January 5, 2007

2006 Year End Review

One of the oldest and most shop-worn of Wall Street adages is "Don't Fight the Fed." No one would enjoy getting up every day to face Mohammed Ali in the ring, but that's what it sometimes feels like for stock investors when the Fed is raising rates. The bell ending the 17th round of rate hikes rang at the August meeting of the Federal Reserve Board when Ben Bernanke and friends decided that raising rates from 1% to 5 ¼% over the preceding 2 + years was enough, at least for a while. With no more Fed to fight, the market rallied from mid July (in anticipation of the August meeting) through to the end of the year with very little in the way of a pause. Investors' memories are short, however. The first half of the year was not so pleasant. The year of 2006 started off with a pretty brisk rally, making the merry month of May even merrier with gains of about 6% up to that point on the S&P 500. If you can remember that far back, the S&P 500 quickly tanked almost 8% into the second week of June. Gloom and doom pervaded. A brief rally failed and by mid July the index was down for the year and almost as low as it had been in June. This, in retrospect, turned out to be the fabled "double bottom" that chart readers look for to signal the end of a decline. It proved to be the turning point this time as well. The pain of the spring and summer has now been forgotten as the rally carried the second half of the year nicely into positive territory.

The Nasdaq Composite ended the year up over 9% and the S&P 500 Index rose over 13%. The bond market experienced some gyrations too. Usually, prices of bonds move somewhat uniformly in the opposite direction of general interest rates. If rates go up, bonds go down, and vice-versa. This year, in what is a fairly rare occurrence, corporate bonds went up in value while Treasury bonds went down. This represents a shrinking of what is called the "risk premium" in yield that investors in corporate bonds demand over the safer U.S. Treasury bonds. Corporations have been known to default on the bonds that they issue; e.g. Penn Central to Pan Am. The U.S. Treasury can print the money to pay off their bonds, so the default risk for them is close to zero. The inflation rate may go up because of all that government-printed money, but you can rest assured you're going to get paid. Not so for corporate bonds. Consequently, investors demand a higher rate on a 10 year bond issued by Montgomery Ward than they do for a 10 year bond issued by the U.S. Treasury, and rightfully so. That difference in yield is the "risk premium." What is interesting is that, although leverage (i.e. risk) in the corporate world has arguably increased, the risk premium has decreased. This may prove to be either an indication that the strength of corporate earnings has permanently increased or evidence that investors have become too complacent about the potential for trouble on the economic horizon. We want to be able to take advantage of the first, but to be prepared for the possibility of the latter.

Energy prices have continued to gain media attention, but their rise seems to have leveled off and is now an exercise in short term volatility with a recent downward bias. We have done well in energy stocks and are reluctant to abandon them entirely for two reasons. First, the long-term demand for energy is likely to continue to increase while supply seems to be constrained. Second, the companies themselves are earning bundles of money and their stocks are statistically cheap. However, a drop in oil prices to $45 per barrel would bring these stocks down for a while, at least. So here we are weighing short term versus long term considerations and must remain flexible.

The housing market slowdown has finally become apparent to everyone. This is a good example of the pendulum-like swings in many markets, going to extremes at both ends of its arc. Just about the time that real estate became a “sure thing,” promoted by the press and cocktail party palaver alike, it no longer was. Markets often go higher than reasonable, and usually have to go lower than expected in order to purge the excesses of speculation that they spawn (or that spawn them). Consequently, we are on the lookout for more fallout from the weaker real estate markets and their “ripple effects” in the stock market and the economy. I would not be surprised to see more about this in the press sometime during 2007.

The U.S. dollar has weakened as we had expected and pharmaceutical stocks have recovered from the bashing they took in the aftermath of the Democratic gains in the last elections. Once again, the immediate knee-jerk reaction (Democrats will crush the big drug companies’ profits) was wrong and cheap valuations provided some protection on the downside. We have taken profits in many of the successful investments we had made when stocks were at lower levels. However seldom, new ideas keep cropping up. Rite-Aid stands out as a beneficiary of the aging population with a rejuvenated chain of stores and a large acquisition making it a major player in the field. Montpelier Reinsurance is another “turnaround” value that has attracted our investment. We have bought both at substantial discounts to their stock prices of a few years ago. These are representative of the selectivity that we have employed in our investments and our high “win ratio” bears out the value of that effort. Maintaining that high ratio of good investments is so important in order to avoid the evils of “negative compounding,” the effects of which became apparent to unwary investors in the aftermath of the “tech bubble” of a few years ago.

The New Year usually brings an influx of new money into the stock market, especially when the previous year finished with the market rising. Corporations and individuals make the largest contributions to their pension plans at this time and the portfolio managers investing those funds are too much afraid of missing further advances to be as cautious or selective as they might otherwise be. Consequently, it would be unsurprising to see a continuation of the advance into the first quarter of 2007. Betting on the sustainability of that advance is a little less certain.

Corporate insider “sell to buy” ratios are extremely high and price earnings ratios have expanded, making stocks more expensive. More ominously, the so-called “sentiment” indicators show that historically high levels of participants expect the market to continue

to advance. Sentiment indicators are "contrarian" and usually portend the opposite of the outcome generally expected. We have gone quite a while without the standard 10% correction in the market and we have just finished a very strong 6 month run. Add to these the aforementioned shrinking "risk premiums" and you have a number of signs that complacency appears to have set in among happy investors, with most participants thinking that the stock market is a fine place to be. That always makes me nervous. Accordingly, we will remain selective in our investments and try to maintain our high ratio of profitable picks.

I also want to welcome Alice Marie Carroll to Carmichael Capital. She formerly handled budgets and financial forecasts for AT&T at their headquarters in New Jersey and will now be the office manager at our main address at 339 Main Street, Franklin TN 37064. Her direct telephone number is (615)595-5825. Please feel free to give her or me a call anytime you would like to discuss any matters regarding your account.

Enclosed you will find your year end statements and reports, including any capital gains statements that are needed for your tax return. Please review them at your leisure and give me a call if you have any questions or suggestions.

I am grateful for the opportunity to have worked with you on your investments over the past year and I hope for many years of success to come for us all.

Best regards,

Claude R. Carmichael CFA