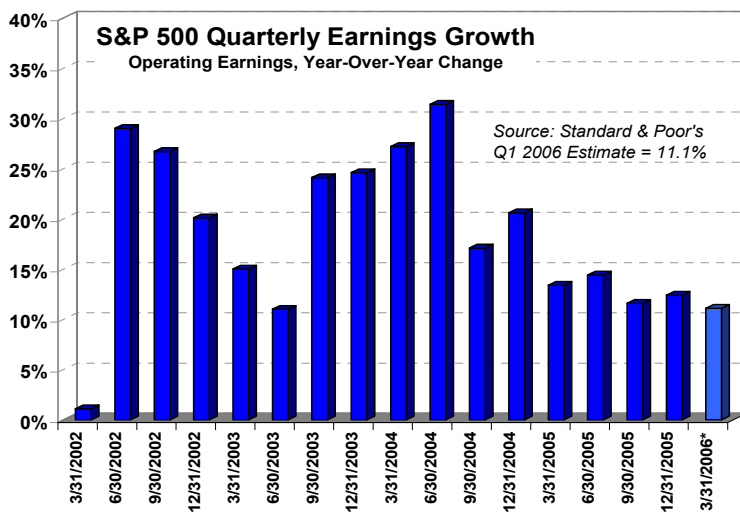


By Ian Fraley

S&P 500 1,301.61 NASDAQ 2,315.58 DJIA 11,250.11

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The many positives for equities that caused us to switch from the defensive stance we had maintained throughout the 2000-02 bear market to the resolutely bullish bias we have stayed with since early 2003 are largely intact, and we continue to anticipate solid gains for stocks in 2006. The year is certainly off to a good start; with three trading days left until the end of March, the S&P 500 is up 4.3% YTD, its best first-quarter showing since 1999 (+4.7%).



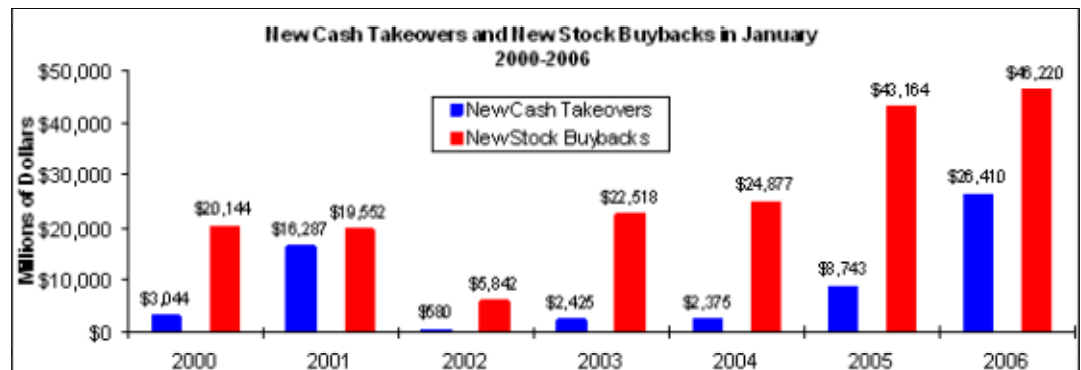
The most important of the positive fundamental trends supporting the equity bull market remain in place, not the least of which are low long-term interest rates and strong profits. The 10-year Treasury note continues to confound the experts by refusing to rise above 5% (something even we had expected to see by now), while corporate earnings have expanded at a remarkably robust rate – the *fifteen* consecutive quarters of double-digit S&P 500 profit growth through year-end 2005 set a new record, with an average quarterly increase of nearly 20%.

Such consistent earnings growth in a benign interest-rate environment has made equities increasingly inexpensive relative to fixed-income alternatives, while at the same time preserving the highly favorable borrowing conditions that have fueled a staggering increase in acquisitions, mergers, and buybacks – January alone saw a whopping \$26.4 billion in new cash takeovers and \$46.2 billion

in new stock buybacks, exceeding the monthly averages of \$21.5 billion in cash takeovers and \$38.1 billion in stock buybacks in 2005 (a record year for corporate buying). The amount of stock being removed from the market by the surging M&A/buyback wave has dwarfed the creation of new shares via IPOs and secondaries, resulting in a reduction of supply that may be without precedent. It is impossible to overstate the bullish implications of this trend.

Meanwhile, investors continue to add bricks to the proverbial “wall of worry” that stock prices love to climb. The bull market began in early 2003 amidst the uncertainty of an impending war, widespread anxiety about an economy that many believed was slipping back into recession, and fears that the U.S. might be facing the onset of Japan-style deflation. *But despite the rampant pessimism of '03, the S&P 500 returned 28.7%.* In 2004, the worrying shifted from a faltering economy to one that might be overheating, and from the possibility of deflation to concern that the Federal Reserve had “fallen behind the curve” by not paying enough attention rising commodity prices as a harbinger of inflation. *Nonetheless, the S&P 500 returned 10.9% in '04.* 2005 began with the nearly unanimous fear that the dollar would fall sharply, if not collapse (it actually rose against most currencies), and investor angst continued to grow throughout the year in the face of soaring gas prices, deadly terrorist bombings, a “housing bubble,” and, of course, the terrible aftermath of Hurricanes Katrina and Rita. *Yet the S&P 500 returned 4.9% in '05.* So far this year, rising tensions surrounding Iran’s nuclear ambitions and fears of a bird flu pandemic have battled for the top spot on the list of things that could slam the economy and the stock market, though real estate, oil prices, the dollar, and plenty of other well-worn worries have yet to lose their power to cause distress. *And still the stock market has managed to make new recovery highs.*

(continued on page 3)



Source: TrimTabs

## Economic Briefing

- **GDP** for the fourth quarter of 2005 was revised upward to show a 1.6% growth rate from the originally reported 1.1%.
- **New Home Sales** slid 10.5% in February after a revised 5.3% drop in January, the largest one-month decline in almost nine years as inventories spiked sharply higher. The weak data conflicted with February **Existing-Home Sales**, which jumped to a 6.91 million annual rate, well above the expected 6.50 million annual rate (but the third consecutive month below the 7 million-plus rate that was maintained from April through November 2005). February **Housing Starts** dropped 8% from January's strong level.
- **Philadelphia Fed** index of regional manufacturing fell to 12.3 in March from February's reading of 15.4, which had been the highest since August of last year. The **NY Empire State** index rose to an extremely strong 31.2 in March from 21.0 in February.
- **Core PPI** (excludes food & energy) jumped 0.3% in February, well above the expected 0.1%. This reading followed a 0.4% increase in January, raising concerns about inflationary pressures building in industrial prices. **Total PPI** fell 1.4% due to a 4.7% decline in energy and a 2.7% drop in food prices. **Core CPI** was up just 0.1% in February, below the expected 0.2% level; the year-over-year increase held steady at 2.1%.
- **Nonfarm Payrolls** were up a very solid 243,000 in February, while January's gain was revised downward to 170,000 from an originally reported 193,000 increase. The net change overall was slightly ahead of estimates. **Average Hourly Earnings** were up 0.3%, in-line with estimates, following two consecutive 0.4% increases that had raised inflation concerns. The **Unemployment Rate** ticked up to 4.8% from January's five-year low of 4.7%.
- **Retail Sales** were off 1.3% in February; excluding autos, sales fell 0.4%. Economists had expected declines of 0.9% and 0.5% respectively.
- **Industrial Production** increased 0.7% in February after a decrease of 0.3% in January. **Capacity Utilization** for total industry rose from 80.8% in January to 81.2% in February, slightly above the 1972-2005 average of 81.0%.
- **Durable Goods Orders** rose a stronger-than-expected 2.6% in February, up from a revised 8.9% plunge a month earlier. Excluding the volatile transportation category, orders were up 1.3% following gains of 1.6% in January and 1.9% in December.
- **ISM Manufacturing Index** was 56.7 in February, up from 54.8 in January and a bit stronger than the median forecast of 55.5, reflecting continued decent growth in the manufacturing sector. The index has remained above 50 since June of 2003.

## Market Indicators

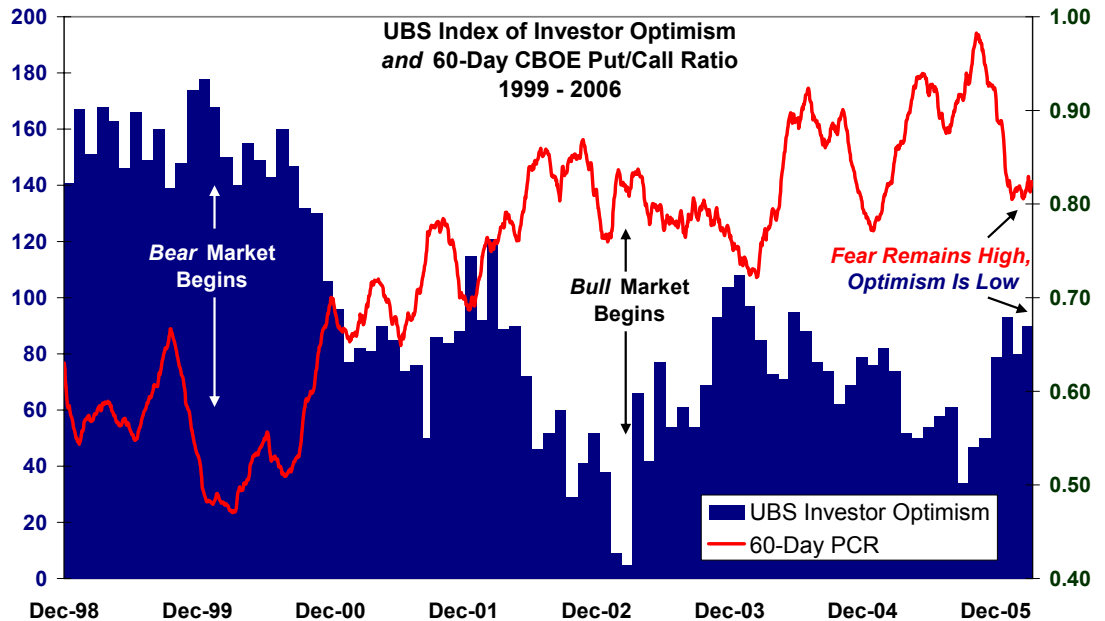
	Current Reading	Level/Trend	
<b>Earnings Yield Spread</b>	1.66	5	↓
<i>Calculated by dividing estimated forward 12-month S&amp;P 500 operating earnings by the price of the index and comparing the resulting earnings yield (E/P) to the 10-year Treasury note yield. We consider readings above 1.0 "very bullish" (5), between 0.0% and 1.0% "bullish" (4), between -1.5% and 0.0% "neutral" (3), between -1.5% and -2.5% "bearish" (2), and below -2.5% "very bearish" (1).</i>			
<b>Yield Curve Ratio</b>	1.01	2	↓
<i>Calculated by dividing the 10-year Treasury bond yield by the 3-month Treasury bill yield. We consider any reading above 2.5 "very bullish" (5), between 1.5 and 2.5 "bullish" (4), between 1.25 and 1.5 "neutral" (3), between 1.0 and 1.25 "bearish" (2), and below 1.0 (i.e., an inverted yield curve) "very bearish" (1).</i>			
<b>60-Day Put/Call Ratio</b>	0.82	4	↑
<i>The 60-day moving average of total put volume divided by call volume on the CBOE. We consider any reading of 0.85 or higher "very bullish" (5), between 0.75 and 0.85 "bullish" (4), between 0.60 and 0.75 "neutral" (3), between 0.50 and 0.60 "bearish" (2), and 0.50 or lower "very bearish" (1).</i>			
<b>Nasdaq Short Interest Ratio</b>	2.68	4	↓
<i>The number of trading days at 12-month average daily volume required to cover total shares sold short on the Nasdaq (data are seasonally normalized). We consider any reading above 2.8 "very bullish" (5), between 2.5 and 2.8 "bullish" (4), between 2.0 and 2.5 "neutral" (3), between 1.7 and 2.0 "bearish" (2), and below 1.7 "very bearish" (1).</i>			
<b>8-Week Insider Sell/Buy Ratio</b>	5.09	1	↓
<i>The 8-week average of total shares sold by insiders of companies traded on the NYSE, AMEX, and NASDAQ exchanges divided by total shares purchased by insiders. We consider any reading below 1.0 "very bullish" (5), between 1.0 and 2.0 "bullish" (4), between 2.0 and 3.0 "neutral" (3), between 3.0 and 5.0 "bearish" (2), and above 5.0 "very bearish" (1).</i>			
<b>UBS Index of Investor Optimism</b>	79	3	↑
<i>A monthly survey of approximately 800 randomly selected U.S. investors with total savings and investments of \$10,000 or more. We consider any reading below 30 "very bullish" (5), between 30 and 70 "bullish" (4), between 70 and 110 "neutral" (3), between 110 and 160 "bearish" (2), and above 160 "very bearish" (1).</i>			
<b>PULSE Panic/Euphoria Model</b>	-0.28	4	↓
<i>A composite measure of investor sentiment developed by Tobias Levkovich which includes margin debt balances, daily Nasdaq volume as a percentage of NYSE volume, retail money-market fund balances, the short-interest ratio between public investors and NYSE member firms, and several other indicators. We consider any reading below -0.3 "very bullish" (5), between -0.3 and 0 "bullish" (4), between 0 and 0.3 "neutral" (3), between 0.3 and 0.6 "bearish" (2), and above 0.6 "very bearish" (1).</i>			
<b>Bottom Line:</b> Although far from bearish in aggregate, our key market indicators do not support the use of leverage at this time. The earnings yield spread is the only indicator that remains in "very bullish" territory, and we view this as a longer-term predictor of stock prices. Of particular concern in the more immediate future is the bearish trend of insider transactions, though this may be explained in part by stock options finally coming into the money after years of being underwater.			

Sir John Templeton once remarked that bull markets are born in pessimism, grow on skepticism, mature on optimism, and die of euphoria. Although the overwhelming pessimism that marked the end of the three-year bear market in late 2002 has given way to a degree of cautious optimism, there is plenty of skepticism about the long-term prospects of the U.S. economy and stock market, and scant evidence of anything bearing even a passing resemblance to euphoria. *Far from it.* The CBOE 60-day put/call ratio (a measure of fear in the market) remains at a very high level, while the latest reading of the UBS/Gallup Index of Investor Optimism stands at less than half the level seen at the 2000 market top. We find it almost impossible to envision a bear market starting amidst such dour sentiment.

That said, our optimistic outlook must be weighed against some growing risks. In the very near term, investors should be cognizant of the fact that the S&P 500 has managed to climb for three years without having seen a "normal" bull-market correction of somewhere between 10% and 20%. Such an event is a matter of *when*, not *if*.

Looking further out, we are becoming increasingly concerned about the protectionist rhetoric coming out of Washington. In the wake of their success stopping the Dubai ports deal, lawmakers are moving to increase Congressional control over foreign direct investment in the United States. Meanwhile, a vote is scheduled for this Friday on one of the most far-reaching tariff bills in recent U.S. history – legislation that would give China two years to significantly revalue its currency or face 27.5% tariffs on all Chinese exports. These and other threats to trade and investment could be disastrous for the global economy, and we will be watching this disconcerting trend very closely going forward.

Another risk is the possibility that the 2003 capital gains and dividend tax cuts will not be extended by the Senate before



they expire in 2008. With President Bush's approval ratings at levels rivaling some of the worst ever seen in the annals of presidential polling, and with many Republican lawmakers distancing themselves from the White House in the run-up to the midterm elections, stocks may begin to discount the likelihood of the de facto tax hike that will result from inaction on this matter. (Regardless of one's political preference, it is important to keep in mind that any development that might result in wealth redistribution creates uncertainty and increases loss aversion, and is thus a negative for stocks.)

Other potentially bearish developments that cannot be ruled out include a rapid increase in long-term rates – something that would materially impact equity valuations and might signal a serious inflation problem down the road. Conversely (though less likely in our view), central bankers might overdo recent efforts to tighten monetary policy, causing yield curves to invert significantly – almost always a precursor to recession.

Taking everything into consideration, however, we must emphasize that the fundamental drivers of the bull market appear more than strong enough to offset these risks for at least the balance of the year. Valuations remain attractive, mergers, acquisitions, and buybacks continue to boom, the overall economic picture is constructive, and sentiment is nowhere near problematic. *Stay fully invested.*

**Ian Fraley** CHIEF EXECUTIVE OFFICER  
ian@financiacapital.com

**Stephen Brennan** CHIEF INVESTMENT OFFICER  
steve@financiacapital.com

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