Capital Management, LLC

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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).

Market Forecast – Second Half 2006
Time to Go Shopping?

Here we are midway through 2006 and the U.S. stock market looks a lot like my wardrobe, boring and essentially unchanged from last year. While investors are growing tired of the market's same drab look, there are signs that a stock sale is approaching and a serious shopping spree may be in order for bargain-oriented investors. Unfortunately, we might have to wait until 2007 to reap the big payoff of any new purchases.

First Half Review

After coming out of the gates strong in the first quarter, the world's stock markets shuttered in the second quarter as fears of rising inflation and higher interest rates set off a chain reaction across the globe. The S&P 500 index sunk about 8% from its highs for the year, before making back some ground the last week or so of June. At the end of the quarter, the index stood at 1,270.20, leaving the widely followed benchmark 1.76% above where it finished 2005 (or a 2.7% return including dividends).

Small cap and international stocks continued to outperform U.S. large cap stocks in the first half. However, in the correction, small cap, international and emerging markets all took a real pounding as investors realized that these areas are not immune to risk. All these categories still ended up with decent gains in the first half.

Aside from a strong rally the last few days of the quarter, spurred by hopes that the Fed has finished raising interest rates, stock and bond investors left the first half of 2006 frustrated.

First Half 2006 Total Returns
(Including Dividends)

Index	2006 First Half Total Return (%)
S&P 500	2.71
Nasdaq	-4.06
Russell 2000 (Small Cap)	8.21
MSCI EAFE (International)	10.02
Emerging Markets	6.42
U.S. Bond Aggregate	-0.85

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I am not all that surprised by the U.S. market's skittish performance this year as my outlook (which I wrote in my January article), so far, seems to be fairly accurate:

"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."***

A Better Second Half?
With six months left in the year, a lot can and will happen. But, as I look forward, I still see more of the same and stand by my forecast for the year – plus or minus 5% from where we finished last year. **However, I now like the odds of the S&P 500 Index finishing the year on the upper end of my range, as a result of corporate earnings coming in a stronger than expected.**

Despite near-term enthusiasm that the Fed is about done raising interest rates, I expect that clear signs that the economy is slowing will keep a cap on the market in the months ahead. Furthermore, the uncertainty of upcoming mid-term congressional elections is just now starting to enter the picture. These factors will act to compress stock price to earnings (p/e) multiples further, and result in more volatility and potentially in a much deeper correction in between now and the end of October, the seasonally weakest months for the market.

At year-end, I see the S&P 500 index at roughly 1272, representing a 2.0% gain for the year (or almost a 4.0% total return including dividends), marking the 2nd consecutive year of low single digit total returns. On the surface, this is not much to get excited about; but the real story is what is potentially in store for 2007, as the stars may line up for a good bull run, particularly for the out of vogue larger U.S. stocks.

Looking for a Turnaround
With the economy still growing at a healthy pace, the job front on solid footing, and corporations flush with cash, why is the stock market so shaky? The threat of higher interest rates and the fear that inflation is spinning out of control are certainly weighing on the market. In addition, the prospects of a slowing economy and a potential shift of power in Washington in the upcoming elections are additional negative influences. The good news is that by the end of the year, many of these issues will clear up providing for some relief heading into 2007.

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Inflation Busters

Just a couple of years ago, the Fed was preoccupied with fighting off a potential bout of deflation as the economy was still grappling with the excess supply in the system courtesy of the 1990's boom. Now, the Fed has reversed course and is concerned about inflation picking up. In typical fashion, it turns out that the Fed either lowered interest rates too much (providing too much stimulus and easy money) or did not raise rates fast enough to slow the economy down, allowing inflationary pressures to build. Regardless, inflation stemming from higher commodity prices and a strong global economy has crept back into the monetary system and is now at the higher end of the Fed's level of acceptable. The question weighing on the market is just how far the Fed will push up interest rates going forward in their quest to keep inflation contained.

Historically, the stock market delivers good returns when inflation runs at a moderate pace, but stumbles when inflation runs too high. The market will need to see convincing evidence that today's higher rate of inflation is only temporary and not part of longer term trend. With the economy starting to slow, inflationary pressures are probably peaking now and should show signs of subsiding over the next 6-12 months. Potentially, late this year or early 2007, we should see relief from advancing commodity prices showing up in the Consumer Price Index and other key inflationary data metrics.

Interest Rates

Higher interest rates hurt stocks in two ways. First, discounting a company's future earnings, dividends, and cash flow back into today's dollars at a higher interest rate will result in a lower stock valuation. Secondly, higher interest rates make interest yielding cash savings vehicles (namely CD's and money market funds) and bonds more attractive.

After 17 straight interest rate increases that began in June 2004, the Fed Funds rate now stands at 5.25% (the Fed raised rates .25% on June 29th), up from 1% just 2 years ago. Money market funds and CD's yields tend to track fed funds over time. A 5% risk-free investment is looking pretty good compared to a directionless stock market.

The good news is that plenty of cash on the sidelines is a prerequisite to drive stock prices higher in the future since these funds will at some point return to stocks once they show signs of a sustained advance.

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Portfolio Positioning

A defensive posture has been warranted so far this year with investors holding more cash in their portfolios than is normally targeted. However, **investors need to start thinking about getting more aggressive over the course of the next several months, especially if the market correction has not fully played out.**

Mid-term election years have historically presented good stock buying opportunities. According to the *Stock Traders Almanac, "*most major corrections occur sometime in the first or second years following presidential elections. In the last eleven midterm election years, bear markets began or were in progress nine times." The reason to step up buying should this correction worsen is that "Since 1914, the Dow has gained 50% on average from its midterm election year low to its subsequent high in the following pre-election year," the Almanac points out.

Since some areas of the market are like old clothing styles in that they eventually make a comeback, it is important to reinvest profits from areas that have outperformed for a long period and put them into areas that have underperformed. In the case of large cap stocks, that might just be the case. In anticipation of a post-election rebound, I believe it is time to start overweighting large cap stocks in portfolios. There is no question that small cap stocks, emerging markets, commodities, and REITs have had investing public's attention for the last several years. All those groups' returns have corresponded to a favorable low interest rate/ high growth environment.

While analysts have been predicting the return of large caps for some time now, I think that we finally are on the verge of seeing a pendulum swing back in their favor. Sure, they are not growing as fast as they once did, but many of these blue chip stocks have not gone anywhere since the late '90's while their earnings advanced significantly (making their valuations very reasonable). I believe that this group may benefit from both earnings surprises to the upside and multiple expansion in 2007. As the economy continues to slow, more money will leave the more risky parts of the market and head towards the safety and dependability of large U.S. multinational companies. Of course, these stocks may get even cheaper should this correction deepen so **pace yourself and don't blow all your money** in one place when you go on this shopping spree!

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