



IN THIS ISSUE

- **Financial Markets Summary**
- **The Importance of Time Frames for Stock Market Volatility**
- **Second Quarter 2006 Economy Review**

High oil prices continue to be the most important long-term challenge facing the economy as has been the case for the past two years (see "Oil - our Most Important Commodity", *Spring 2004* at www.sharpergranite.com). Uncertainty regarding interest rate increases by the Federal Open Markets Committee (FOMC) continues to be the chief risk facing the stock and bond markets in the near term.

History shows that market gyrations are common during times of high uncertainty in FOMC interest rate movements. This effect impacts the markets far more than wars or other geopolitical shocks (see "Historical Impact of war on Investments", *Spring 2003*). Raising rates too high could send the economy into recession as it has done ten of the last twelve interest rate hike cycles. Not raising rates enough could permit high inflation, which is an even worse scenario.

One of the largest drivers of inflation is consumer *belief* that inflation will occur. If consumers believe prices will be significantly higher at a later date, they are more likely to make purchases sooner, thus increasing demand and increasing prices, or inflation. Inflation belief tends to be a self-fulfilling prophecy. Therefore, FOMC chairman Ben Bernanke must signal the markets that he will be tough on inflation for psychological reasons as well as monetary reasons. Because Bernanke is a new chairman, it is important that he err on the side of high rates and possible recession.

During much of the past four years the Fed's moves were well known. Quarter-point increases at each FOMC meeting were a given. However, over the past quarter various members of the FOMC issued mixed signals to the markets regarding the future of interest rates. Bernanke has encouraged this communication as he believes that greater transparency with day-to-day Fed analysis is healthy. But this greater transparency is adding to stock and bond volatility as the market tries to guess where the rate hike cycle will peak.

In fact, the second quarter of 2006 flashed the highest stock market volatility recorded since 2002.¹ With market volatility at a high point this quarter we discuss the time horizon effect of investment risk (defined as market volatility). Please read "The Importance of Time Frames for Stock Market Volatility" as it could have a significant impact on your investing perspective. For a deeper understanding of this subject, read *Fooled by Randomness* by mathematician and Wall Street veteran, Nassim Nicholas Taleb.²

Financial Markets Summary

Following the strongest Q1 for the S&P 500 Index in seven years, on May 8th the Russell 2000 Small-cap Index set an all-time high while several other major indexes approached their all-time highs. Then, recalibrated estimates of the Fed rate hike cycle caused severe turbulence in world markets. From May 10th to the June 13th nadir, Japan fell 19.8%, Latin America fell 29.5% and even gold, generally stable, fell 21.5%.³



For the quarter, global asset declines were broad and deep. Of the 142 stock, bond and real estate sectors currently tracked by Sharper ♦ Granite, only 18% finished the quarter with positive gains. Sectors hurt the most this quarter included: networking (including Cisco) -17.9%, biotech -11.8%, semiconductor -11.1%, software -9.2%, technology -8.2%, small cap -5.6%, health care -5.4%, and Japan -5.3%.³

The S&P 500 Index fell mildly this quarter, returning -1.4% including dividends, but this belied heavier global weakness. The NASDAQ returned -7.5%. Fidelity Magellan, one of the largest and most well known mutual funds returned -22.3%. Given this drop across diverse global asset classes, Sharper ♦ Granite is pleased with its client performance this quarter.

The bond market also continued to fall as it has three of the last four quarter due to climbing interest rates 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, returned -0.4% including interest payments to bondholders.

The average of all Sharper ♦ Granite client portfolios finished -1.3% (net of fees) and maintained a risk level 22% less than the S&P 500 Index.⁴ If normalized to the same level of risk as the S&P 500 Index, Sharper ♦ Granite client portfolios would have finished -2.0% (net of fees).

The Importance of Time Frames for Stock Market Volatility

In the second quarter market volatility registered some of the highest readings in years.¹ Higher volatility levels are typical near interest rate inflection points, which is the situation we are experiencing. So how does this effect you? Should you watch your account value more frequently or less? This discussion may contribute to the way you deal with the effects of short-term volatility.



Sharper ♦ Granite uses a statistical analysis tool called Monte Carlo to help analyze possible variances in the markets. This tool is similar to the one that NASA uses to predict how the Space Shuttle will fly given several unknown variables on launch day, such as wind, air pressure, engine burn rates, etc. NASA uses a history of nearly 200 Shuttle flights to determine the different possibilities. Consider the following example using Monte Carlo and 200 years of market data.

Let us say that you have agreed with your advisor that your portfolio should have a risk, or volatility, similar to that of the S&P 500 Index. Based on historical returns since 1802 (which are similar to returns since World War II), in a fair, efficient market you can expect a return during a given year of 12% and a volatility defined by a standard deviation of 16%.^{5,6} This means there is a 68% chance that your return will fall in the range of 12% +/- 16%, that is, between -4% and 28% in a given year. It also means there is a 95% chance that your return will fall between -20% and 44% in a given year.

A 12% return with 16% volatility also translates into a 77% probability of finishing the year with a gain. This sounds pretty good. But because there is volatility between the beginning and end points of the year, the probability of finishing any given quarter with a gain is only 67%. If you prefer to look at your account monthly, the probability of an increase in a given month is 61%. The probability of an increase further reduces to 52.5% in a given week, 50.8% in a given day, 50.11% in a given hour, and 50.01% in a given second.⁶ This is the scaling property of randomness.

The investor who reviews his/her portfolio annually will see a gain in eight out of ten years. The investor who reviews monthly will see a gain in six out of ten months, and the investor who watches his/her portfolio daily will see only five more up days than down days over the course of the year.

Now, consider the joy felt from a gain versus the pain felt from a loss. Some psychologists estimate the negative emotional effect of a loss to be up to 2.5 the magnitude of the positive effect of a gain.² This implies that even with successful investment performance, stress could be heightened by watching a portfolio too frequently.

Studies by Amos Tversky and 2002 Nobel Prize winner Daniel Kahneman show that the degree of rationality in decisions made subsequent to a gain is much higher than in decisions made subsequent to a loss. This is because these decisions are mediated in different parts of the brain.² Safety, fight or flight decisions are conducted in a manner that does not involve conscious memory. In a classic psychology case a Swiss doctor had an amnesic patient so severe that he would have to reintroduce himself every fifteen minutes. One day he secreted a pin in his hand before shaking hers. The next day she quickly withdrew her hand as he tried to greet her, but still she did not recognize him. The scientific name for the two memories, conscious and nonconscious, is declarative and nondeclarative. Much of the risk avoidance that comes from experiences is part of the second.² In other words, people's risk avoidance comes more from personal experiences than from studies of history.

A large part of successful investing is psychological. Our instincts of fear and greed tend to drive our decisions in the short term to buy high and sell low, even when history shows we should do otherwise.

This perspective also shows the value of matching portfolio risk with portfolio time horizon. When an investment is anticipated to be needed within say a year or two, risk level should be reduced because the odds of a positive portfolio are lower the shorter the term. If the investment need date is several years away, as is usually the case for retirement funds, then time is on the side of the aggressive and patient investor. Since 1871, stocks beat bonds 94% of the time over all rolling 20-year periods and 100% over all rolling 30-year periods.⁵

Observance Frequency	Gain Frequency
Year	77%
Quarter	67%
Month	61%
Week	52.5%
Day	50.8%
Hour	50.11%
Second	50.01%

Second Quarter 2006 Economy Review

Oil prices ended the quarter above \$70/barrel and remain, along with rising interest rates, the biggest threat to the economy and 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) an estimated 0.1%/year.⁷ \$65/barrel vs. \$25/barrel for a year could cut U.S. GDP by one-half.

Furthermore, we believe that oil will persist above \$60/barrel due to demand during this global growth phase. T. Boone Pickens correctly predicted at the end of the 1Q06 that oil would hit \$70/barrel this quarter. He is now predicting \$80/barrel by year-end.⁸

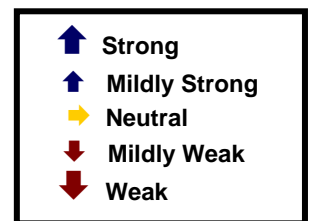


Following the Federal Reserve's 16th and 17th consecutive 0.25% increases to the target short-term target rate this quarter, interest rates now sit near 5.25% for both long and short-term Treasuries with a 60% chance of another quarter-point hike in August.⁹ In fact, interest rates are rising all around the world as the vast global savings and liquidity are finally beginning to drain, especially from the Bank of Japan.

While many of the indicators below have become mixed, this is normal near an interest rate cycle peak as the Federal Reserve Bank tightens money supply by increasing short-term rates and selling treasury bonds. The FOMC now has the difficult job of engineering a "soft landing" for the economy – slowing growth to fight inflation without triggering a recession (defined as two consecutive quarters of negative growth). Thus, seeing some economic measures slow from heated to more moderate growth levels is good for the economy at this point.

Leading Economic Indicator Summary

↓ **Market Cycle:** Summer stock market performance, as measured by the S&P 500, trails that of every other season. While calendar Q3's (we label summers) on average do show market improvement, it is less than during other seasons. Since 1946, calendar Q3's average only 5.9% annualized total return, versus Q1's 15.0%, Q2's 10.8% and Q4's 20.7%.⁵ September, the final month of our upcoming quarter, is historically the worst month of the year for stocks. It is the only month that averages negative returns.⁵



As discussed above, stock, bond, currency 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 compared to 18.5% in years of declining interest rates.¹⁰

Furthermore, during the last nine interest-rate cycles, stocks have actually fallen an average of 7% between the time of the last Fed tightening and its first easing.¹¹

The current bull market cycle is the second longest on record without a 10% correction in the S&P 500 index. With the recent volatility increase and declines in other major indexes, that time could be ending.

↓ **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, when not facing re-election, are more likely to push laws that help the economy in the long-term but are unpopular in the short-term.

Since World War II, the second year of the cycle has seen the S&P 500 Index 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.⁵

↑ **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. 1Q06 GDP was revised upward to a sizzling 5.6% annual rate following the hurricane-effected 1.7% annual 4Q05 rate.¹² This was the 18th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001.

↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, is hovering in the region of modest growth while capacity utilization in June reached a six-year high.¹³ This was the tenth consecutive quarter of expanding manufacturing activity.

Manufacturer optimism is strong. 90% of both large and small manufacturing companies are optimistic about business outlook over the next twelve months.¹⁴

➔ **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, advanced at a rate in the upward range of that targeted by the FOMC. As of May the twelve-month core CPI rate is 2.1% and the five-month annual rate is 2.6%.¹⁵ 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 during the last three-and-a-half years but is now showing some signs of slowing. January retail sales were especially strong, rising 2.6% due to warm weather, but have been flat since.¹⁶

According to both the Conference Board¹⁷ and the University of Michigan Consumer Confidence Survey¹⁸, consumer confidence decreased in May but ticked upward in June.

However, we continue to be concerned whether the U.S. consumer will continue spending as gas prices remain high and housing values trend flat to downward while personal interest rates like home equity loan rates rise significantly. Historically, the change in retail expenditures moves very closely with the change in home shopping, which we know is already in decline.¹⁹ Moreover, a recent UCLA Anderson Business School study claims that eight of the last ten recessions since World War II began in the housing sector.²⁰

↑ **Capital Spending:** Cash as a percentage of stock-market value for the S&P Industrial companies is at its highest level since September, 1988, generating large potential for more capital spending.²¹

Additionally, orders for non-defense capital goods excluding aircraft, an important barometer of business spending, have increased steadily and substantially from January 2005.^{14, 22}

Capital goods orders have been rising since summer, 2001. Demand for U.S. capital goods may illustrate a second-order effect of globalization. As successful foreign producers flood U.S. markets with cheap consumer goods from China and elsewhere, those producers then invest to increase factory capacity. As they do this they are also boosting demand for the kind of capital goods the U.S. makes, like high-tech machinery and aircraft.²³

↑ **Investor Sentiment:** Investor sentiment has been generally high since September, 2003. This extreme situation has cooled consistently throughout the year, which is an improving sign as it indicates that more investor cash may be on the sidelines.²⁴

↑ **Corporate Earnings:** S&P 500 company profits increased 14% in 1Q06²⁵, better than the 12.6% expected as of April 1st. Of those reporting, 67% beat expectations, which is better than the long-term average of 59%.²⁶ That is the twelfth consecutive quarter of double-digit earnings growth, a feat that has occurred only twice since 1950.²⁷ Energy company profits continue to buoy profits of the overall S&P 500.²⁸

Based on current earnings, Goldman Sachs currently rates the S&P 500 as 12% undervalued.²⁹

- ➔ **Insider Trading:** As of the market peak in early May, insider-selling momentum had continued at its highest levels since 2000,³⁰ picking up even from February and March, two of the highest insider-selling months on record.³¹ Insider buys have been picking up in the energy sector.³²
- ⬇ **Investor Cash Potential:** Cash levels within mutual funds continue to be low, under 7%. 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.³³ Possibly offsetting this is the huge global savings glut. Foreign investors may well continue to increase investment in U.S. companies.
- ⬆ **Merger and Acquisition Activity:** 2006 is on pace to be the most active merger and acquisition year ever. The largest acquisitions of the year have been: AT&T buying BellSouth for \$66.7B, Wachovia buying Golden West Financial for \$25.3B, Johnson & Johnson buying Pfizer's consumer brands unit for \$16.6B, Capital One Financial buying North Fork Bancorporation for \$14.8B, Alcatel buying Lucent for \$13.4B, and SuperValu and CVS buying Albertson's for \$11.3B.³⁴

Notes and Acknowledgements:

1. Based on the VIX volatility index as reported in *Barron's*, July 3, 2006
2. *Fooled by Randomness*, Nassim Nicholas Taleb, Random House 2005
3. Indexes used: NASDAQ 100 (QQQQ), Vanguard European (VGK), Morgan Stanley Capital Index Japan (EWJ), S&P Latin America 40 (ILF), streetTRACKS Gold (GLD), Goldman Sachs Network (IGN), NASDAQ Biotech (IBB), Goldman Sachs Semiconductor (IGW), Goldman Sachs Software (IGV), State Street Technology (XLK), Russell 2000 Small Cap (IWM), and Vanguard Health Care (VHK)
4. 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
5. *Stocks for the Long Run*, Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University
6. Sharper ♦ Granite analysis
7. Merrill Lynch, April, 2003
8. T. Boone Pickens, interview on *CNBC*, July 6, 2006
9. Based on the Fed Funds futures contract prices on July 7, 2006 as illustrated by *CNBC*
10. TDWaterhouse Research
11. *Wall Street Journal*, April 4, 2006; *Wall Street Journal*, June 14, 2006
12. U.S. Commerce Department, June 30, 2006
13. Institute for Supply Management (ISM), June 2, 2006; U.S. Federal Reserve, as reported in the *Wall street Journal*, June 16, 2006
14. *NAM/Fortune Magazine Index*, May 15, 2006
15. *Business Week*, July 17, 2006
16. *Wall street Journal*, April 24, 2006
17. The Conference Board, June 28, 2006
18. University of Michigan, June 14, 2006
19. Alliance Bernstein as reported in the *Wall Street Journal*, April 25, 2005
20. Edward Lehman, Ph.D., Professor of Economics, Anderson School of Business, UCLA as reported in *Wealth Manager*, June 2006
21. Standard and Poor's as reported in the *Wall street Journal*, May24, 2006
22. U.S. Census Bureau, *BusinessWeek*, May 8, 2006
23. Commerce Department as reported in the *Wall Street Journal*, May25, 2006
24. UBS (Union Bank of Switzerland) Index of Investor Optimism, July 3, 2006
25. Thomson Financial, May 8, 2006
26. *Barron's*, May 8, 2006
27. *Business Week*, March 6, 2006
28. Morgan Stanley as reported in *Barron's*, February 27, 2006
29. Abby Joseph Cohen of Golman Sachs as reported on *CNBC*, June 14, 2006
30. *Barron's*, May 1, 2006
31. Thomson Financial, May, 2006
32. Susquehanna Financial as reported on *CNBC*, June 20, 2006
33. Ned Davis Research, March 20, 2006
34. Dealogic and *Wall Street Journal*, June 26, 2006

Questions?
 Contact us at:
questions@sharpergranite.com