

Financial Markets Commentary

3rd Quarter 2006

Summary

November 2, 2006

The third quarter of 2006 turned out a lot better than we expected, given what we knew three months ago. World stock markets had been quite weak from the middle of May to the middle of July, and we were concerned that they would remain that way all summer. Market strategists had begun to use the word “stagflation”, which made investors nervous. Stagflation is the term for when economic growth slows yet inflation continues to rise; it is generally not a good environment for stocks (or bonds). Fortunately, from the middle of July just about everything started going right. First there was the cease fire in Lebanon, which took some of the pressure off oil prices. Then the Federal Reserve ended their interest rate tightening campaign. With a downturn in the housing market prices of raw materials (lumber, gypsum, copper, etc.) began to decline. By Labor Day it became clear that America was not going to have much of a hurricane season in 2006. All of these factors helped investors come to the consensus that the economy did not have a stagflation problem. This run of good news has emboldened investors to be buyers at what are traditionally the worst months of the year (September and October).

While investors found renewed interest in stocks last quarter, their purchases were predominantly of larger, dividend-paying companies. Utilities and consumer staples, two of the most defensive sectors, were among the best performers. Smaller, more economically sensitive companies did not do particularly well. With oil going from \$76 per barrel to \$62, it is no surprise that natural resources was the worst sector to have been invested in during the quarter. For the quarter, the average U.S. stock fund gained a little less than 2%. The largest companies did the best gaining more than 5% on average, with mid-capitalization funds gained about 1% and small company funds posting a modest decline overall. You would have to go back to 1998 to find a quarter where large companies out-performed by this much.

International stocks gained more than domestic stocks once again, but the margin of victory was the smallest in several quarters. Every region of the world gained except Japan. Emerging markets continued their rebound from a sharp sell-off in May but they did not do as well as Europe. The preference for larger over smaller also held true in overseas markets. Remember that companies in emerging markets are not necessarily small; Samsung (South Korea), Infosys (India), and Petrobras (Brazil) and among the largest global companies.

Perhaps the biggest surprise last quarter was the strong performance of the bond market. Bond investors were optimistic at the beginning of the quarter that the Fed would stop raising rates. Not only did that happen, but energy prices came way down and the housing slump deepened. All of this is positive for most bonds, since they imply less inflationary pressure. The average bond rose 3.8% last quarter, more than bonds had returned in the previous six quarter combined! Long term Treasuries had a total return (yield plus appreciation) of more than 5%. Mortgage and high yield bonds gained 3% and short term bonds were up 2%. Money market yields were higher than those of most bonds, but because they do not rise in price when interest rates fall they returned just 1.1% on average.

Strategy

Our strategy did not change last quarter. We've been modestly defensive for some time, on the belief that we are experiencing just a relief rally and not the beginning of a new bull market. Our cash levels have remained above average. We don't expect to raise our stock weighting until after market prices reflect the cyclical slowdown in the economy and the distress in the housing market.

Outlook

As long as investors believe that the good news is somewhat temporary, they will continue to prefer larger, more stable sectors of the market. Risk adverse behavior after a three year period of rising stock prices is typically not a good sign. If the stock market were ready to make a major advance, we should see technology and financial services become market leaders. We have seen a little of that in recent days, but we tend to view it as a false signal, much like a 50 degree day in Minnesota in February. Like the weather, there is cyclicity to the economy. We have not seen nearly enough "Winter" to convince us that Spring is at hand.

Commentary - How We Add Value

Opportunities to significantly out-perform the stock market do not come around all that often. The conditions that enable large excess returns involve sizable mispricing of risk. In other words, investors become excessively greedy or fearful. Most of the time investor sentiment is mixed, so markets only move to very minor peaks or valleys. At these times, managers can only hope to deliver modest extra return. There are two ways we can add value, either by under- or over-weighting an asset class or by superior individual security selection.

The asset class approach, otherwise know as "top-down" investing, is usually derived from a broad theme. For instance, a popular theme right now is the bursting of the housing bubble. Housing prices enjoyed a decade-long period of far above average performance through 2005.

Largely because of strong housing-related activity our economy was strong enough to withstand severe headwinds in the form of a technology meltdown and the 9-11 attacks. If housing prices decline over the next several years such that they return to their long term trend line, this might lead to an economic recession. If one believes this scenario, then excess return could be generated through the under-weighting of asset classes and sectors that depend on a robust housing market (think stocks, especially building materials, retail, and lending companies) and the over-weighting of securities that benefit from reduced economic activity (government bonds, media and health stocks).

The security selection or “bottom up” approach is concerned with finding better bonds, stocks, or mutual funds. No matter what the economy or overall market is doing, a certain amount of excess return can be generated if one can successfully identify the best stocks in a given industry, the best fund manager in a given market subset (such as mid-cap growth stocks), or a combination of fund managers that as a whole can add more return relative to the market than the risks they take.

At Capital Strategies, we attempt to employ both methods. Security selection is an ongoing area of attention. We always strive to better our results in this area, and it accounts for well over half of the exchanges we make. We utilize the top-down approach less often, because there are fewer times when it is clear that the market is under- or over-weighting the likelihood of a particular economic scenario unfolding. However, when you catch one of these macro-economic themes right, the payoff can be very large.

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