

Quarterly Market Review

By Clark Whitten, CFA, Investment Analyst

Financial Markets and Economic Analysis, Third Quarter 2005

Summary

Despite the body blows from two major hurricanes, high energy prices, and two more interest rate increases from the Federal Reserve, the U.S. equity markets were still standing with mostly positive numbers in the third quarter. While much of New Orleans was damaged from flood waters and high winds from Hurricane Katrina, it was the damage to a vulnerable chokepoint for U.S. energy markets that spurred energy prices higher with crude oil prices hitting a record \$70.85 on August 30. Compounding the problem was the arrival three weeks later of Hurricane Rita, a slightly-less powerful storm, that hit the refining centers of Port Arthur, Texas, and Lake Charles, LA. Rita spared Houston, but the damage she caused, combined with Katrina's onslaught, paralyzed nearly 26% of the nation's overall refining capacity and struck 2,900 of the Gulf of Mexico's 4,000 production platforms. In response to Katrina, Congress and the President appropriated \$62 billion in emergency spending, which some have speculated could eventually reach \$200 billion. These emergency and reconstruction expenditures are likely to reverse what had been a decline in the federal budget deficit as a percentage of GDP, thanks to higher tax receipts. This spending and demands on tight raw materials (e.g., cement) as well as the higher energy prices could lead to inflationary pressures later this year or next year.

While much of New Orleans was damaged from flood waters and high winds, it was the damage to a vulnerable chokepoint for U.S. energy markets that spurred energy prices higher.

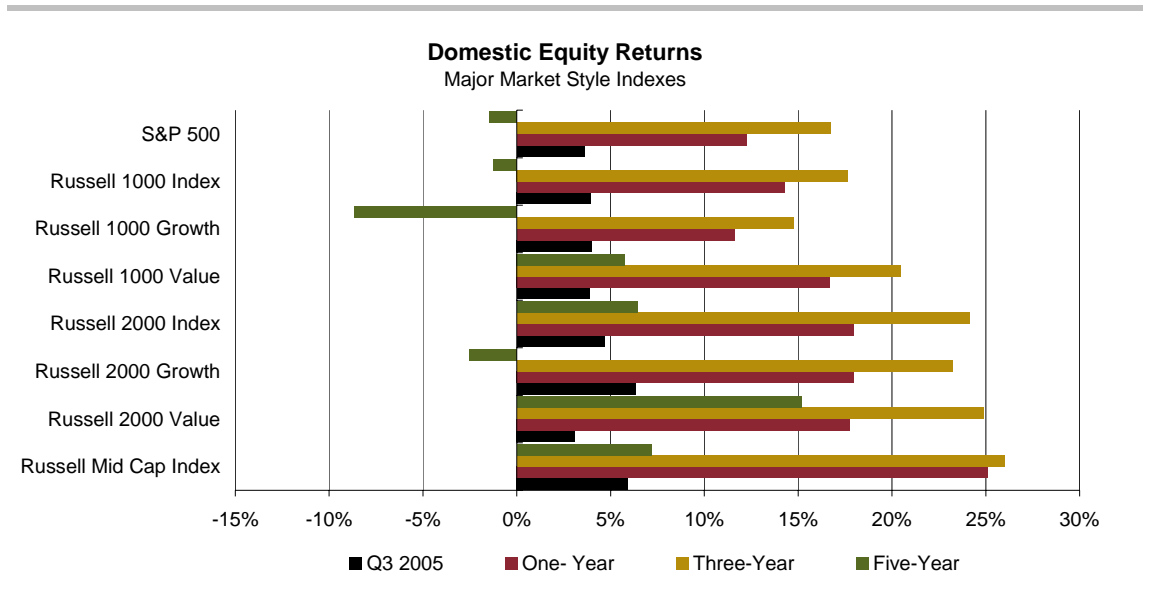
These inflationary concerns were what led the Federal Reserve to increase the Federal Funds Rate another 25 bps to 3.75% on September 20th in one of the most analyzed decisions in a year. There had been some discussion that there might be a pause in the tightening mode (11 increases in 16 months), but the Fed concluded that Katrina's impact on inflation was more worrisome than its impact on growth. Alan Greenspan, who will end his 18-year tenure as Chairman in January, continued with tough talk, warning about the dangers of taking credit risk too lightly for too long and about housing imbalances. U.S. job growth rose at a steady pace in August, but that was before 279,000 people filed for unemployment insurance due to Katrina. Analysts feel that the number of lost jobs could be as high as 400,000 and the nation's unemployment rate of 4.9%, a four-year low, could rise. The Commerce Department also noted that the economy grew at a 3.3% annual rate in the second quarter, which analysts expect to decline to 3% in the third quarter and 2.8% in the fourth quarter. Operating EPS for the companies in the S&P 500 Index were expected to advance 16% year-over-year in the third quarter – marking the 14th consecutive quarterly double-digit increases. U.S. equity markets were buoyed by this expectation, which appeared to outweigh concerns over the interest rate increases or the hurricanes, as nearly every asset class managed respectable results during the third quarter. The bond market was mostly lower, however, as inflation concerns appeared to carry more weight than the Fed rate increases, which were largely anticipated. The dollar touched its highest levels versus the euro and the yen in more than two months and traded at the top end of its summer range versus the other two currencies based on the perception that the Fed would continue to raise rates; but, the dollar's overall effect was minimal in terms of international returns.

Domestic Equity Markets Overview

Overall, the domestic equity markets showed decent returns for the third quarter, bringing most of the indices into positive territory for the year. Small and mid-sized stocks continued to out-pace large cap stocks in the third quarter, albeit, more narrowly; and, bucking recent trends, growth edged out value. Investors demonstrated a preference for riskier stocks, as the S&P 500 stocks with the highest betas had returns that more than doubled those of the broad market. The lowest quality stocks, as defined by S&P based on growth and stability of earnings and dividends, were up 7.5%, and the returns on the two highest-quality segments were negative. The higher beta, lower quality preference and strong outperformance of "hot" industries, such as oil services, could be indicators of investors chasing short-term performance.

Not surprisingly, Energy was easily the top performing sector in the S&P 500 with a 17.8% gain for the quarter and 40% for the year.

Not surprisingly, Energy was easily the top performing sector in the S&P 500 with a 17.8% gain for the quarter and 40% for the year. The sector now represents 10.3% of the capitalization-weighted Index as compared to 7.2% at the start of the year. The Utilities and Information Technology sectors also performed well, while the worst performing were Telecommunications and Consumer Discretionary, each generating slightly negative returns. S&P 500 stocks generated a return of 3.6% in the quarter to bring the Index's year-to-date performance back into the black with a 2.7% return. Small-cap growth stocks had the best performance in the quarter with a 6.3% return for the Russell 2000 Growth Index. Growth generally out-gained value at each market cap segment by small margins, except in the small cap segment in which value trailed growth by 3.2%. Year-to-date, the Russell 2000 Value still leads its growth counterpart, 4% to 2.5%. Large cap growth stocks, as represented by the Russell 1000 Growth Index, generated a 4% return compared to a 3.9% return for the large cap value index. The Dow Jones Wilshire REIT Index, the second quarter's biggest gainer, returned 3.9% in the third quarter and is up 11% for the year.



International Markets Summary

During the third quarter, the developed and emerging markets substantially outperformed the domestic equity indices. The dollar impact was minimal, as its strength, relative to the developed market currencies, resulted in a return 1% less than local currency returns, while its slight weakness, relative to emerging market currencies, added 0.5% to returns. In dollar terms, the MSCI EAFE Index was up 10.3% for the quarter, while the MSCI Emerging Markets returns increased 18%. Year-to-date, the dollar's strength has had a more telling effect on the EAFE with a 9.0% return in dollar terms compared to 20.5% in local currency, while the MSCI Emerging Markets Index has shown less than a 2% difference (25% in dollar terms, 26.4% in local currency).

Japan was easily the best-performing developed market in the third quarter with a 19.1% dollar return. The Nikkei hit four-year highs, thanks to rising consumer confidence, firming labor market conditions, strong consumer durables sales, and the landslide victory for Prime Minister Junichiro Koizumi's party in the lower-house elections. Norway was the second-best performing developed market with a 15.4% dollar return, while Austria (12.3%) finished third. The Emerging Markets Index was led by the Eastern European region with a 37.6% dollar return. Some of the bigger country gainers for the quarter, in dollar terms, were: Argentina (49.3%); Russia (48%); and Czech Republic, (31.5%). Latin American funds led all mutual fund categories with a 29.3% return, while the iShares MSCI Brazil led the ETF market with a 34.8% return, continuing a recent trend.

The Nikkei hit four-year highs, thanks to rising consumer confidence, firming labor market conditions, strong consumer durables sales, and the landslide victory for Prime Minister Junichiro Koizumi's party in lower-house elections.

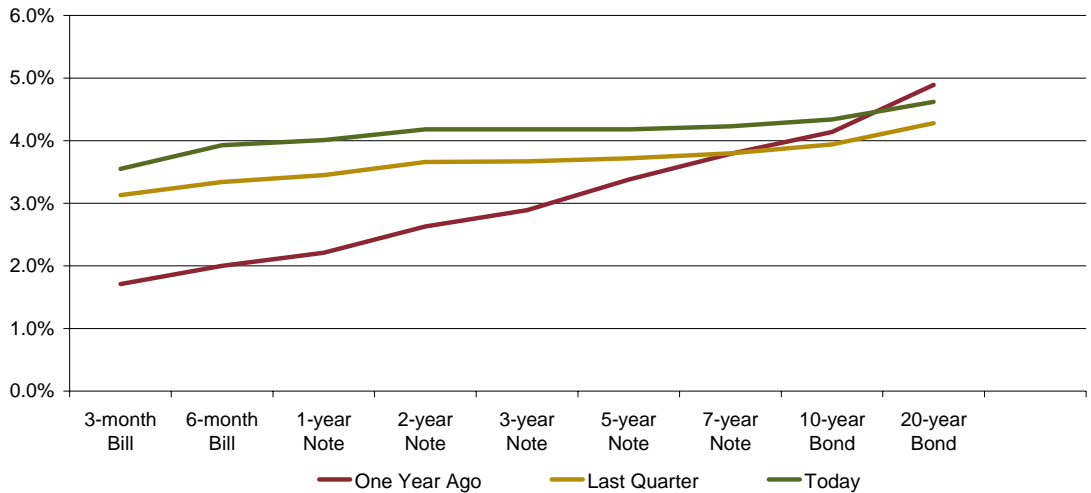
Fixed Income Summary

Longer term taxable bonds, representing the best performing segment in the second quarter, were among the worst performing in the third quarter, as concerns about inflation raised caution among fixed income investors.

The flattening of the yield curve, which has been the dominant force in the bond market for two years, continued in the third quarter, as the difference between the 3-month Treasury bill and the 20-year Treasury bond dipped to 107 bps from 115 bps in the second quarter. A year ago, the 3-month-to-20-year spread was 318 bps. Throughout the year, the yield curve has been twisting as the Federal Reserve’s continuing rate increases have pushed up short-term yields, while low inflation and strong investor demand have contributed to keeping a cap on longer-term rates, although those rose slightly too during the quarter. A worry is that the Fed, which has shown no signs of slowing its tightening cycle, may raise rates too much and help invert the yield curve, as in 2000 (which presaged the last recession).

Longer term taxable bonds, representing the best performing segment in the second quarter, were among the worst performing in the third quarter, as concerns about inflation and the prospect for slower U.S. growth led to more caution among fixed income investors. The Lehman Brothers’ U.S. Long Treasury Index was down 1.7% in the quarter, but still is up 5.4% on the year. Shorter-term treasuries performed better in the quarter, but had negative returns as well. The U.S. Aggregate, Government-Credit, and Corporate Investment Grade were all negative as well, while the U.S. MBS Fixed Rate Index was up by 7 bps. The municipal indices mirrored the taxable indices with the longer-term bonds underperforming shorter-term municipals and producing negative returns; however, the shorter-term municipal indices did post slight gains. The best performing index by far was the Lehman Brothers Emerging Markets Debt Index, which had a 4.2% return for the quarter, and is up 9.5% year-to-date. Likewise, the U.S. Corporate High Yield Index was up 0.8% for the quarter and is up 2% year-to-date, despite ever tightening spreads.

Treasury Yield Curve



Outlook

The fourth quarter of 2005 will likely be impacted as the hard economic numbers start arriving to confirm the effects of Hurricane Katrina on U.S. growth and interest rates. Some observers feel that Katrina, undoubtedly, will have reduced the economy’s growth in the third quarter, but that might also lead to a rebound in the fourth quarter as government spending on reconstruction gets underway. This more optimistic view, which the bulls hope will spur a fourth quarter rally like last year, will vie against bearish opinions that persistently high energy prices, rising interest rates, job losses from Katrina, and a general rise in inflation may slow or even derail the economy.

The Investment Manager Outlook Poll showed that managers are more bullish on international equity markets and are increasingly bearish on U.S. stocks, bonds, real estate, and consumer goods concerns (fearing rising gas prices will curb discretionary spending). In terms of domestic stocks, the managers slightly favor large cap growth stocks and generally expect large caps to outperform smaller caps based

on the belief that larger companies perform better when the value of the dollar falls, which is expected to resume despite recent strengthening. As for the fixed income markets, there is not much optimism as the Federal Reserve is expected to raise rates twice before the end of the year. While fixed-income investments would have higher yields next quarter and into next year, rising rates would keep downward pressure on prices.