MV Capital Management E-Update

Pausing in the Corridor
August 12, 2006

The Fed took a pause from – or perhaps even brought to an end – the longest sustained rate increase campaign since data on the Fed funds rate started being recorded in 1954. Meanwhile the stock market continues to drift through the dog days of August in the narrow corridor where it has been most of the time since late last year. Investors for the most part appear to have concentrated their strategic decisions on whether to opt for the beach, the mountains, the golf course or the vineyards.

One thing that most observers can agree on is that there isn't much out there to agree on. Ultimately the Fed's policy comes down to two things – economic growth and inflation. Fed chairman Bernanke, in leading the 9-1 vote on August 8 to keep rates at the present 5.25%, signaled his belief that while some inflationary pressures persist, they will most likely be held in check by moderating growth. How much inflation? How much slowdown?

The problem is that while signs of slowing growth abound, from the housing market to sluggish employment and a decrease in business equipment spending, there are plenty of other signs that inflation may not be going away all that readily. Wage and benefit costs per unit of output, which have been remarkably subdued for a long time, grew at 4.2% in the second quarter while productivity – output per hour worked in the nonfarm business sector – slowed to a 1.1% annual rate during the same period.

Wages tend to be "stickier" than other inflation components, and if they put upward pressure on the CPI while growth continues to slow then we are flirting with one of the less pleasant memories of the 1970s – stagflation. Mr. Bernanke is betting on an absence of factors that would take us back to the days of pet rocks and roller disco. If he is right then we could reasonably expect a soft landing for the economy and generally positive prognosis for the market. The bond market seems to concur with this outlook – the yield curve exhibits no signs of inflationary panic bidding up rates at the long end. The data, however, are uncertain.

This uncertainty is likely to leave the equity markets hanging out in that corridor where they have been for so long, at least in the very near term. The difference between 1250 and 1300 is a bit under 4%. That's where the S&P 500 has been meandering since November of last year with the exception of a brief upward breakout in the late 1st quarter of this year and a couple pushes through the downside during the recent May-June correction. And while the market has been essentially directionless it has not been calm – volatility since May is up from levels seen earlier this year, though still not as high as longer term historical averages.

As we head into the fall the question will return: what has and has not been priced into the market's current levels? Sadly, we think the heartbreaking troubles that persist in the hotspots of the Middle East have been factored in already – for reasons that are all too grounded in experience and reality, investors don't expect to see much good news there in the near term. We dream of the day when hope will triumph over experience, prove them wrong and let the people of that troubled part of the world have the peace and happiness they so deserve.

One potential X-factor is the outcome of US midterm elections. If the Democrats regain power over one or both houses of Congress it will throw into question the political agenda for the remaining two years of the Bush Administration. Unfortunately, all of the political analysis and bloviating punditry that we will be served up over the next two months will likely not tell us much

about what voters are ultimately going to decide to do on November 7. Prognosticating based on how the market performed during prior midterm seasons is an essentially useless exercise (answer: sometimes it was up, sometimes it was down). Elections may serve as yet one more reason for investors to stay cautious, which could prolong the sideways corridor market and keep a momentum trend from developing one way or the other.

What to do? In the equity markets, we are reaffirming the view we have expressed in prior e-updates that cash-rich mega caps are a good place to be for our core strategy, both because of their continuing attractive fundamentals versus price and because large and strong is a good place to be when times are uncertain. There may be some tactical benefits derived from taking on a certain amount of additional exposure to defensive sectors such as consumer staples and healthcare, though we do not think this is the right time for large concentrated bets.

In the bond markets we do not think the flat yield curve will last forever, in fact, quite the opposite, that it will readjust upwards on the long end over the coming months, an argument in favor of extending the average duration of our bond portfolios. How fast or by how much long rates go up depends greatly on that inflation enigma we talked about earlier. We think there is a reasonable case to make for conditions being right in the early part of next year for Fed rate decreases, and longer-duration bond portfolios would be in a good position to benefit from this.

However we think that the smartest thing anyone could do in this current market is to live by the mantra that past performance is no guarantee of…well, anything. Broader market performance so far this decade has not been conforming to longer-term historical trends. We think the rationale for a disciplined strategy anchored by intelligent asset allocation is even stronger than usual, and we think this is the best way for us to put our clients in the position to win.

With warm personal regards,

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MVCM 2006 0006
DOFU: August 2006

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