



STRATEGIC FINANCIAL  
MANAGEMENT GROUP



## Investment Strategies & Insights

### “To Do No Harm”

One of the primary tenets of the Hippocratic oath, sworn by physicians, is “to do no harm”. This same principle is at the heart of our philosophy on managing portfolios... to minimize the potential for loss when the risks appear greater than the potential for gain. There are times, over the short-term, when this strategy will put you on the wrong side of an upward move in the markets...which is precisely what happened this last quarter.

At the end of the second quarter, there were several psychological barriers that were causing a downturn in stock prices, ranging from uncertainty over Federal Reserve policy to high oil prices to a sharp decline in the housing market to geopolitical conflict between Israel and Hezbollah. Based upon these factors, we made changes in the portfolios to become more defensive until stocks regained an upward momentum that appeared to be sustainable.

As stocks began to rally from their July lows, there remained some factors that caused concern about the true strength of the market’s move. The first was the below average trading volume...an indication that the majority of investors were still on the sideline watching for signs of a broad market rally. Unfortunately, this was the next factor that caused hesitation...the fact that the number of stocks going up in price was limited to a small number of large companies. Even though the large stock indexes, the Dow 30 and the S&P 500, were rising, the vast majority of stocks on the exchanges were not experiencing the same good fortune.

It was only after Labor Day that the volume increased and the broader participation of stocks of all market segments took place. It was at that point that our investment disciplines signaled that there was true strength in the rally and we increased our stock positions at that time. This stage of the economic and market cycle is often the most difficult to interpret due to the increasing number of mixed signals and seemingly contradictory information.

### The Ingredients of Sustainability

The financial markets need certain ingredients in order to sustain their momentum. These components can vary depending upon where we are in the cycle, but there are several factors that always seem to be in the back of investor’s minds...earnings... interest rates...and inflation. There are many subsets of these big three, but for many they are the filter through which decisions are made.

The catalysts that brought us a new high for the Dow 30 were falling oil prices and lower interest rates. Our economy, and corporate profits, are heavily dependent upon consumer spending. Lower interest rates are seen as a stabilizing force in the residential real estate market and lower energy costs increase the spendable income of most Americans. With the Fed no longer increasing short-term interest rates, it sends a signal that inflation is not a significant worry at the present. If the consumer’s ability to spend has been buoyed, the housing market negotiates a soft landing, and inflation worries are easing...then the sustainability of economic growth and higher stock prices could be in the cards for the near future.

**3rd Quarter 2006**

**“Better a thousand  
times careful than  
once dead.”**

**Proverb**

### SUMMARY:

Falling interest rates and lower oil prices fuel recent rally in stocks.

Housing market is cooling rapidly and concerns for a hard landing remain.

Support for housing could come from recent move of mortgage rates lower.

Lower energy costs have resulted in an upturn in consumer spending.

Both the economy and financial markets are sending mixed signals as a transition phase has begun.

The question that remains is how long the up cycle will extend as the impact of globalization is measured.

*Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.*



## Inside the Economy

### Inflation and Interest Rates

- Inflation remains below 4% (year over year) but should move higher due to very low inflation in the 4<sup>th</sup> quarter of 2005...a statistical anomaly.
- However, lower energy prices, slower job growth, and lower prices paid at the wholesale level, should help keep real inflation low in the near-term.
- The Federal Reserve has shifted its interest rate policy to neutral, keeping the Fed Funds rate at 5.25%.
- The 10 year Treasury bond rate has fallen to 4.7% and mortgage rates have been declining as well.

### Economic Output and Direction

- The output of the U.S. economy (GDP) for the 2<sup>nd</sup> quarter was revised downward to a 2.6% growth rate.
- Additional signs point to continued slowing in the last half of the year with the leading economic indicators declining in four of the last five months.
- Even though unemployment is low at 4.6%, new job growth is slowing, reducing concerns about inflation coming from higher wages.
- Increased new orders is encouraging, especially when coupled with lower prices paid at the wholesale level.

### Business and Consumer Indicators

- Both the service and manufacturing sectors of our economy are showing signs of slowing, but the overall outlook is still positive.
- In August, it appeared that the consumer was dead...but in October you can hear cries of "long live the consumer".
- Retail sales are up 7% over last year as lower gas prices and interest rates are helping spending.
- The prices on imported goods are not inflating and the incentives on big ticket items remain.
- With the decline in the residential real estate market, the uncertainty as to the ultimate outcome is the biggest obstacle to continued economic growth.
- Much more data is needed to evaluate whether the outcome for the housing market will be a hard or a soft landing.

## Inside the Markets

### The Stock Markets

- The number of stocks making new highs is a good sign of the internal strength of a market advance.
- With great fanfare the Dow 30 has reached a new all-time high, but the number of stocks making new highs on the New York Stock Exchange (NYSE) has just recently crept into positive territory.
- As the economy shows signs of beginning to slow, investors have begun the transition to larger stocks, perceived to be safer.
- Large company stocks (S&P 500) were up +5.1% for the quarter, while small company stocks (S&P 600) were down -1.1% ...evidence of the shift.
- Earnings momentum remains healthy with 63% of companies reporting earnings higher than the same quarter a year ago.
- The length of time that certain sectors of the market do better than the broad market is declining, with the leaders becoming the laggards every two months.
- This type of leadership rotation makes it difficult to determine longer-term market direction.

### The Bond Markets

- The direction of interest rates on longer-term bonds took a decisive turn downward in the 3<sup>rd</sup> quarter.
- The bond market appears to believe that the Fed's tightening cycle is over...the economy is slowing significantly...and inflation is being tamed.
- All three of these views are subject to debate and the continued decline in interest rates may be a bit premature.
- The likely scenario is that interest rates will remain within a fairly narrow range unless a significant event drives them higher (spike in inflation) or lower (housing market collapse).

### Commodities

- Commodity prices took a tumble in the 3<sup>rd</sup> quarter, led by a sharp decline in oil prices.
- Continued declines would require that global demand slow significantly.
- If OPEC cuts production to stabilize oil prices and China and India maintain their growth pattern, prices could return to their upward trend.



One of the underlying principles of both the economy and the financial markets is that they are cyclical. Economics, at its core, is about gathering a variety of information about the financial interactions of people and measuring the impact of changing incentives on their behavior. It is the reaction to these incentives that causes the cycles to move up or down.

There is often a reliance on the historical patterns of these cycles to determine where we are and how much further we have to go before the cycle changes. Based upon that approach, we could determine that the average economic expansion has lasted 4.9 years, or 19.4 quarters. We have just completed the 20<sup>th</sup> quarter in the current expansion, measured from the 3<sup>rd</sup> quarter of 2001 low point. If the “dismal science” was that easy, and accurate, then it would be clear that we are in the last stages of this economic cycle and we could predict the market’s response to that data.

We do not believe it is prudent to rely on this approach since the shortest cycle was 5 quarters and the longest was 40 quarters... a difference of almost nine years. To explain these differences, we must understand that the dynamics impacting the domestic and global economies can change radically at times. Many believe that we are in a much longer wave of the cycle, due to global competition and technology, and that we are now experiencing a mid-cycle slowdown.

We fully understand that efforts invested in attempting to predict the future could be much better spent elsewhere. We examine both the economic and market data and look for confirming trends, as well as conflicting information, to set our investment strategies by the intermediate term trends that surface. There are times, like now, when this is much more challenging since the data is not consistent...but the changes are too modest in both magnitude and duration to alter our outlook at present.

It has become apparent that both the stock and bond markets are currently signaling the expectation that the economy...and more specifically the housing market... are going to experience a “soft landing”. This outcome would be accompanied by lower inflation, a stable interest rate environment, and moderate economic growth that could be sustained as we continue to “muddle” through in this long wave of global expansion.

We believe that there are too many mixed signals coming from the economic data to feel with great certainty that

this most favorable of outcomes is for sure. However, we also know that the process of completing the transition to a new long-term trend can take months, and sometimes years.

We will always be guided by the philosophy of protecting capital, even though we occasionally sacrifice short-term returns. As a result, we think that allowing the momentum of the markets to dictate our strategies is the best approach in order for us to reach our investment objectives of capturing market returns when the risks are deemed acceptable.

Best regards,

*Strategic Financial Management Group*

### **Investment Strategies & Insights**

is written by the scribes at Strategic Financial Management Group.

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