MV Financial Group E-Update

Realignments on the Horizon
March 16, 2006

March and October are two months in the calendar year when many investors hold their breath going in and breathe a sigh of relief when they make it through with no major negative outcomes – witness the Dow Jones in October of 1987 and 1989 and the NASDAQ collapse that began after it reached its high of 5132 in March of 2000. So far, March 2006 looks much more like a lamb than a lion. The broader equity market indices are up strongly on the year, with the Dow Jones Industrial Average showing a 4.05% YTD gain through March 14, the S&P 500 Index up 3.94% and brushing the 1300 level, and the NASDAQ 4.11% higher.

In fact, we are seeing continued signs of global economic resilience. The Bank of Japan's announcement on March 9 that it was ending six years of super-easy monetary policy was a signal that the world's second-largest economy has emerged out of a 15 year slump. The BOJ, US Fed and European Central Bank are now all maintaining policies premised on the continuation of low-inflation growth. This may give investors short term jitters in wondering how high rates will go, but with the Fed likely to cap its rate hikes within the first half of this year it is more likely that the prospect of sustained real global economic growth will be a net benefit to the markets.

If this is not a March to beware, it is perhaps one for which to be aware – aware, that is, of signals that point to potential realignments in long-standing market trends. A good place to start would be real estate. We find it significant that 30-year mortgage rates currently average around 6.37% nationwide as compared to 5.58% in the summer of 2005, according to data from mortgage lender National City Corp. The increased cost of financing real estate investment, along with the perception that record-breaking housing price increases are coming to an end, is likely to divert capital out of real estate into other asset classes.

This has not yet been reflected in the securities markets. The Dow Jones Wilshire REIT index (full-cap) has gained 12.09% year-to-date as of the close March 13, more than three times the gain on the S&P 500. Will this asset class be to 2006 what the tech sector was to 2000 – an overreaching comet roaring into March but headed shortly for a fall? Perhaps not in such a dramatic fashion, but we think this would be a good time to rebalance away from real estate and lock in the gains achieved to date.

Another trend that we believe is due for a change is the relative performance of large cap and small cap equities. The Russell 2000 index of small cap stocks has earned an average annual return of 9.35% for the period January 1999 through month-end February 2006, as compared to 2.72% for the large cap Russell 1000 index. Highly capitalized US stocks with large net cash balances have been trading at a discount to their fundamental values for some time. Our current asset class allocations reflect expectations of a shift from small to large caps in general and in particular to mega-cap, cash-rich stocks.

The bond market is having a tough time of it so far this year. We have noted in recent past e-updates the unusual flat to inverted shape of the yield curve since last November. In economic cycles of yore this was a frequent indicator of an impending recession. With global growth robust as noted above, recession is not a likely scenario in 2006, and in fact the yield curve has been slowly realigning to a more normal upward slope since early March. This means that medium- and long-term bond prices (which move inversely to yields) are decreasing, putting downward pressure on fixed income portfolios. Our recommendation for fixed income is to stay mostly in the short-term market and avoid getting locked into potentially vulnerable long-term positions.

While it would not be true to say that all trends reverse themselves, the investment markets do consistently exhibit the characteristics of mean reversion – so that strong movements in one direction in the short term tend to revert over time to their long term averages. Every boom market has its chorus of cheerleaders saying "this time it's different". Our view, however, has always been to beware short-term greed and maintain long-term discipline. Rebalancing to sell winners and buy losers may sound counterintuitive, but it is a fundamentally important part of our disciplined strategy. It is the right thing to do for our clients and it helps us avoid the sleepless October and March nights that the short-term market timers experience.

With warm personal regards,

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