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## *Financial Markets Commentary*

### *3<sup>rd</sup> Quarter 2005*

October 20, 2005

#### Summary

World stock markets rallied nicely during the third quarter on the belief that the Federal Reserve was close to ending its two year tightening campaign. Though this premise turned out to be wishful thinking, the market did not truly give up the idea until the first week of October. Greenspan himself gave no sign that he would back off; investors more or less talked themselves into it. Even when government reports consistently indicated that the previous rate hikes had not slowed the economy, the market seized on the destruction of Hurricane Katrina to insist that the Fed must at least pause. At it turned out, not even a gasoline price spike caused by a devastating hurricane could derail the current economic recovery.

When the economy does well, economically sensitive sectors like energy and raw materials tend to do very well. Energy was up almost 20% on the quarter. Interest rate sensitive areas like real estate, financial services, and bonds often struggle in this environment. While real estate (+3.3%) almost matched the Standard & Poors 500 (+3.6%), bonds actually declined modestly. There was a pronounced performance advantage for higher risk securities over lower risk securities last quarter. Again, that was based upon a presumption on an expected Fed policy that has turned out not to be true, as such the market gains in July and August have been largely given back in the first two weeks of October.

Last quarter was very good to international investors. A stronger U.S. economy means better growth all over the world. Even Japan saw a sharp rise in economic growth. The rise of the dollar this year has made foreign products more competitive. Japan rose 22%, emerging markets rose 17%, and Europe added about 9%.

A strong economy often pressures interest rates, and this quarter was no exception. Bonds don't do well under these conditions. High yield bonds got a little lift from the economy (enough to rise 1%), but the rest of the bond market (excepting emerging market debt) finished even or slightly lower on the quarter.

## Strategy

We did not believe that the Fed's tightening was over, so we did not adopt a more aggressive posture. Nevertheless, our returns again exceeded the benchmarks for their risk category. Emerging markets also provided a big lift to our more aggressive portfolios.

*(Please note that we have changed the Capital Strategies performance benchmarks, see the attached descriptions and explanation of our new benchmarks.)*

The economy is strong, and in the face of a real estate market that the Fed chairman clearly wants to cool down, interest rates aren't coming down anytime soon. In fact, if history is any guide, the Fed will ultimately tighten too much and some time next year we will be close to a recession. Therefore, we are going to be increasing cash positions in your portfolios (getting more defensive) in the coming weeks as the opportunities arise.

## Outlook

The stock market often falls into October, making a low point and then rallies through the end of the year. We certainly saw that in 2002 and 2004. Recent weakness suggests we might be near an intermediate term bottom. However, we are at the part of the economic cycle in which good returns are more difficult to achieve. Therefore, we are planning to use the market's seasonality bias to raise cash into strength. The rationale is explored in greater detail in the Commentary section.

## Commentary – If You Controlled the Market

If you controlled the market, you would probably decree that it should go up every day. But then everybody else would notice that the market went up every day and they would put all their money in it and everybody would get rich and then, since everyone was rich, a cup of coffee would cost \$100 and in a sense nobody would be rich. That is somewhat facetious, but the point is, the market cannot go up every day. There are, however, more and less favorable conditions in which to invest.

Suppose you can't control the market, but you can control interest rates and valuation. You would want interest rates to fall, because that makes a dollar of future earnings worth more. So you would set interest rates high at the beginning such that there was room for them to fall steadily for a long time. You would set stock valuations low, so there would be a lot of room for P/E multiples to expand. This was the scenario back in 1982. Over the next 17 years, stocks averaged in excess of 17% per annum. Unfortunately, a long period of falling interest rates and above average returns produced an environment where interest rates were low and valuations were very high. Such was the case in 2000. Since then, stocks have averaged -0.5% per year.

**It would be nice to report that today's conditions are more similar to those of 1982 than 2000, but sadly that is not the case. Interest rates may have entered a multi-year rising period. Valuations may be in a long process of moderating as investors react to rising inflation by preferring tangible assets like real estate and commodities. If so, there will still be attractive periods to invest in stocks and bonds but they will be shorter and the magnitude of the gains will be much less than they were from 1982 through 1999. Periods where the Federal Reserve is aggressively trying to bring inflation under control have been especially difficult for stocks historically. That is where we are now, so we have to act accordingly.**

**If we controlled the market, we could take all of our money out of the market, push stock prices way down, then buy back at the bottom. Since we don't, we have to work in concert with the market's own growth and fallow periods. Ultimately, we are working toward a much more attractive environment for financial assets. Already money market yields have improved from less than 1% to almost 4%. Dividends on stocks have been rising faster than at any time in the past fifteen years. It will require patience on our part and yours as well to allow the market to give us the opportunity to make really attractive investments once again.**

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