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**O**il prices and rising interest rates continue to be the chief risks facing investors this quarter. The decline in residential real estate prices, the U.S. trade deficit, and the uncertainty associated with war and terror round out our top five list of economic concerns this quarter.

Looking toward the spring quarter we continue our primary focus, as we have for the last two years, on ascending oil prices, which now approach \$70/barrel (see "Oil - our Most Important Commodity", *Spring 2004*). Oil prices continue to be stretched on the demand side by an increasingly strong global economy and on the supply side by new geopolitical threats, this quarter from Iran and Nigeria.

Following the Federal Reserve's 15th consecutive 0.25% increase in the target short-term rate this quarter, interest rates now approach 5% for both long and short-term Treasuries. In fact, interest rates are rising all around the world as the vast global savings and liquidity are finally beginning to drain. See how these are currently affecting key sectors of the economy in this quarter's "Economy Review".

## Financial Markets Summary



On Valentines Day the Dow pushed above 11,000 for only the second time in the last six years and ended the quarter at 11,109. The first quarter of the year tends to be strong, and from January 1 to March 31, 2006, the S&P 500 Index returned 4.2% including the dividends paid out by those companies. The bond market fell as interest rates climbed in the U.S. and around the world. The Lehman Aggregate Bond Index, which Sharper ♦ Granite uses as the benchmark for its taxable bond investment performance, finished -0.7% including interest payments to bondholders.

The average of all Sharper ♦ Granite client portfolios gained 4.8% (net of fees) and maintained a risk level 24% less than the S&P 500 Index.<sup>1</sup> When normalized to the same level of risk as the S&P 500 Index, Sharper ♦ Granite client portfolios finished 5.9% (net of fees), significantly better than the S&P 500 Index. This represents the ninth quarter in the last thirteen that the average of all Sharper ♦ Granite portfolios beat the S&P 500 Index on a risk-adjusted basis. 89% of Sharper ♦ Granite client portfolios beat the S&P 500 Index on a risk-adjusted basis.

Of the 111 stock, bond and real estate sectors currently tracked by Sharper ♦ Granite, 78% finished the quarter with positive gains, Sectors driving this strong quarter with double digit increases in their representative indexes included: small caps, real estate, telecommunications, gold, Europe and Latin America. Of these, Sharper ♦ Granite currently tilts its portfolios toward small caps, Europe and Latin America, but away from real estate and telecommunications. As a rule, Sharper ♦ Granite does not believe in gold as a sound long-term investment option in any economic regime.

## First Quarter 2006 Economy Review

Oil prices ended the quarter just below \$70/barrel and remain, along with rising interest rates, the biggest threat to equities. High oil prices hit the economy with a double-whammy: they slow corporate profit growth and consumer spending while also spurring inflation. Every \$2/barrel increase costs the U.S. Gross Domestic Product (GDP) 0.1%/year.<sup>2</sup> \$50/barrel vs. \$25/barrel for a year could cut U.S. GDP by one-third. \$70/barrel oil for a year could cut the U.S. GDP by on-half.

Furthermore, we believe that oil will persist in the \$60/barrel price range due to demand during this global growth phase. T. Boone Pickens correctly predicted at the end of the quarter that oil would hit \$70/barrel soon and that \$100/barrel was possible in the event of supply disruptions in Iran and Nigeria.<sup>3</sup>

As anticipated, on March 28th the Federal Reserve increased its target short-term interest rate by 0.25% for the 15th time in a row. The bond market, as defined by the Fed Funds futures pricing, is calculating a virtually certain increase of 0.25% more to 5.0% at its next meeting on May 10th and a 54% chance of an increase following that.<sup>4</sup> Long-term rates surged this quarter to nearly 5% for the 10-year Treasury bill.

We continue to keep a keen eye on the interplay between interest rates and inflation precursors such as commodity (especially oil) prices, but this quarter our leading economic indicators still reflect a slight positive.

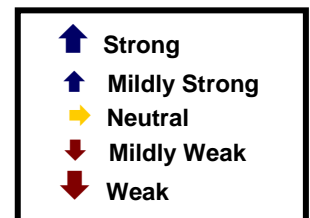


## Leading Economic Indicator Summary

- ➔ **Market Cycle:** The second quarter of each year is typically strong, historically averaging an annualized return of 10.9% with April tending to be the strongest month.<sup>5</sup>

As discussed above, stock, bond, cash and real estate markets all continue to battle a period of increasing interest rates. Stock market returns since 1970 have averaged only 8.7% in calendar years of increasing interest rates as compared to 18.5% in years of declining interest rates.<sup>6</sup>

- ➔ **Political Cycle:** We are in the second year of President George W. Bush's second term. Historically, the second year in the presidential cycle brings only average returns for the stock market. This is in part because the presidential office and Congress are less likely to push laws that help the economy in the short-term at the expense of the long-term when they are not facing re-election. For example, a particular domestic program may be popular in that it helps the economy immediately, thus gaining incumbent votes for politicians. But the increased spending may also raise the federal budget deficit, hurting the economy in the long-term.



Since World War II, the second year of the cycle has seen the S&P 500 post an average gain of 9.7%, overall and 11.0% under Republican presidents. When the data is reviewed back to 1888, second years average only 8.2% and 8.3% under Republican presidents.<sup>5</sup>

➔ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 4Q05 GDP was revised to 1.7%.<sup>7</sup> This represents the slowest quarter since 4Q02 and is well below the 4.1% average of the prior ten quarters.<sup>8</sup> The slowdown was primarily due to the hurricanes and winter weather impacting consumer spending. Still, it was the 17th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001, and 1Q06 GDP is expected by most economists to be much stronger due in part to the relatively warm weather around the U.S.

⬆ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, decreased through the quarter as its rate of increase continues to slow.<sup>9</sup> However the index still shows overall manufacturing expansion. This was the ninth consecutive quarter of expanding manufacturing activity.

Additionally, new orders for manufactured goods in January increased 1.6% from the previous month.<sup>10</sup> This was the largest increase in five months.

Finally, capacity utilization, the share of industrial capacity that U.S. companies are actually using, is at 81.4% this quarter vs. a low point of 73.9% at the end of 2001. 81% is the average level over the past twenty years.<sup>11</sup> Thus, from a factory standpoint, we have finally worked off much of the excesses that developed during the last recession.

⬆ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, continued to advance at the gradual and manageable pace targeted by the Federal Reserve. The core CPI is up only 2.1% from January, 2005 to January, 2006, and the Federal Reserve's preferred inflation gauge, the core index for personal consumption expenditures (PCE), is up only 2.0%.<sup>12</sup> However, energy prices in January were 24.8% higher than the previous year.<sup>13</sup> The longer oil prices stay above \$60, the greater the impact on inflation.

⬆ **Consumer Spending:** Economists watch consumer spending closely because it accounts for two-thirds of all U.S. economic activity. Consumer spending has been strong the last three years and increased this quarter through February. January retail sales were especially strong, rising 2.3%.<sup>14</sup> The Consumer Confidence Index also increased this quarter through March.<sup>15</sup> However, we continue to be concerned whether the U.S. consumer will continue spending as housing values trend downward and personal interest rates like home equity loan rates rise significantly.

⬆ **Capital Spending:** An important barometer of business spending, orders for non-defense capital goods excluding aircraft, was up 7.5% over 1Q06.<sup>10</sup>

Corporate orders and shipments for capital goods continued to be strong through the end of 4Q05.<sup>14</sup> Much of this is due to corporations' cash-heavy balance sheets. After nine consecutive years of net spending by corporations from 1993 – 2001, corporations saved \$560 billion over the past four years.<sup>16</sup> This represents the potential for an economic boost to offset potentially weaker consumer spending in future quarters.

Finally, business optimism is at a new eight-year high. 91% of respondents from both large and small companies were optimistic about their business outlook in a recent 4Q05 *Fortune* magazine survey.<sup>17</sup>

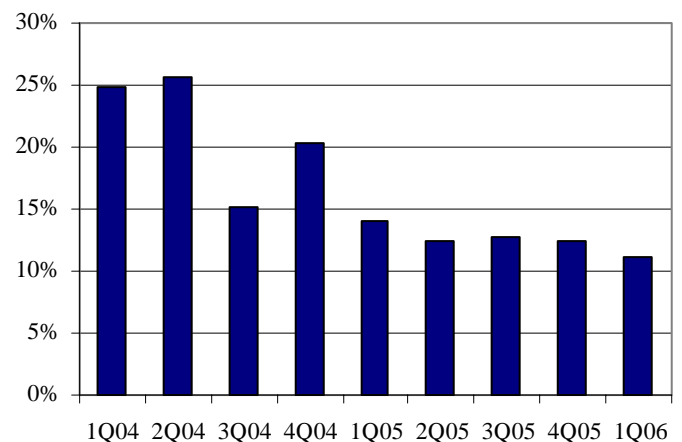
⬇ **Investor Sentiment:** Investor sentiment has been generally high since September, 2003. This extreme situation cooled throughout the first quarter but still represents a significant headwind for the market as it indicates that professional investors, who first place their bets, then tell the world their opinion, have already pushed much of their available capital into the market.<sup>18</sup>

↑ **Corporate Earnings:** S&P 500 company profits increased 12.5% in 4Q05<sup>19</sup> and are anticipated to be near 11.2% this quarter,<sup>20</sup> though analysts estimates have been trending downward slightly over the course of the quarter.<sup>21</sup> If so, that would be the 11th consecutive quarter of double digit earnings growth, a feat that has occurred only twice since 1950.<sup>14</sup> Energy company profits continue to buoy profits of the overall S&P 500.<sup>22</sup>

➔ **Insider Trading:** The 30-day average of insider trading in dollar terms was similar this quarter to that of 2005. While this measure decreased significantly in January, it rebounded in February and March to 2005 average levels.<sup>23</sup>

↓ **Investor Cash Potential:** Cash levels within mutual funds this quarter are less than 4%, a level not seen since the early 1970's. So much cash already in the market implies that there is more potential for outflow from stock investment than there is for inflow. In the ten years since 1965 when mutual fund cash levels rested below 7%, the stock market returned only 1.8% on average.<sup>24</sup> Possibly offsetting this is the huge global savings glut. Foreign investors may well continue to increase investment in U.S. companies.

### S&P 500 Company Profit Growth<sup>19</sup>



#### Notes and Acknowledgements:

1. Arithmetic average used for return measurement. Asset-weighted average beta used for risk adjustment to market-risk level within each portfolio. Performance includes assets tracked for clients that lie outside Sharper ♦ Granite direct management, which amount to less than 10% of total assets. All client portfolios weighted equally in calculation
2. Merrill Lynch, April, 2003
3. T. Boone Pickens, interview on *CNBC*, March 31, 2006
4. *Wall Street Journal*, April 14, 2006
5. *Stocks for the Long Run*, Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University
6. TDWaterhouse Research
7. U.S. Commerce Department, March 29, 2006
8. *Wall Street Journal*, January 28, 2006
9. Institute for Supply Management (ISM), April 3, 2006
10. U.S. Commerce Department, March 7, 2006
11. *Wall Street Journal*, April 4, 2006
12. *Business Week*, April 10, 2006
13. U.S. Department of Labor, March 10, 2006 as reported in the *Wall Street Journal*
14. *Business Week*, March 6, 2006
15. The Conference Board, April, 2006
16. Corporate savings in the U.S. defined as undistributed profits plus depreciation minus gross investment. Sourced from the U.S. Commerce Department and the Federal Reserve via J.P. Morgan as reported in the *Wall Street Journal*, April 3, 2006
17. National Association of Manufacturers (NAM) and *Fortune*, March 6, 2006
18. UBS (Union Bank of Switzerland) Index of Investor Optimism, April 17, 2006
19. *Wall Street Journal*, April 3, 2005
20. Reuters, April 3, 2006
21. *Wall Street Journal*, March 20, 2005
22. Morgan Stanley as reported in *Barron's*, February 27, 2006
23. InsiderCow, April 3, 2006
24. Ned Davis Research, March 20, 2006

Questions?  
 Contact us at:  
[questions@sharpergranite.com](mailto:questions@sharpergranite.com)