

# SHARPER ♦ GRANITE



*Optimal Portfolio Management*

**FALL**  
**2005**

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Last quarter's letter warned that "scientists are predicting one of the most severe hurricane seasons ever." Indeed, Louisiana, Mississippi and Alabama were hit by Hurricane Katrina, one of the worst natural disasters in U.S. history. Last quarter we highlighted a set of economic risk factors that had peaked to historical extremes: oil prices, interest rate spreads, residential real estate prices, the U.S. trade deficit, and the uncertainty associated with war and terror.

Each of these factors was discussed in detail last quarter. In this issue we review how oil price risk, interest rate risk, and the general U.S. economy will likely be impacted by yet another risk factor at an extreme, weather risk, specifically, hurricane Katrina.

## Financial Markets Summary



In the third quarter of 2005, the S&P 500 Index gained 3.6%. Long bond yields finally began to rise, pushed in part by the increased inflationary expectations following Katrina. This contained the Lehman Aggregate Bond Index to finish nearly flat at -0.6%.

When calibrated to the same risk as the S&P 500 Index, the average of all Sharper ♦ Granite client portfolios gained 3.9% (net of costs).<sup>1</sup> As the chart on the following page shows, the average of all Sharper ♦ Granite client portfolios beat the S&P 500 significantly this quarter, marking the 8th quarter in the last eleven that the average of all Sharper ♦ Granite portfolios outperformed the S&P 500 Index on a risk-adjusted basis. 70% of all Sharper ♦ Granite client portfolios beat the S&P 500 on a risk-adjusted basis.

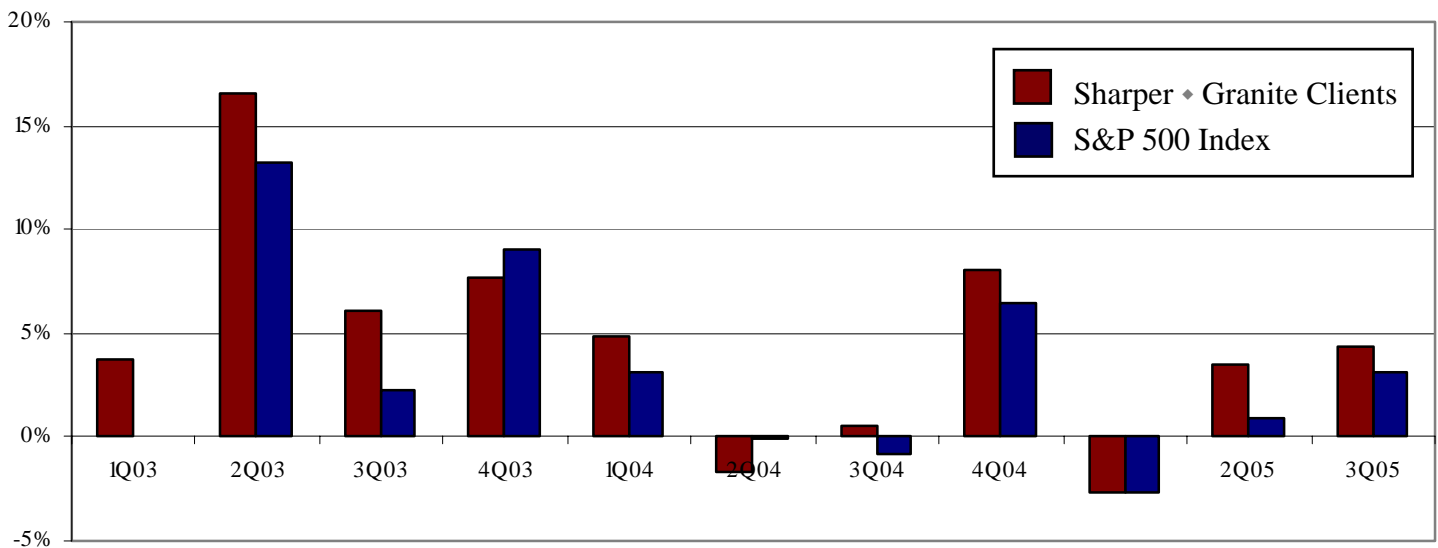
Sharper ♦ Granite again tilted portfolios toward the energy, utility and Asia sectors this quarter. These tilts contributed to a total return performance that comfortably beat the market. See Sharper ♦ Granite's recommended tilts toward energy and utilities in "Tilting Portfolios to Improve Performance", *Fall 2004*.

Total return (stock price change + dividend) of typical investments representing these and other leading sectors in Sharper ♦ Granite portfolios are shown in the chart to the right.

Over the last 12 months the average Sharper ♦ Granite client portfolio returned 13.6% when calibrated to the same risk as the S&P 500 Index. Over this time period the S&P 500 returned 9.3%. ♦

Sector	S♦G Investment	Quarter Change
Asia	EWH	+9.3%
	EPP	+9.6%
Latin America	ILF	+29.4%
Europe	IEV	+8.1%
Semiconductors	IGW	+13.7%
Biotechnology	IBB	+13.4%
Energy	XLE	+20.7%
Utility	XLU	+6.5%

## *Sharper ♦ Granite Risk-adjusted Returns Vs. S&P 500 Index Last Three Years*



## Third Quarter 2005 Economy Review

The extremes facing the economy discussed in last quarter's letter remain. They are, in decreasing order of economic importance: oil prices, interest rates, residential real estate prices, the U.S. trade deficit, and the uncertainty associated with war and terror.

While all of these risk factors are still present, we now must consider the impact of Katrina and Rita on the first two, oil prices and interest rates.

On September 20th the Federal Reserve increased short-term interest rates for the tenth consecutive time by 0.25%, raising the federal funds target rate to 3.75%.

However, gulf hurricanes Katrina and Rita added significant uncertainty to the rate hike process. On one hand, the hurricanes curbed consumer sentiment and cut expected 2005 gross domestic product (GDP) due to interruptions in gulf port traffic of oil and other goods. Drags on the economy imply an easing of monetary policy by the Federal Reserve Board. And in fact, many expected the Fed to pause its interest rate hike cycle.

On the other hand, the interruption in oil drilling and refinery production made goods like gasoline more scarce. When the supply of goods falls, prices rise, increasing inflation and pressuring the Fed to raise rates in order to tighten lending. In addition, massive new government reconstruction projects will fuel growth and demand for goods. This will tend to increase prices.



On September 20th the Fed determined that inflation is still the greater concern, opting to raise rates and signal that more 0.25% rate hikes are likely. While few welcomed another rate increase, in a sense this move was a vote of confidence for the U.S. economy. The past five years have witnessed terrorist attacks, a burst tech-stock bubble, corporate accounting scandals, wars in Afghanistan and Iraq, and a doubling in oil prices. Yet the economy, after a mild recession in 2001, has embarked on a solid expansion with little inflation. In fact, since the last oil peak in the mid-70's, the economy has proven increasingly resilient to shocks. Economic volatility has decreased to a level less than half of what it was thirty years ago.<sup>2</sup>

Due to Katrina and Rita, employment and output should take a sizeable hit, the length and depth of which are unknown. However, some things are working in the economy's favor since the oil crunch of the late 1970's. The U.S. economy is increasingly more energy-efficient. While GDP has doubled since 1979, oil consumption has risen only 9%.<sup>3</sup> Furthermore, Congress has reduced regulatory constraints on oil supply over the last two decades.

### *S&P 500 Index Performance Following the Most Costly U.S. Hurricanes <sup>4</sup>*

Hurricane	Cost (billions)	Time after Hurricane		
		1 Month	6 Months	1 Year
1. Charley/Frances/Ivan/Jean, Aug – Sep 2004 <sup>5</sup>	\$45.0	6.0%	13.3%	15.9%
2. Andrew, August 1992	\$26.5	1.9%	7.3%	11.9%
3. Hugo, September 1989	\$7.0	-0.6%	-3.3%	-12.2%
4. Floyd, September 1999	\$6.0	-4.9%	10.6%	9.6%
5. Allison, June 2001	\$5.0	-1.4%	-7.9%	-17.4%
6. Fran, September 1996	\$3.2	3.2%	18.4%	39.0%
7. Opal, October 1995	\$3.0	1.9%	10.2%	20.5%
8. Isabel, September 2003	\$3.0	0.5%	8.0%	7.9%
9. Frederic, September 1979	\$2.3	-5.0%	-6.1%	15.5%
10. Agnes, June 1972	\$2.1	-2.1%	8.2%	-3.8%
11. Alicia, September 1983	\$2.0	2.5%	-5.1%	0.8%
12. Bob, September 1991	\$1.5	0.6%	5.7%	7.6%
13. Juan, August 1985	\$1.5	7.7%	29.5%	27.4%
14. Camille, August 1969	\$1.4	0.3%	-8.5%	-13.3%
	<b>Average</b>	<b>0.8%</b>	<b>5.7%</b>	<b>7.8%</b>

Following Katrina, the federal government immediately eased environmental and transportation regulations so that existing gasoline inventories could more readily reach the U.S. population. The release of oil and gasoline from the strategic reserve supplies in the U.S. and Europe also helped contain the rise in oil prices.

Private sector shock absorbers also sprang into action following the hurricanes. The robust temporary-worker industry helped to redeploy displaced workers. The national transportation system rerouted freight around destroyed tracks and bridges using sophisticated logistics software. Diversified loan packages securitized with mortgages from diverse geographies mitigated credit risk to local banks in the region and kept mortgages flowing to gulf region real estate customers.<sup>6</sup>

While the personal and economic devastation will linger for years, we have faith in the resiliency of the U.S. economy. A look back at the 17 most costly hurricanes in U.S. history in 14 different years dating back to Camille in 1969 shows that the economy and stock market recover reasonably well from hurricanes. One month following the hurricanes' U.S. landfall, the market averages a 0.8% increase (10.0% annualized), and six months following -- a 5.7% increase (11.7% annualized). These gains are in line with typical one and six-month stock market gains. ●

## Leading Economic Indicator Summary

➤ **Market Cycle:** The first week in October marks the three-year anniversary of the current bull market. The first year of bull markets tends to be the strongest, and this time is no different. The first year of this bull market yielded 34% S&P 500 returns, the second year yielded 8%, and the third year yielded 9%

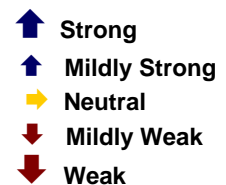
The fourth quarter is upcoming and tends to be the strongest of each year. November and December have been the strongest months for the S&P 500 since World War II.<sup>7</sup>

However, we are still in a period of increasing interest rates. Stock market returns since 1970 have averaged only 8.7% in years of rising interest rates compared to 18.5% in years of declining interest rates.<sup>8</sup>

⬇ **Political Cycle:** We are in the first year of President George W. Bush's second term. Historically, the first year in the presidential cycle is the weakest for the stock market. Since World War II, the first year of the cycle has seen the S&P 500 Index post an average gain of 9.1%, and only 3.4% under Republican presidents. Only eight of the 15 post-WW II first years have been positive. When the data is reviewed back to 1888, first years are still the worst performers. However, the market has performed better during times of a Republican-controlled Congress, which we have currently.<sup>7</sup>

⬆ **GDP Growth:** Gross Domestic Product (GDP) is the official economic measure of the U.S. economy. It is a measure of all goods and services produced in the United States. Second quarter 2005 GDP was revised to 3.3%. This continues a trend of solid, steady growth and is in line with a healthy, growing economy. It was the 15th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001.<sup>9</sup>

Hurricanes Katrina and Rita have lowered 2005 GDP estimates from approximately 3.9% to 3.5%.<sup>10</sup>



**Have a friend or family member who can use a free portfolio analysis?** As a free service to clients, Sharper ♦ Granite will perform portfolio analyses for clients' friends and family. The analysis "x-rays" a current portfolio of mutual funds, stocks, and bonds across multiple accounts to review balance, risk, performance and costs.

We are happy to suggest simple adjustments that may improve return, lower risk, or reduce costs. Often times, simple changes to mutual funds, stocks or bonds in a 401(k) or an IRA can improve returns, lower risk levels, and improve alignment with specific financial goals such as college or retirement.

- ➔ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, increased sharply in July and especially September, despite the impact of the hurricanes, reversing a trend of decreasing expansion that began in January 2004.<sup>11</sup>

Meanwhile, the Philly Fed Index, widely observed as a leading indicator, in August fell to its lowest level in three months.<sup>12</sup>

- ⬆ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI (blue line in chart) remained subdued in the low 2% range where it has been most of the year. However, excluded from the core CPI is the high cost of energy.<sup>13</sup> While energy costs are generally excluded from core CPI measurements because of their volatility, consumers are becoming increasingly used to high energy prices. The longer oil prices stay in the \$60 range, the more we must consider energy prices to be “core” and factor energy into our inflation projections.

In fact, consumers’ long-term inflation expectations rose to a four-year high of 4.6% over the coming year.<sup>14</sup> This is somewhat important because inflation tends to be a self-fulfilling prophecy. That is, if people believe prices will be higher tomorrow, they tend to buy today, thus creating demand and driving prices higher.<sup>17</sup>

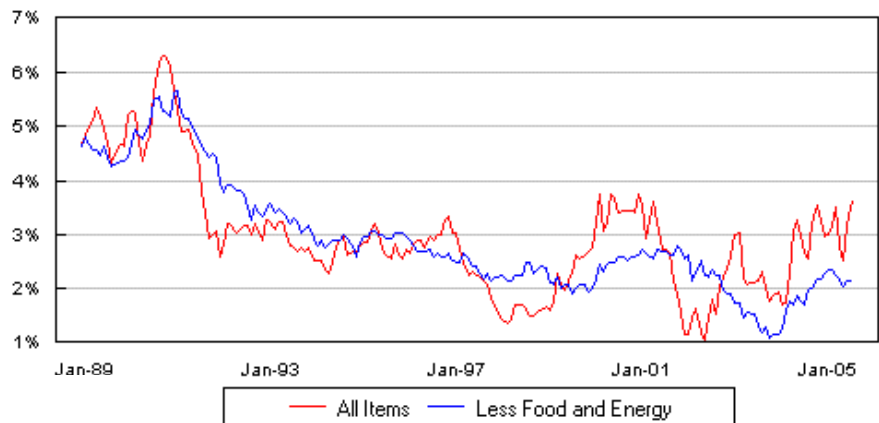
- ➔ **Consumer Spending:** Economists keep a close eye on consumer spending because it accounts for two-thirds of all U.S. economic activity. U.S. retail sales declined sharply August. Katrina likely accounted for only a small part of the decline since the area affected accounts for 1% of total U.S. retail sales. The long-term retail spending trend, however, continues to be strong.<sup>15</sup>

The increase in short-term interest rates by the Fed and high gasoline prices continue to take their toll on consumer spending. For each 1% that the Fed raises short-term interest rates, consumer spending falls about 0.6%.<sup>16</sup>

Consumer sentiment declined dramatically in August and September. Impacted by Katrina, the University of Michigan Consumer Confidence Survey showed its largest two-month decline since comparable records began in 1978. The index is now suddenly at its lowest point since 1993.<sup>14</sup> The Conference Board survey, conducted in the wake of Katrina, reached its lowest reading in two years.<sup>17</sup>

- ⬆ **Capital Spending:** Orders for capital goods remained flat through July and August. Businesses are overall positive in their economic outlook and planned spending, though indicators slowed somewhat in the third quarter.<sup>18</sup>

*Consumer Price Index Year over Year Change*



↓ **Investor Sentiment:** Investor sentiment has remained generally high since September, 2003. In June, 2005, sentiment reached its most exuberant point yet.<sup>19</sup> This extreme condition cooled a bit during the first five months of the year but then rebounded in the second and third quarters, indicating 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>20</sup>

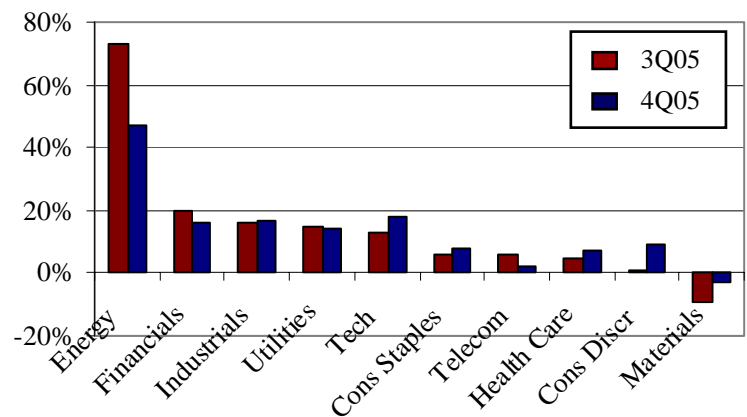
↑ **Corporate Earnings:** The price-to-leading-earnings (P/E) ratio for the S&P 500 sits at 16.<sup>21</sup> This implies stocks are at relatively good value.

Current third quarter S&P 500 earnings are estimated to grow at 17.8% over 3Q04.<sup>22</sup> While this is quite strong, most of this strength is coming from the energy sector, projected now to increase 73% over 3Q04.

Fourth quarter projections are currently showing 16.5% growth -- to be led again by the energy sector.

Having energy and financials as the biggest growth drivers could mean that investors get little impact for each additional dollar of earnings. These two sectors carry low PE ratios, so positive earnings reports will have a relatively muted effect.

### Corporate Earnings Sector Estimates



↓ **Insider Trading:** Insider buys peaked in the second quarter, which is considered a positive leading indicator for the market, but then turned and declined substantially in the third quarter.<sup>23</sup>

#### Notes and Acknowledgements:

1. Arithmetic average used for return measurement. Asset-weighted average beta used for risk adjustment to market-risk level. Performance includes assets tracked for clients that lie outside Sharper ♦ Granite direct management, which amount to less than 4% of total assets. All client portfolios weighted equally in calculation
2. Economic volatility is measured as the standard deviation of GDP over rolling five-year periods. Data is from the Bureau of Economic Analysis
3. U.S. Department of Energy
4. Cost is in nominal 2005 dollars. Data is from National Hurricane Center
5. Date of Charley landfall used, August 14, 2004
6. *Wall Street Journal*, September 16, 2005
7. Jeremy J Siegel, Professor of Finance, Wharton School of Business at Penn University
8. TDWaterhouse Research
9. Bureau of Economic Analysis, August 31, 2005
10. Macroeconomic Advisors LLC, September 16, 2005
11. Institute for Supply Management (ISM), October 4, 2005
12. Philadelphia Federal Reserve Bank, September 15, 2005
13. U.S. Department of Labor, September 15, 2005
14. University of Michigan Consumer Confidence Survey, September 17, 2005
15. U.S. Commerce Department, September 15, 2005
16. Merrill Lynch, May, 2005
17. Conference Board, September 27, 2005
18. U.S. Census Bureau
19. Investors Intelligence, September 30, 2005
20. Citigroup Investment Research, October 3, 2005
21. *Wall Street Journal*, October 4, 2005
22. Thomson Financial, October 3, 2005
23. InsiderCow.com, September 30, 2005

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