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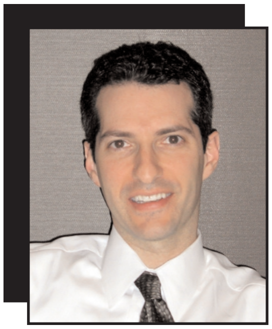
By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than twelve years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

2006 Market Commentary

Once again, it is the time of year for New Year's resolutions and market forecasts. Some people may resolve not to make any more forecasts, as it can prove quite frustrating when the market does not appear to act rationally (in other words, go as you predicted). For me, having an opinion on the market goes with the territory. So for better or worse, here I go again. However, before I share my expectations for 2006, it is only fitting to look back at what I predicted for 2005.

In my January 2005 article, I wrote,

*"While I believe corporate earnings will continue to grow this year, I think the market will place a lower valuation multiple on those earnings, **resulting in a relatively flat to potentially down market**...although the consensus of Wall Street analysts and market strategists is for the market to advance around 8%-10% in 2005, I do not believe that positive returns should be a forgone conclusion."*

After see-sawing up and down in a fairly tight range for most of the year, U.S. major stock averages were basically flat, making my 2005 forecast look pretty good. The Dow Jones Industrial Average finished slightly negative, registering a -0.6% loss with the S&P 500 fairing a little better, finishing in positive territory with a 3.0% gain.

As seen from the chart below, U.S. stock and bond markets struggled to make headway in 2005 compared to international stocks which enjoyed a solid year as investors searched for better returns abroad.

Index	2005 Return
DJIA	-0.61%
S&P 500	3.0%
Nasdaq	1.4%
Russell 2000 (Small Cap Stocks)	3.3%
MSCI EAFE (International)	10.9%
U.S. Bond Aggregate	2.4%

Outlook for 2006

My assessment of 2006's investment environment is not much different than 2005's. **I expect a continuation of this choppy, mostly sideways market, but this time with more volatility (notably absent the last two years).** Earnings should continue to grow by a fairly decent clip in 2006 (7%-10%). But, as the year progresses, persistent worries of a slowing U.S. economy or potential recession in 2007 will cause market multiples to slip further. The result will be meager gains (or losses) for U.S. equity markets. **This time next year, I would expect to see the S&P 500 and Dow plus or minus 5% from where we are now.**

Diversification and a defensive posture, including a higher allocation to cash, are warranted, so investors can take advantage of buying opportunities that may emerge.

Review of 2005

U.S. corporations did indeed log some healthy earnings growth in 2005. In fact, operating earnings for companies comprising the S&P 500 grew by roughly 13%, marking the fourth year in row of impressive, double-digit earnings growth. Despite solid earnings, inflation fears stemming from higher energy and commodity prices, coupled with the prospects for higher interest rates, kept a lid on the U.S. stock indexes.

Energy was the big story in 2005, as the price of oil and natural gas soared. In fact, operating earnings for energy companies in the S&P 500 grew by a whopping 44.5%, more than double the earnings growth of companies in the industrial sector (the sector with the second-strongest earnings growth in 2005). Higher global demand for energy and raw materials (particularly in China), and domestic supply constraints exacerbated by Hurricanes Katrina and Rita forced up energy and other commodity prices.

Amazingly, the U.S. economy largely shrugged off the energy shocks and natural disasters and was able to register reasonably strong GDP growth throughout the year (averaging close to 4%). Much of that growth can be attributed to the resilient U.S. consumer that continued to spend in the face of higher food and fuel costs. The U.S. stock market was tightly range-bound in 2005. Before finishing the year up 3%, the S&P traded up as much as 5% in mid December and only down as low as 6% in April (representing about a 10% swing from high to low).

In 2005, alternative asset classes such as natural resources and precious metals provided better returns than traditional stocks and bonds. Also, international developed markets and emerging market stocks had strong returns despite the strengthening U.S. dollar negating some of those returns.

Factors Favoring a Flat Market in 2006

As we head into the New Year, the market faces many of the same challenges that kept it locked in a trading range all of 2005. I see many of these same issues persisting into 2006 that will likely result in low returns.

- Fed Finally Makes Saving Worthwhile
- Corporate Earnings Destined to Slow
- Change in the Leadership at the Fed
- Weak Technicals for Midterm Election Years

Fed Finally Makes Saving Worthwhile

Thanks to 13 straight interest rate hikes by the Federal Reserve, the interest rate earned on money market funds and CD's has improved drastically. A little over a year ago, you got a measly 1% in a money market fund. As a result, investors shifted their funds into riskier asset classes (stocks, real estate, high yield bonds, etc.), thereby driving up the prices of those asset classes in the process.

Now, investors can earn 4% or more on their money with hardly any principal risk. Furthermore, the Fed is expected to raise rates at least one more time in January, making short term savings vehicles all the more attractive. With the stock market sputtering along, CDs and money market funds will continue to gain appeal, slowly turning investors back into savers. In fact, that is the Fed's goal – cool the economy down by drying up excess liquidity, thereby snuffing out building inflationary pressures brought on by the robust economic expansion. There is already evidence that this trend is well underway as money market balances appear to have bottomed slightly below $1.9 trillion over the summer and have climbed back steadily to over $2 trillion since then.

The chart below better illustrates how investors have shifted their funds in recent years in response to changes in interest rates and the performance of the stock market.

Mutual Fund Holdings

Percentage Breakdown By Asset Class

Year	Equity Funds	Hybrid Funds	Bond Funds	Money Market	Total
1990	22.5%	3.4%	27.3%	46.8%	100.0%
1991	29.1%	3.7%	28.3%	38.9%	100.0%
1992	31.3%	4.8%	30.7%	33.3%	100.0%
1993	35.8%	7.0%	29.9%	27.3%	100.0%
1994	39.6%	7.6%	24.5%	28.4%	100.0%
1995	44.4%	7.5%	21.3%	26.8%	100.0%
1996	49.0%	7.2%	18.3%	25.6%	100.0%
1997	53.0%	7.1%	16.2%	23.7%	100.0%
1998	53.9%	6.6%	15.0%	24.5%	100.0%
1999	**59.0%**	5.5%	11.9%	23.6%	100.0%
2000	56.9%	5.0%	11.6%	26.5%	100.0%
2001	49.0%	5.0%	13.3%	32.8%	100.0%
2002	41.7%	5.1%	17.6%	35.5%	100.0%
2003	49.7%	5.9%	16.7%	27.7%	100.0%
2004	55.2%	6.2%	15.6%	23.0%	100.0%
Nov-05	55.5%	6.4%	15.4%	**22.7%**	100.0%

Source: ICI

You can see that at 22.7% in Nov-05, money market balances as a percentage of all mutual fund holdings are at their lowest level in nearly 15 years. With rates on CDs and money markets getting better, rather than worse, it is hard to imagine that investors will not be lured into keeping more of their investable funds in cash (at least until the Fed starts lowering rates again in late 2006 and beyond). Attractive savings rates will deprive the stock market of what has been its primary source of fuel over the last two years.

Earnings Destined to Slow

As mentioned earlier, corporate earnings have gone through an incredibly strong growth cycle over the last four years. That rate of growth is slowing and should continue to do so as materially higher borrowing rates (following a string of Fed rate hikes) and slower consumer spending start to weigh on corporations' bottom lines.

A slower pace of economic activity will translate into lower earnings and the market placing a lower multiple on those earnings. If operating earnings for the S&P 500 grow by 8% in 2006 and the multiple on those earnings slips to 15x earnings (currently at 16.25x), the result is a flat market.

Don't Drop the Torch on the Hand-Off

On January 31st, Alan Greenspan will end his fifth term as Chairman of the Federal Reserve Board of Governors, the body that sets and implements U.S. monetary policy. His replacement, Ben Bernanke, will inherit a healthy, growing economy with low unemployment and inflation under control. He will also inherit a flat to inverted yield curve (a situation where short-term interest rates are higher than long-term interest rates), which almost always foreshadows a coming recession or economic slowdown.

One would expect there to be some global anxiety regarding the new Fed Chairman's approach to managing the world's largest economy. However, thus far, Howard Stern's move to satellite radio has garnered far more mainstream media attention that Greenspan's retirement. Hopefully, the new Chairman can avoid a financial crisis like the Black Monday stock market collapse of 1987, which Mr. Greenspan had to deal with just a few short months after taking office.

History Suggests Market Weakness or Correction

According to the Stock Trader's Almanac, a publication containing historical market trends and statistics, almost all bear markets start in the first year following a presidential election year and ended the following year. In addition, the average decline from the high point of the Dow to its low is 22%, which suggests the Dow could retrace down to 8500 or so before recovering. While a market correction is tough on returns in the short-run, should one occur it will serve as an incredible buying opportunity.

Factors Favoring an Up Market in 2006

There are also numerous factors that may play out in the market's favor this year, leading to some upside surprises in returns in 2006. These positive factors include:

- Low Interest Rates Persist
- Resumed Foreign Purchases of U.S. Stocks
- Positive Earnings Surprises

Fed Keeps the Party Rolling

Uncertainty surrounding when the Fed will stop raising interest rates has served as a big overhang on the stock market. Once the threat of additional interest rate hikes is lifted, the market should react positively, at least in the short run. There is plenty of debate as to how far the Fed will go, but after 13 straight hikes, the end cannot be too far off.

Foreigners Like Us Again

Sill aching from the pounding they took when the U.S. tech bubble burst in 2000, foreign purchasing of U.S. stocks has languished over the last few years. Instead, foreigners have been buying record amounts of U.S. dollar denominated debt (U.S. Treasury, Agency and corporate bonds).

However, data from the last few months indicate that a turnaround may be underway as net purchases of U.S. stocks by foreigners have started to show some signs of activity. If foreign buying resumes with any strength, that could provide the additional demand necessary to boost the U.S. market much higher.

Earnings Exceed Forecasts

Over the last two years, earnings have surprised us and have come up greater than expected. The same may hold true for 2006. Companies may find that the greater consumer income will enable companies to increase prices without impacting demand, thereby padding their top and bottom lines.

2006 Portfolio Strategies

Even though the market will likely enjoy an "end of Fed tightening rally" sometime during the year, providing a boost to stocks, I believe that such a rally may be relatively short-lived. By halting rate increases, the Fed's action will confirm that the economy is indeed slowing. Investors will then shift the focus of their concerns from the Fed to slowing corporate earnings growth, potentially even a recession.

Late in the Game

Playing it safe this late in the business cycle by underweighting U.S. equities and/or investing in defensive sectors makes sense. Should a pullback materialize this year, investors should buy stocks aggressively using cash positions. However, short-term market movements are hard to predict. So staying invested in stocks is warranted because there may be a rise before the fall.

Shifting To Higher Quality

Investors should also stay diversified with both U.S. and international (non-dollar denominated) equities as foreign stocks should continue to do well this year. However, investors should use strength in emerging markets as selling opportunities since those markets appear overheated and ready for a pullback. Large cap stocks should perform as well as riskier small caps in the year ahead so exposure to smaller companies should be contained.

Preparing for Lower Rates

Investors that are holding cash earmarked for fixed income investments should start buying short-duration U.S. government and high grade corporate bonds over the next several months. Once the Fed stops raising rates, they will consider lowering them soon thereafter, which will present holders of high quality bonds the ability to earn income and capital appreciation.

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