

2006 Forecast Inside The Crystal Ball

To quote Stephen Leuthold of the Leuthold Group, LLC, "it's thermal pollution time again, that time of year when Wall Street's prognosticators expel large volumes of hot air. This year, with heating costs through the roof, any supplemental source of hot air is most welcome."

As we turn the calendar to a new year, hardly anyone is without an opinion on the future of the stock market. **More opinions were recently generated on investments than on the weather as a Google search on "2006 stock market forecast" generated 5.6 million "hits."** Expanded searches showed the traditional bull market bias still intact as 1.56 million hits were generated when "positive" was added to our search while only 1.27 million hits were returned from the addition of the "negative" preface.

In order to give our readers a glimpse into the future from across the full spectrum of market "experts," we have included representatives from virtually every investment discipline and asset class – from brokerage firm strategists to hedge fund and mutual fund managers covering stocks, bonds, real estate, commodities and currencies. We even included newsletter writers. To avoid any domestic or parochial bent, our crystal ball gazers span the continent from New York City to Newport Beach, CA and around the globe from Zug, Switzerland to Hong Kong.

The purpose in presenting the disparate views of these market veterans is not to record their predictions for future grading. Rather, **the objective is to examine the issues they see driving the world's economies, and the rationale behind their predictions of success or failure for various markets and strategies.** With Art Samberg of Pequot Capital Management predicting a 20% gain in the U.S. stock market and Marc Faber of Marc Faber Ltd., Hong Kong foreseeing a 20% decline in the same U.S. market (Barron's Roundtable, January 16, 2006), at least one of them, and probably both, will be wrong.

Over The Horizon

Looking beyond the wide range of estimates for target levels or market returns for year-end 2006 (which we provide in a summary table), virtually all the experts were at least posing the same critical questions:

- 1. When will the Federal Reserve stop raising interest rates, and will the baton pass from Chairman Greenspan to successor Ben Bernanke result in any changes in Fed policy?**
- 2. Can U.S. consumers continue to be the primary support for the economy in light of higher interest rates, surging energy costs and an expected housing market slowdown?**
- 3. Will the faster growth economies in Asia, India and the Emerging Markets be a better investment opportunity than the lagging U.S. markets?**
- 4. Will there be progress in the Iraq war and will a geopolitical event emanating from Iran, Syria or even Venezuela rock the markets?**

13 Rate Hikes – How Much is Enough

Looking first at the combination of interest rates and Fed policy, **the consensus view is that the Fed is going to raise rates at least twice more -- once in January at Greenspan's farewell meeting and then on March 28 at Bernanke's inaugural meeting as chairman.** Bond guru Bill Gross (Founder and chief investment officer, Pimco, Newport Beach, Calif.) predicts at least a pause at the 4 1/2% Fed funds level with ten-year Treasuries in the 4 3/8% range.

Abby Joseph Cohen, (Chief U.S. investment strategist, Goldman Sachs, N.Y.) pegs the 10-year Treasury at a substantially higher 5-5 1/4%, reflecting her belief that the OPEC nations will not continue to be buyers of U.S. government debt at levels sufficient to maintain the current lower rates. **With an International Monetary fund forecast of U.S. trade deficits of \$890**

billion in 2006 and \$980 billion in 2007, it is hard to argue that foreign central banks will really want to buy almost \$2 trillion more U.S. debt at today's rates. Money manager and author, John Mauldin, sees the Federal Reserve Board, including chairman-to-be Bernanke, intent on letting some air out of the real estate bubble by raising rates "until the housing market cries uncle."

The potential impact of higher rates would be substantial on both the bond and stock markets. **For example, a 1% increase in 10-year rates would cause principal erosion in the underlying bonds of roughly 7%, nearly two percent greater than one year's interest income.** The impact on the stock side would come from a slowdown or even a halt in consumer spending.

Felix Zulauf (Founding partner and president, Zulauf Asset Management, Zug, Switzerland), paints a dreary picture, pointing to the recent housing trends in the U.K. and Australia, which he says are two years ahead of the U.S. market cycle. There, **housing markets are now flat and retail sales growth has plummeted from 4-5% to 0-1%, a trend he sees hitting the U.S. in the second half of '06.** With HELOC (home-equity line of credit) loan rates having already risen from 4.75% to 7.75%, further rate hikes would clearly be a drain on household cash flow, which brings us to question number two.

Consumers Running On Empty?

According to Bill Gross, the "American homeowner has learned to use his home as an ATM machine." Gross cites a study conducted by Federal Reserve, supporting chairman Greenspan's theory that the economy has been supported substantially by mortgage-equity Withdrawals to the tune of \$600-\$700 billion over several years.

As described by John Mauldin, this producer/consumer cycle has worked because **"Foreign nations, but primarily Asian nations, take our electronic dollars and send us 'stuff.' On our side of the equilibrium, American consumers agree to not save very much and borrow against our rising housing values to hold up our end of the bargain. They, in turn, agree to keep prices down."** But, according to Zulauf, the cycle is about to break down since, for spending to continue at the '05 rate, consumer debt accumulation would

have to increase by \$500 billion, an unsustainable pace.

The consumption bailout, if there is to be one, must come from the corporate sector. Abby Cohen argues that, despite a deceleration in personal consumption spending, business fixed investment could grow 10%. She sees information technology unit purchases up 20-25%. Mario Gabelli (Chairman, GAMCO Investors Inc., Rye, N.Y.) agrees partially with Cohen, but points more to the capital equipment and infrastructure spending in Brazil, Russia, India and China than to the tech sector. **While the supply side of the equation is producing at full throttle, the demand side may be running a little short on cash.**

Adding to consumers' woes is the high cost of energy. Among our experts, **Zulauf, Samberg and Faber all predict a range of \$50-70 for oil this year.** Most telling for the long-term are the statistics cited by Faber: China's yearly per-capita consumption of oil is 1.7 barrels. U.S. per capita consumption is 27 barrels. Korea's and Japan's are 17 barrels. The U.S. has 740 vehicles per 1,000 people. In China there are three, and in India there's one. Although alternative-energy sources are on the drawing board, **the only prospect for a dramatic decline in energy prices is a severe recession, hardly an attractive solution.**

Emerging Markets, Still Emerging?

Unlike the U.S. stock market, which turned in a lackluster year, overseas, particularly emerging markets, enjoyed supercharged returns. Bill Gross argues that, **if the dollar weakens, (his conclusion is that "the dollar as a currency is doomed"), other non-dollar-denominated markets in Europe and Asia will participate more fully in the global expansion.** "They are as cheap as or cheaper than U.S. stocks, and they are denominated in currencies that are cheaper than the dollar." This observation is borne out by the fact that even after a three-year bull run, **emerging markets are still selling for only 12 times earnings.**

According to Tony Cragg, manager of the Wells Fargo Asia Pacific Fund, we are in for another solid year in '06. **Cragg is confident that the fundamentals are still in place, that there is "decent earnings growth and valuations are low."** Rudolph-Riad Younes, comanager of the **Julius Baer International Equity Fund favors**

Eastern Europe, particularly Turkey and Russia, a region he says “has great dynamics and will continue to surprise on the upside.”

Gonzalo Pangaro, manager of the T. Rowe Price Latin America Fund, remains positive even after posting a 60% gain in '05. **Pangaro cites “continuing strong earning growth with both Mexico and Brazil lowering interest rates.”** He does recognize the “key risk” of politics in Latin America as national elections are scheduled for seven countries in the region, including Mexico and Brazil.

And finally, Mark Headley, manager of the Matthews Asia Pacific Fund, sees more reasonable valuation in Chinese stocks, which have underperformed for two consecutive years. **The Matthews group is also positive enough on India to launch its own India fund.** According to Headley, “People seem to be starving for growth, and the domestic Indian growth story is very exciting.”

While this picture looks bright, Julius Baer's Younes reminds that much of the boom in Asia is tied directly to the “overindulgence and over consumption of Anglo-Saxon consumers. **Sooner or later, we'll see some adjustment to these imbalances and you'll see deterioration of fundamentals in Asian economies.”** Forewarned is forearmed.

Event Risk – The Greatest Unknown

The geopolitical setting is as complicated and, with the rise in oil prices, as economically centered as ever. Marc Faber describes what he calls the **“warcycle theory,” which says commodity prices rise, international tensions increase, war results and prices go through the roof.** As evidence of this developing condition, he points to the newfound power of Venezuelan and Iranian Presidents Hugo Chavez and Ahmadinejad, keepers of major oil reserves.

Tensions are growing as the U.S. expresses its concern about Iranian nuclear capability while the Chinese, Russians and Indians seem to be more concerned with access to Iranian oil. The war in Iraq continues with evaluations of progress measured in election year rhetoric. **While the geopolitical dimension is perhaps the most difficult to fit into any forecasting model, it might also be the piece that has the greatest potential short-term impact.**

To again quote Steve Leuthold as I did at the opening, “Predictions are for show, while the coming year's ongoing portfolio shifts are for dough.” The added value of our investment management is its time proven discipline. **The measure of success is not one's expertise in forecasting but rather the ability to capture the unexpected opportunities and to minimize the unanticipated risks in order to reach each client's financial objectives.** We look forward to meeting these challenges in 2006.

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