a lower rate overall in 2005 than in 2004;
- If businesses hadn't added substantially to real inventory levels, GDP growth would have been negative for the 4th quarter. Private businesses increased inventories by $26bn in the quarter, after decreases of $15bn over the prior six months;
- Imports increased sharply in the 4th quarter, and exports didn't. The trade gap for the quarter ending in November was $198bn. It was $176bn for the prior quarter, and $166bn one year ago;
- Finally, total government spending declined in the quarter, thereby detracting from calculated growth. In particular, Federal spending declined 7.4% in the 4th quarter, after rising a robust 7% in the third. That swing alone reduced GDP growth by over 1%.

A few other observations about the current economy that might be useful in shaping our investment thinking -

Personal income vs. outlays – Despite the quarter's robust increase in disposable personal income, it was only 0.3% higher in real terms than for the fourth quarter of 2004. Not much growth there. And, the nation's personal saving rate (disposable income minus outlays) still remains below zero (we had the lowest sustained savings rate in 2005 since the Great Depression). The data really does support the common belief that consumer spending growth in 2005 was almost all financed with increased borrowing;

Employment levels in the 4th quarter increased only modestly, but the trend remained up. Household survey data indicates 344,000 more people were employed during the quarter. The unemployment rate declined to 4.9%. It was 5.4% a year ago. Employment levels increased by just over 2.5 million persons last year;

The inflation picture was again one of the quarter's biggest economic surprises. This is currently one of those complex "two-handed" issues. Reflecting an 11% decline in the energy price index, overall consumer prices dropped at a 1.6% compound annual rate in the 4th quarter. But for the year, the CPI was up 3.4%, its highest rate of increase since 2000, due in part to sharp energy price increases. Excluding food and energy, CPI advanced at a low 2.2% rate for all of 2005 (same rate of increase as 2004). On the negative side, producer prices for finished goods rose 5.4% last year, and prices for raw inputs rose 22%. Finally, we seem to be losing the global "terms of trade battle", with import prices up 8% in 2005, while export prices rose just 2.7%;

Monetary policy - The Federal Reserve Governors twice raised the target Fed Funds interest rate during the quarter, to 4.25%. The Fed raised rates following each of its meetings in 2005, pushing the Fed Funds rate up 2.0%. So far, they've given no indication of curtailing rate increases following each future meeting, but have modified their commentary to suggest that current policy is no longer accommodative (i.e., inflation-inducing). So, Wall Street has concluded the time for the Fed to end this "tightening" phase is nigh. Interestingly, the M3 measure of money supply was 7.8% higher in December than one year ago. Such robust growth is indicative of an easy money policy, not a tight one.

Our view? Higher inflation, driven by rising "inputs" costs, has found its way into our system. The domestic economic cycle is moving into a slower growth phase. The consumer and government are nearly tapped out, and need to delever. It hasn't shown up yet, but investors should be increasingly concerned about negative affects on corporate sales growth and profitability.

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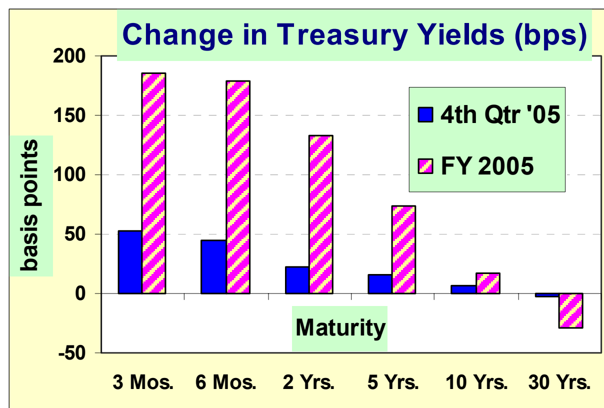
The Bond Market - "on the other hand . . . . ."

One weak month, one mediocre month, and one strong month, concluding a poor (but not bad) year. That pretty much sums up the 4th quarter for the US$ bond market. You were hard pressed to find a sector which earned over 1% in the quarter – the exceptions were emerging market and very long term Treasury bonds. Equally, only one sector returned less than 0% - unhedged non-Dollar developed foreign market bonds (solely because of the negative currency effects).

Chart 1. Yield Curve Shifts in 2005



Federal Reserve actions ensured short-term rates rose in the quarter, and three month T-bills closed December at a 4.09% yield (up from 3.55% at the end of September). As Chart 1 reflects, interest rate changes over the 4th quarter mirrored their behavior for the full year 2005. Rates on 3 and 6 month T-bills increased the most, 2- and 5-year rates rose less, the 10-year bond barely moved, and the 30-year bond's yield actually declined. The full yield curve flattened to just 47bps, from 262bps when the year began. This was an unprecedented shift.

Table 4. Bond Market Returns

periods ended December 31, 2005;

Bond Index	4Q '05	Trailing Returns 1 Year	3 Years
Aggregate Bonds	**0.6%**	**2.4%**	**3.6%**
US Gov't, all	0.7	2.7	2.8
US Treas, long	*1.3*	*6.5*	*5.5*
Mortgages	0.6	2.6	3.5
Inv. Grade Credit	0.5	2.0	4.9
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High Yield Credit	0.7	2.7	13.4
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Global, Unhedged	(2.7)	(6.5)	5.6
Global, Hedged	0.8	5.0	4.0
Emerging Markets	2.1	11.9	17.2

After losing value in October/November, prices for virtually all bonds rose in December, buoyed by increased investor demand in the face of evidence that growth of our domestic economy was slowing down. Long-term Treasury bonds again topped all other sectors of the U.S. Aggregate bond index for the 4th quarter (see Table 4), as prices on Treasury bonds with maturities over 20-years advanced 2.5% in December. Parts of the yield curve inverted briefly in December for the first time in five years. That's when short term market yields, like for the 2-year Treasury, are higher than long-term yields, like for the 10-year Treasury.

Credit spreads in the investment grade market were consistent with less risk taking, as AA bonds outperformed A's, which outperformed BBB's. But, matters got a bit more complex in the high yield sector. The sector did better than investment grade bonds, and *lower* quality paper fared best. Investors remain concerned that a high level of M&A activity is in the cards for 2006-7, with investment grade companies increasingly taken over by buyers who finance the acquisition using borrowed money. Many investors prefer to buy the already leveraged (thus, "LBO-proof") high yield sector. We touched on this issue last quarter.

Foreign bonds *without* the currency exposure (either $-denominated or currency-hedged) did relatively well in the quarter. Long-term sovereign bonds returned an attractive 2.6%, as interest rates in Europe declined. But, the real action yet again was in emerging markets. Led by hard commodity exports, large bond issuers like Mexico, Brazil, Russia, and Venezuela have seen their economies prosper, and their credit ratings increase. In a world searching for higher yields, investor demand maintained prices in the quarter, and emerging market bonds "earned their coupon."

The 2005 bond markets were very challenging for core bond investors and their managers. The benchmark 10-year Treasury began the year at 4.25%, bounced between 3.88% and 4.66%, and ended the year at 4.40%. Rising shorter term rates reduced total returns to well below realized inflation rates. This had been expected to happen as we entered the year, and many reduced portfolio durations to protect against rising rates. But, this approach *hurt* returns if you simply eliminated very long-term bonds. You really needed to marry T-bills with 30-year paper in order to outperform. All in all, the "easier" way to outperform in 2005 was through the use of emerging market, high yield and hedged foreign currency bonds (unhedged foreign bonds killed returns, because the Dollar rallied so strongly). Not many investment mandates allow such flexibility, and even fewer managers took full advantage of those markets.

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U.S. Equity Markets Rotate Toward Growth

The domestic stock market provided moderately positive returns in the fourth quarter, as Table 5 reflects. Mid-cap stocks again led the market higher, whether one looks at value or growth indices. This was the case throughout 2005, and was also the general trend in 2004. In fact, Q4 was the twelfth straight quarter that mid-cap stocks outperformed large caps.

Table 5. U.S. Equity Market Returns

periods ended December 31, 2005;

	Trailing Returns		
	4Q '05	**1-Year**	**3-Years**
Growth			
Large Cap	3.0%	5.3%	13.2%
Mid Cap	3.4	12.1	22.7
Small Cap	1.6	4.2	20.9
All-cap / All style	*2.3*	*6.3*	*16.4*
Value			
Large Cap	1.3	7.1	17.5
Mid Cap	1.3	12.7	24.4
Small Cap	0.7	4.7	23.2

The quarter also saw the continuation of better returns from "growth" stocks compared to those considered "value". This has occurred over the past three quarters, across the capitalization spectrum. Only during 2005's weak 1st quarter did value stocks perform consistently better than growth across the market spectrum, but it was enough to skew the calendar year returns in favor of value. If the rally we've seen this January does not reverse itself too soon (or too sharply), market indices at the end of March will reflect that trailing 1-year returns from growth-biased stocks exceeded those of value, and the popular financial press will be all over the "story."

Chart 2. Stock Returns Track Earnings

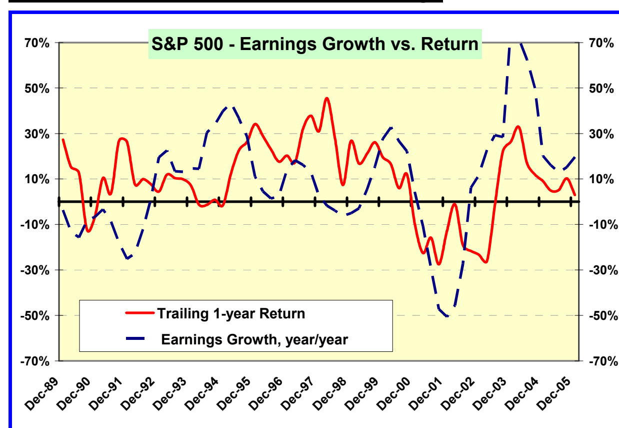

Table 6 looks at industry sector performance for the 4th quarter in two dimensions. The first is how well the stocks in each sector performed. The second dimension, "contribution", combines performance with importance (the relative size of the sector's stocks compared to those of all the other sectors). In the large cap space, the bigger financial and industrial sectors, although outperformed by materials, were more important contributors to positive returns. Heavily weighted tech stocks were the biggest positive contributors to small cap returns, followed by the financial and industrial sectors. We see energy stocks across the market cap spectrum were significant market laggards, at least temporarily reversing their two year role as market leader. Energy and utility stocks are much more heavily represented in "value" indices.

Table 6. Fourth Quarter Sector Performance

Sector	**Large-caps (S&P 500)**		**Small-caps (Russell 2000)**	
	Return %	Contribution	Return	Contribution %
Materials	11.1%	0.3%	3.8%	0.2%
Financials	8.2	1.7	2.0	0.5
Industrials	5.0	0.6	3.3	0.5
Health Care	1.4	0.1	0.3	0.0
Consumer Disc.	1.2	0.1	1.3	0.2
Info Tech	1.0	0.2	3.6	0.6
Consumer Staples	0.8	0.1	(4.1)	(0.1)
Telecomm Srvcs	(0.2)	(0.0)	0.6	0.0
Utilities	(5.5)	(0.2)	(10.2)	(0.3)
Energy	(7.4)	(0.8)	(6.8)	(0.5)
S&P 500	2.1%	2.1%		
Russell 2000			1.1%	1.1%

We think an important story is about how market returns are tracking with corporate earnings growth (see Chart 2 at left). The market is a forward-looking discounting mechanism, and share prices normally react in advance of earnings growth changes. But, returns lagged earnings growth for a few years coming out of the 1990-91 recession, especially when interest rates were rising in 1994-95. The situation reversed itself (and then some) later in the decade. The current recovery shows a similar lag coming out of 2001, with the earnings trend turning up sooner than stock prices, and to a much greater degree. The current disconnect has persisted longer this time, perhaps because investors were harmed so badly when the hyped income levels of 1999 and 2000 came crashing down. Investors may be unwilling to accept current profit growth at face value and reflect it in share prices. Meanwhile, S&P earnings have now increased at double-digit percentages for 10 consecutive quarters, which has occurred only twice in the past 50 years!

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International Equities Finish the Year Strong

With global inflation fears in remission and optimistic economic growth forecasts abounding, the fourth quarter saw double-digit stock returns from both developed and emerging markets. This occurred despite a surprisingly strong US$, which cut sharply into what were otherwise extraordinary local currency returns. The developed market EAFE index advanced 4.1% in the quarter, bringing the annual return up to 14% (29.5% in local currency terms). The MSCI Emerging markets index continued to soar, rising 7.2% during the quarter and 34.5% for the year.

Table 7. International Equity Markets

	Local Currency Return %		U.S. Dollar Return %	
	4th Qtr 2005	Year 2005	4th Qtr 2005	Y-T-D 2005
MSCI EAFE	**7.2%**	**29.5%**	**4.1%**	**14.0%**
- Int'l Growth			*4.1*	*14.6*
- Int'l Value			*3.9*	*15.1*
- Europe	4.6	25.5	2.0	9.9
- Pacific, ex-Japan	12.7	38.1	8.6	23.0
- Japan	16.5	44.7	11.9	25.6
- Germany	6.8	27.4	4.4	10.2
- United Kingdom	3.3	20.1	0.2	7.4
- Canada	2.9	25.6	2.2	28.9
EAFE Small Cap			**7.5**	**26.2**
Emerging Mkts	**7.0**	**35.8**	**7.2**	**34.5**
- EM Asia	7.4	28.7	8.7	27.5
- EM Europe	5.8	52.6	5.3	45.2
- EM Latin America	5.7	38.0	3.5	50.4

From a style standpoint, international growth stocks finished 2005 slightly behind value stocks (14.6% versus 15.1%), but had some momentum on their side. Growth stocks outperformed value stocks for the last three quarters of 2005, and many are looking for that trend to continue in 2006. Small cap stocks continued to outpace large caps, with a 26.2% return for 2005. International small cap stocks have outperformed large cap stocks each year since 1999. Unsurprisingly, many managers indicate they are finding better values in large cap land.

Best performing sectors in the fourth quarter were information technology, industrials, financials, and materials, each of which advanced over 7% in Dollar terms. For the year, materials (28.4%), industrials (25.3%), energy (18.8%) and financials (15.9%) led the way. Only one sector finished the year in negative territory, as telecom stocks dropped 12%.

At the country level, developed market results were led by Japanese stocks, which surged 11.9% during the quarter (16.5% in Yen terms), and advanced 25.6% for the year (+44.7% in Yen). Good news on earnings drove the market higher in the first part of the quarter, and strong inflows buoyed the market the remainder of the quarter. Estimates of GDP growth for 2005 and 2006 continue to be revised upward, putting pressure on the Bank of Japan to hold off on raising interest rates for fear of derailing the recovery.

Despite sluggish economic growth, European markets advanced on the back of corporate improvements and merger and acquisition activity. During the quarter, smaller countries were the best performers, with the Netherlands (8.1%), Switzerland (7.3%) and Denmark (6.5%) leading the way. Germany posted good results (4.4%), but France and the UK generated returns of less than 1%. Norway was the worst performing European market, as high-flying oil stocks corrected.

Both New Zealand and Australia are experiencing the effects of tighter monetary policy, cooling off housing markets and slowing consumer spending. Stock market returns last quarter were modestly negative. Hong Kong also lost 3% during the quarter. Given its US$-pegged currency, interest rate increases here directly affect discount rates there, which puts pressure on the sizeable real estate market.

Within emerging markets, commodity-rich Latin American and Eastern European markets led the way. Strong exports, increasing consumer confidence and a resolved credit card crisis, propelled South Korean stocks to the leading position in Asia. India and China also contributed to solid results within the Asian region.

Table 8. International Sector Performance ($ terms)

	Emerging Markets		Developed Markets	
GICS Sector	4th Qtr 2005	Y-T-D 2005	4th Qtr 2005	Y-T-D 2005
Info Technology	13.9%	32.0%	11.0%	11.0%
Industrials	6.7	25.5	8.6	25.3
Financial Services	10.3	32.2	7.7	15.9
Materials	3.9	29.9	7.1	28.4
Cons. Discretionary	13.5	34.0	5.8	10.9
INDEX RETURN	**7.2**	**34.5**	**4.1**	**14.0**
Health Care	19.0	36.6	2.1	12.8
Cons. Staples	6.1	38.0	2.1	9.3
Utilities	1.5	35.5	1.4	11.7
Energy	(1.5)	62.4	(7.3)	18.8
Telecomm Services	3.7	25.7	(7.7)	(12.0)

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Back Page Perspectives

There are no guarantees, and we're not able to see around corners any better than the next person. Nonetheless, we've got some views on the investment issues you probably need to wrestle with early in 2006 –

- We've been pounding the table for much increased allocations to international and small-cap equity for a few years, so 2005 was to some extent an "expected" outcome. Last fall, we finally reduced our support for domestic small-cap allocations to a market neutral weight, which we figure to still be about 14% of total domestic stock exposure. We remain comfortable with higher allocations to international stocks than others are, up to a maximum of 40% for the most aggressive investors (of total *equity*, not of total portfolio). Finally, we still think emerging markets and small-cap exposure should play a very prominent role in international allocations. Here's the simple reason for all this –

Comparable valuations: Price vs. Cash Earnings

MSCI World Real Estate	17.2x
S&P 500	12.0x
Russell 2000	11.9x
Int'l Small-caps	11.7x
International Large-caps	9.9x
Emerging Markets	9.2x

- Aggressive diversification can be an uncomfortable proposition, and the non-core areas have certainly had a very good run already. Yet, we still think investors will be better served by extending their exposures in these areas. The traditional asset allocation approach starts with the premise that 100% *of your equity exposure* should be publicly traded domestic large-cap stocks, and then selectively peels off small allocations to other equity asset classes. But, the cumulative market value of the S&P 500 index of (mostly) large cap stocks is $11.2 billion, while the cumulative market value of the global MSCI All Country World index of stocks is $24.2 billion. Why not turn the default position on its head, by asking what is so uniquely attractive about public large cap stocks to justify more than a market neutral weight of 45% (of *equity* exposure)?

- Institutional investors have been actively staking out increased positions in what are termed alternative investment strategies. A corollary to our aggressive equity diversification theme is the observation that plans of all sizes need to directly assess these alternative investment areas.

  In particular, we see the private market equity sector as still offering institutional investors unique return opportunities. From a corporate finance perspective, the environment remains very favorable for "going private" investments;

- If China buys it, the price is going up (e.g., oil, copper, wheat); if China sells it, the price is going down (window air conditioners). Their increased demand for raw inputs has already raised the price deck for many hard commodities, but this demand growth story is far from over. Institutional investors who are highly sensitive to rising inflation should build a moderate natural resource allocation;

- The world sells, the US buys. And, the US pays for its purchases with borrowed money. We are a nation that is both highly leveraged and a net international borrower (many elements of Japan's economy are highly leveraged, but their domestic savings is a great internal financing source). It's hard to see how this situation can sustain itself indefinitely. We were wrong about the Dollar's direction in 2005, but the structural weaknesses have only gotten worse;

- To increase their downside protection while the Fed was in a tightening mode, in mid/late 2004 we recommended clients shorten the duration (i.e., interest rate sensitivity) of their bond portfolios, and further diversify into high yield and foreign offerings. We've analyzed the results of this recommendation to date, and they've been spotty on a cumulative basis. Reduced downside risk hasn't recently been a big deal for investors, and the diversification elements have boosted returns only a little. Nonetheless, we still regard "equal returns with less volatility" as a valuable portfolio concept.

A report in Bloomberg reminds us about the January Barometer. From 1938 through 2004, the January direction of the S&P 500 "predicted" its full-year direction 80.6% of the time Even if we don't count January's result into the calculation, for the 11 months following January, the January direction of the S&P 500 was predictive 73.1% of the time.

And, while we're confusing cause and effect, it's once again time to mention the Super Bowl Barometer. The S&P 500 has risen during 75% of the years in which an NFC, or original NFL (i.e., before the merger with the AFL) team wins the Super bowl. With Seattle and Pittsburgh both qualifying, it's a lock!!

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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