

Commentary

by Ian Fraley

Report Card 2005

In early January, we predicted that the U.S. dollar would “move higher against the euro and other major currencies during the next twelve months.”¹

Few shared our bullishness on the greenback. As the *Financial Times* reported at the end of 2004, “This is one of the rare times that the currency markets and most academic economists speak with one voice. The pressure on the dollar is downward.”² In fact, some of the most pessimistic dollar bears were among the investment world’s most prominent names. “The dollar is going down,” declared influential bond fund manager Bill Gross. “You

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Executive Summary

How did we do in 2005? Our major bullish call on the dollar in January was possibly the most timely of any forecaster, and our July warning that long-term rates were heading higher looks good so far. But though U.S. indices are up this year, as we predicted, the gains have not met our expectations. Also, our advice to reduce foreign equities in favor of U.S. stocks was premature in spite of our correct view on currencies (many global markets are showing better YTD gains than U.S. indices even in dollar terms). Finally, our top sector pick, technology, performed no better than the overall market, and we missed the best categories (energy & utilities).

Notwithstanding a mixed record in 2005, we believe that tech will continue to deliver the strong performance it has demonstrated in recent months. Tech funds possess two conditions historically correlated with subsequent strong performance: they have the worst five-year record of any sector, and are among the three most unloved categories based on fund flows for the first time since 1993 (a year that preceded great returns). While retail investors have been dumping tech shares, corporations and private equity firms have been snapping them up at bargain prices, and there is every reason to expect this merger, acquisition, buy-back, and privatization boom to continue. Meanwhile, short interest on the Nasdaq is at unprecedented levels, even higher than at the bear market bottom three years ago.

Our advice is to be patient – the tide has already turned.

Economic Briefing

- **GDP** increased 3.8% in the third quarter, the 16th consecutive quarter of expansion in the U.S. economy and the 8th straight quarter growth between 3% and 4.5% – the longest streak of such consistent growth since World War II. Subtracting from the positive news, however, was a 3.1% annualized increase in the **Price Deflator** following a 2.6% rate in the second quarter.
- **Philadelphia Fed** index of regional manufacturing came in at 11.5 in November following 17.3 in October and below forecasts for a dip to 15.3. However, the **NY Empire State** jumped to a strong 22.8 in November, up from 12.1 in October and 15.6 in September; economists had expected a reading of 15.0.
- **CPI** and **Core CPI** (excludes food & energy) were both up 0.2% in October – the first time in seven months that the core rate was above 0.1%. October **PPI** rose 0.7%, as energy prices jumped 4.1%. **Core PPI** declined 0.3% and is up only 0.4% over the past six months (about a 0.8% annualized rate).
- **Nonfarm Payrolls** rose 56,000 in October, below expectations for an increase of 102,000. However, September’s previously reported loss of 35,000 jobs was revised upward by 27,000 to a decline of only 8,000. **Average Hourly Earnings** were up 0.5%; an increase of only 0.2% had been expected. The **Unemployment Rate** fell to 5.0% from 5.1% in September.
- **Productivity** was up an annualized 4.1% in the third quarter, well above expectations for a 2.6% increase and up from 1.8% in the second quarter – good news on the inflation front.
- **Retail Sales** fell a much smaller-than-expected 0.1% in October. Auto sales were not as weak as had been expected, and excluding autos sales rose a better-than-expected 0.9%. **Same-Store Retail Sales** were strong across the board, as Wal-Mart reported a 4.3% jump in sales, Target came in with a 5.7% gain, and Costco posted a very impressive 10.0% increase. Specialty stores also reported strong numbers.
- **Durable Goods Orders** dropped 2.1% in September, a bit more than had been expected but perhaps not surprising given the net increase of over 7% during the prior four months.
- **Housing Starts** tumbled in all regions of the U.S. in October, falling an average 5.6% after September’s surprisingly strong increase of 2.4%. New Building Permits also declining, down 6.7% (the largest decrease since September 1999).

FCNOTES Core Strategy Portfolio

Current Holdings	Symbol	Size	Change
SPDR Trust (S&P 500)	SPY	65.0%	-
Nasdaq 100 Trust	QQQQ	20.0%	-
iShares Russell 2000 Growth	IWO	5.0%	-
Diamonds (DJIA)	DIA	10.0%	-

Bold Text indicates a new position or a change to the size of an existing position since the previous issue of *fcNOTES*.

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can count on it.”³ Warren Buffett – probably the most famous money manager of all time, and certainly the wealthiest – disclosed in April that he was continuing to make a \$21 billion dollar bet that the U.S. currency would decline despite having already lost \$310 million on his short dollar position in the first quarter of the year.⁴ Other notables who were bearish on the dollar included former Fed chairman Paul Volker, who opined that the odds of a dollar crash in the next few years were as high as 75%.

Underlying this rampant pessimism was the unprecedented size of the U.S. current account deficit, which made “dollar devaluation inevitable” (to quote *The Economist*).⁵ Indeed, the only question still being debated at the start of 2005 was whether or not an “orderly” decline might be orchestrated by policy makers to avert a full-blown currency crisis.

But there was just one small problem with the near-universal belief that America’s trade deficit would put severe downward pressure on the dollar: “It is pure nonsense,” we wrote on January 1, 2005. “In the final analysis, none of the oft-repeated concerns about the current account deficit stands up to historical scrutiny, and there is no reason whatsoever to believe that America’s foreign creditors will suddenly decide to dump their dollar-denominated assets.”⁶ (We were right – in September, the most recent month for which we have data, foreigners invested a staggering \$102 billion in U.S. securities, a new monthly record.)⁷

In our view, there was only one explanation for why the dollar had declined against most foreign currencies from 2001 through the end of 2004, and it was the same reason that we expected it to reverse course in 2005: Interest rates.

Starting with a surprise half-percent reduction on January 3,

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Macro Biases

Items in **BLUE** represent changes or additions since last month’s issue .

Short-Term = under 6 months; Long-Term = 12- to 18-months

- S/T Bullish , L/T Bullish **U.S. Equities**.
- S/T Neutral, L/T Bullish **European Equities**.
- S/T Neutral, L/T Bullish **Japanese Equities**
- S/T Neutral, L/T Bullish **Emerging Market Equities**
- S/T Bullish, L/T Neutral **U.S. Dollar** (against euro & yen)
- S/T Bearish, L/T Bearish **U.S. Treasuries**
- S/T Bearish, L/T Neutral **Crude Oil**

Trading Levels

	Current Reading		Level/Trend
Earnings Yield Spread	1.98	5	↓
<i>Calculated by dividing estimated forward 12-month S&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>			
Yield Curve Ratio	1.13	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>			
60-Day Put/Call Ratio	0.94	5	↑
<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>			
Nasdaq Short Interest Ratio	3.98	5	↑
<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>			
8-Week Insider Sell/Buy Ratio	2.82	3	↑
<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>			
UBS Index of Investor Optimism	47	4	↓
<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>			
PULSE Panic/Euphoria Model	23	5	↑
<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 -10 “very bullish” (5), between 0 and -10 “bullish” (4), between 0 and 10 “neutral” (3), between 10 and 20 “bearish” (2), and above 20 “very bearish” (1).</i>			
Bottom Line: The September/October market correction saw investor sentiment go to extreme levels, presenting an excellent opportunity to initiate long positions. The 60-day put/call ratio, which remains a very bullish 0.94, hit 0.98 in mid-October – the highest level ever recorded. We are watching the yield curve ratio carefully (an inversion would be bearish), but all of our other indicators suggest more big stock market gains to come.			

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2001, the Federal Reserve had lowered the federal funds rate a total of thirteen times, taking it from 6.5% to a 46-year low of 1% on June 25, 2003. By cutting rates so aggressively, Fed officials made holding dollars less attractive; better returns could be earned on securities denominated in the currencies of countries where yields were higher. And the perception that these interest rate differentials would widen even further was fueled by a historic shift of focus for the Federal Reserve in the summer of 2003. In a statement following the May 6, 2003 meeting of the Federal Open Market Committee, with U.S. interest rates already half those of Europe, the Fed declared that it was concerned about an "unwelcome substantial fall in inflation" and promised that it would act aggressively to protect against even the possibility of deflation.

The fact that the bulk of the dollar's decline against the euro and other currencies since late 2001 had coincided with the most aggressive period of Federal Reserve easing in modern history was no coincidence as far as we were concerned, and our prediction that the greenback would strengthen in 2005 was based on the simple premise that because consumer prices were rising, and because America's economy was growing a good deal faster than the economies of Europe and Japan, the Fed would boost rates at a more rapid clip than the ECB and BoJ. As U.S. interest-bearing investments became more attractive relative to those of other countries, the dollar would rise.

This is exactly what happened. With fewer than six weeks remaining before the end of the year, the dollar is showing a 15.3% year-to-date gain against the euro and a 16.1% gain against the Japanese yen.

But while the timing of our dollar forecast at the start of the year could hardly have been better, we cannot say the same for our simultaneous recommendation that investors lighten up on international holdings. It is not that we expected international stocks to decline; to the contrary, we wrote in January that, "We expect 2005 to be a terrific year for global equity markets."¹⁴ The problem in our view was that the rising dollar would negate much, if not all, of the appreciation in foreign stocks held in dollar-denominated portfolios. To illustrate this point, we cited the United Kingdom's FTSE All-Share Index, which gained 14.8% in 1992, a year in which the S&P 500 rose only 4.5%. However, despite the superior performance of British stocks, an American actually would have *lost* 7% on the FTSE All-Share Index due to a decline of 19% in the pound against the dollar.

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Sentiment Timeline

Equity Markets & Sectors

"**Energy** bulls believe that the dearth of major oil and natural-gas discoveries in recent years should keep oil prices and energy-company profits high.... 'The cash flows from these companies should be pretty staggering for some time,' says David Dreman, [Dreman Value Management and Forbes columnist].... Mr. Dreman and other bulls are largely banking on the thesis that unlike past oil shocks over the past three decades, this one will continue thanks to broader demand world-wide. And even if new reserves are found, it will take time to build up refining capacity to boost supply." WSJ, 10/7⁸

"The **U.S. stock market** is meeting expectations this year. Unfortunately for investors, those expectations were pretty dismal to begin with.... What's making many investors nervous is that there has been much more talk lately about the things that have traditionally been bull market killers: slowing corporate earnings growth, rising inflation and rising interest rates. Those issues have been dogging the stock market all year and were the primary reasons that expectations for share price appreciation in 2005 were limited to begin with. But in the last few weeks, the worries have deepened. The surge in oil and natural gas prices after Hurricane Katrina hit the Gulf Coast, knocking much of the region's energy production out of commission, has raised fears about a debilitating effect on consumer spending, and on corporate earnings, from fuel costs." LA Times, 10/9⁹

"If you're prone to motion sickness, it's time to get out your pills because we're in for a bumpy ride. Money managers, economists and investment strategists warn that uncertainty over the direction of energy prices and central-bank interest-rate policies, as well as worries about inflation and economic growth, augur a volatile time in world financial markets. And for the superstitious, don't forget it is October: Remember 1929, 1987 and 1998?... It is rare for **stocks** to rally in such an environment." WSJ, 10/13¹⁰

"Net flows into American-domiciled **American-equity funds** are just positive for the year so far, but have deteriorated sharply. Net outflows in August were \$6.9 billion, and a further \$2.2 billion or so has walked since. Meanwhile, mutual funds based in America have poured \$14.5 billion this year into **emerging markets**, another \$14.5 billion into **global and international** funds and \$5.5 billion into **Japan**. **Europe** suffered outflows earlier in the year, but is now attracting dollars." The Economist, 10/15¹¹

"If U.S. equities are currently the 'damp squibs' of the financial markets, meanwhile, **Japanese stocks** are the rockets. Asked which assets they expect to perform best over the next year, 44 percent of asset allocators said Japanese equities." Merrill Lynch, 10/18¹²

"The headwinds facing **stocks** begin with soaring energy prices.... A couple of other worries for investors: First, stocks aren't cheap. The S&P 500 trades at 19 times the past 12 months' reported earnings, or about 25% higher than its long-term average P/E of 15. Second, the current bull market is old." Fortune, 10/17¹³

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The 1992 example was a good one. This year, the strong dollar has been a significant drag on the returns of American investors holding foreign securities. For instance, the German DAX index has been one of the best performing global indices year-to-date, up more than 20%, but EWG (the dollar-denominated exchange traded fund that tracks the German stock market) has gained only 3.8% (not much better than the S&P 500) due to the huge decline in the value of the euro. Stunning double-digit increases in several other stock markets outside the U.S., however, have been enough to offset the adverse impact of exchange rate movements in diversified foreign equity portfolios held by American investors. EFA, the ETF that tracks the MSCI Europe, Australia, and Far-East index, has risen 8.5% since the start of the year, versus an increase of 3.0% the S&P 500.

So ironically, in spite of the fact that our two major predictions in January were right on the money – the U.S. dollar has surged against the euro, yen, and other major currencies, and global stock markets have been very strong – our belief that U.S. equities would outperform foreign stocks held in dollar-denominated portfolios was proven incorrect.

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Since we started writing FCNOTES, it has been our practice to issue a “report card” in late November or early December, reserving January for our annual market outlook. Periodic accountings such as these are rare in the investment business, and for good reason: professional economists and strategists tend to be wrong a lot more often than they are right, and the last thing they want to do is shine a spotlight on their mistakes. Regular readers of FCNOTES know that we like to do our small part to remedy this situation (we have been particularly tough on Bill Gross this year...), but now it is our turn to step into the harsh glare of hindsight.

Mutual funds are required to tell prospective investors that “past performance is no guarantee of future results.” In general, this is a good warning to keep in mind, as today’s best fund categories are more often than not tomorrow’s laggards. That said, giving money to a manager who has failed to outperform his or her benchmark year-in and year-out is probably not a good idea, and likewise we would expect our readers to examine the success or failure of the forecasts contained in prior issues of FCNOTES before following our advice going forward.

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Sentiment Timeline

Equity Markets & Sectors (continued)



The Economist, October 8th – 14th

“As interest rates rise and U.S. economic expansion threatens to slow, American investors are funneling more money offshore, betting that **non-U.S. stocks** will lead for years to come.... ‘In the long run, I think international investments offer real opportunity,’ says Jeff Schappe [BB&T]. ‘I think that could well continue for the next couple years.’ BB&T is urging clients to keep 15% of their stock investments overseas, a much higher percentage than it has recommended in the past, and ‘we are considering raising that over time,’ Mr. Schappe says.” WSJ, 10/17¹⁵

“**Japan** has been the consensus bet in equity markets this year... But some worry that the mood has become far too sanguine. After all, two recent articles on Japan in The Economist and Barron’s had remarkably similar headlines (‘The Sun Also Rises’ and ‘The Sun Finally Rises’).” FT, 10/18¹⁶

“**American equities** are the most unpopular investment class in the world today, according to Merrill Lynch’s Survey of Fund Managers for October. A net 52 percent of asset allocators plan to underweight U.S. equities over the next 12 months — the most negative stance the survey has recorded in the past six years.” Merrill Lynch, 10/18¹⁷

“**Fund managers** are growing increasingly risk-averse, apparently unnerved by rising US interest rates and recent market turbulence. Cash holdings, short-termism and caution are on the rise, according to Merrill Lynch’s monthly poll of the global investment industry. The survey’s Wall of Worry – a composite indicator that charts changes in risk appetite and cash levels – is at a three-year high.” FT, 10/19¹⁸

“Erratic **stock-market** returns and persistently low interest rates have left a lot of investors worried about the performance of their retirement portfolios. A small but growing number are turning to self-directed IRAs... that allow them to diversify their retirement savings beyond the typical mutual fund menu into investments such as real estate.” Kiplinger’s, 10/2005¹⁹

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So how did we do in 2005? The record is mixed. Our major call on the U.S. dollar in January, made a mere five days after the euro peaked, was quite possibly the most timely of any forecaster anywhere (though as we have already mentioned, our simultaneous recommendation to reduce foreign stocks was not). And while it is still very early in the game, our warning on July 5 that the quarter-century-long bull market in bonds was finally ending and that interest rates on the long-end of the curve would begin to move higher looks good thus far – the yield on the 10-year Treasury note hit 4.67% earlier this month, the highest level since June of 2004. (Yields have backed off a bit during the past few days, but as we wrote in August, “we doubt that the 10-year note will breach 4% again.”)²⁶

Less accurate, however, was our outlook for stocks. Instead of soaring 25%, as we predicted on January 1, the S&P 500 is currently up only 3% on the year (before dividends). And the tech-heavy Nasdaq, which we expected to outperform the other major U.S. market averages, has instead spent most of the year in the red, only recently managing to get back above its 2004 year-end closing level. Finally, we were flat-out wrong in our country and sector recommendations. We have already mentioned the underperformance of U.S. stocks relative to many foreign markets, even after adjusting for the adverse impact of currency movements on the latter. On the sector side, our largest portfolio allocation was technology, a category that struggled early in the year but has displayed impressive relative performance throughout the second half.

Thanks to the recent strength in tech stocks, which has put the Nasdaq's year-to-date gain within 60 basis points of the 3% increase in the S&P 500, we are at least happy to report that this position has not hurt our readers on a relative performance basis (and may in fact end up beating the market by a nice margin this year if the momentum we seeing now carries over to December). The same cannot be said, however, for our failure to identify what turned out to be the two best-performing sectors in the S&P 500 in 2005: energy (+35.0% YTD) and utilities (+11.9% YTD). Clearly it was a mistake not to overweight these areas of the market.

In January, we will release our outlook for 2006, and – barring anything unexpected – the overriding theme will be “buy American.” But as a preview to what we anticipate in the coming year, we will devote the body of this FCNOTES

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Sentiment Timeline

Equity Markets & Sectors (continued)

“Financial-market risk is rising,’ warns Michael Belkin [Belkin Ltd.]... adding that the increased risk likely signals ‘the end of a period of complacency and the beginning of a big shakeout.’ He notes that his models see nearly all **global stock markets** declining. ‘Whether it will be a slow grind lower or a rapid collapse remains to be seen,’ says Mr. Belkin.... His advice: Use brief two-day and three-day rallies as a selling opportunity; reduce ‘long’ exposure to stocks; shift into defensive sectors, such as **consumer staples** and **health care**; and use futures and options to hedge.” WSJ, 10/20²⁰

“Nearly half the professional portfolio managers surveyed in *Barron's* latest Big Money poll... call themselves ‘bullish’ or ‘very bullish’ about the market's prospects through next June. The bulls' camp has swelled by nearly 10 percentage points since last spring, despite, or more likely because of, the fact that stocks are underwater. Today's bulls aren't necessarily the brash optimists of a few years ago, but are possessed of a quieter faith that some semblance of balance must return to the **equity market**.... While the latest poll had a decidedly bullish tilt, the proportion of bears also expanded, to 28% from last spring's 22%.” *Barron's*, 10/24²¹

“A specter from the past has been haunting the **stock market** lately.... The specter is inflation, and until recently, many investors thought it was dead and gone. Lately, if you believe the Federal Reserve, it isn't exactly ba-a-a-ck, but it is lurking. The Fed's fear of inflation, together with its clear intention to keep raising U.S. short-term interest rates to keep inflation in check, is the main thing that has prevented the much-awaited fourth-quarter stock rally from commencing.” WSJ, 10/24²²

“In the face of rising interest rates, persistently high energy prices that could restrain consumer spending, and several downbeat corporate revenue forecasts, Standard & Poor's Investment Policy Committee has lowered its **stock market** expectations for this year and next.... Because of our lower targets, we have reduced our recommended **domestic equities** exposure to 45% from 50% and increased our **foreign stock** allocation to 20% from 15%.” Standard & Poor's, 10/26²³

“Investors poured money into **global equity funds** at a record pace so far this year while **US funds** saw plummeting inflows.... Inflows into global stock funds, which invest internationally as well as in the US, reached \$79.9bn so far this year, a jump of 19.3 per cent over the \$67bn for the whole of 2004. By contrast US-only funds attracted only \$28bn in inflows so far this year, down 74.6 per cent from the \$110.4bn that was invested in these funds in 2004. Carl Wittnebert [TrimTabs] described the growth in global inflows as ‘off the charts.’” FT, 10/27²⁴

“Money is starting to flow out of Europe and back into the U.S. Over the past week, **European equity funds** saw an outflow of \$625 million, while **U.S. equity funds** gained \$574 million, according to Deutsche Bank. That marks the fourth straight week that European funds have suffered outflows, confirming a reversal in investment trends.... The reason: Europe isn't as cheap relative to the U.S. thanks to gains seen earlier this year.” WSJ, 10/31²⁵

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to our admittedly premature decision focus on technology, and explain why this sector will continue to remain among our largest sector positions going forward.

Tech Turns

In April of 2005, we reiterated our recommendation to overweight technology stocks in spite of the more than 8% decline that the Nasdaq had suffered since the start of the year. "What little attention the media have devoted to technology during the past six months has been decidedly bearish relative to other sectors," we wrote on April 1. "But once again, the media fail to recognize an important turning point: *technology stocks are finally cheap because no one thinks they are.*"³³

The relative weakness of technology during the first quarter certainly called into question our decision at the start of the year to make this sector the largest overweight in our core equity portfolios. But tech stocks have shown impressive resilience during the latter part of the year – since April 1, when we urged our readers to stay the course, the Nasdaq has risen 12.1%, versus increases of 6.4% and 3.5% for the S&P 500 and Dow Jones Industrial Average, respectively.

Is this the beginning of a new trend, one that will persist throughout 2006? We think so, for several reasons.

Ready For Rotation

Technology mutual funds have put up the worst numbers of any sector over the past one-, three-, and five-year periods. This miserable track record may make for a lousy sales pitch, but it is tremendously bullish for the simple reason that any category of security that has performed poorly in the past five years will almost always shine during the next five years, and vice-versa.

There have been remarkably few exceptions to this rule during the past several decades. Take one of today's investor favorites, real estate. From 1995 through 1999, the Dow Jones Real Estate Index returned 40%. This may not seem bad on the surface, but keep in mind that the second half of the 1990s witnessed extraordinary stock market returns. To wit: during this same period, the total stock market surged 237%, while the best-performing sector (technology, of course), returned a whopping 650%!

Real estate was simply a *terrible* place to be in the latter part of the 1990s relative to other sectors, and it was therefore inevitable that this category would subsequently

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Sentiment Timeline

Equity Markets & Sectors (continued)

"European markets have comfortably outperformed Wall Street so far this year. But Morgan Stanley, having favoured Europe, changed its view, saying it now expects the **US** to outperform **European equities** in the coming six to 12 months." FT, 11/1²⁷

"Despite foreign stocks' long run, many Wall Street strategists and financial planners are telling clients to increase their exposure to **international equities**. Driving the new recommendations are expectations for continued strong growth overseas and pessimism about **U.S. stocks'** returns.... Indeed, U.S. investors continue to pour money into overseas funds, with investment flows this year already surpassing those of 2004. Standard & Poor's investment-policy committee raised its recommended international stock allocation to 20% from 15% in late October. J.P. Morgan Private Bank... boosted its suggested holdings of foreign stocks to around 33% from 20% about two months ago.... Merrill Lynch's wealth-management strategy group has slowly raised its foreign-stock allocation over the past 12 to 18 months and may boost it further in the near future.... More than \$82 billion has flowed into international and global stock funds so far this year, already topping last year's total, according to AMG Data Services. By contrast, less than \$34 billion has flowed into U.S. stock funds in 2005, down from \$122 billion for all of 2004.... many strategists see foreign stocks maintaining the lead while U.S. equities post single-digit returns." WSJ, 11/8²⁸

"In the first nine months of this year, a net \$71.2bn flowed into 'international' (non-US) funds, while only \$27.2bn went into US-based funds.... [Since] 1984, **foreign funds** have only once received greater inflows than **US funds**. That was in 1990.... Inflows for US funds peaked at \$259.5bn – 37 per cent higher than in any other year – in 2000, as investors bought at the top of the internet bubble, just in time to catch the ensuing bear market." FT, 11/10²⁹

"Many investors may find their **international-stock** allocation has grown over the past year. Rather than cutting back, many strategists are raising their recommended foreign-stock allocations. They see a number of headwinds facing the **U.S. stock market**, including slowing profit growth and high energy prices, and good prospects for continued growth in **emerging markets** and **Japan**." WSJ, 11/12³⁰

"This summer, the big debate was over whether the rally in **Japan's stock market**... had staying power. Now the leading question for global equity investors is whether it makes sense to jump on a bullet train that has left the station. The answer, say many investment managers and strategists, is yes. Last week, First Global (UK) Ltd.... told clients to 'Buy, Buy, Buy Japan.' The firm predicted the benchmark Nikkei 225... would soar 48% to 69% to as high as 24000 by the end of 2006." WSJ, 11/17³¹

"This year, **Japanese stocks** are rallying again – and mutual funds that focus on these stocks are an investment craze.... Japan funds have attracted \$5.3 billion in new money, the most since AMG Data Services began tracking Japanese flows in 1992." WSJ, 11/18³²

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exhibit relative strength – from the beginning of 2000 through the end of 2002, the Dow Jones Real Estate Index gained 48%, while the total stock market *lost* 38% and the technology sector plunged 72%.³⁹ But after five years of impressive outperformance in real estate, this sector is past due for rotation, and so is the worst performer during the first half of this decade, technology.

Unloved Means Undervalued

It is our belief that retail investors who were infatuated with technology stocks at the height of the bull market in early 2000 finally capitulated in 2004, after three long years of asking the question “is it finally time to buy tech again?” – and getting burned every time they did.

In 2004, technology was among the three sector fund categories that suffered the largest percentage of outflows according to Morningstar’s annual “Unloved Funds” study (and we would not be surprised to see similar outflows when the 2005 numbers are released, though that remains to be seen, of course). This marked the first time since 1993 that technology funds had made this list, and it is instructive to examine what happened in the years that followed: from year-end 1993 to through year-end 1999, technology was by far the *best* sector to own, returning an eye-popping 827%.⁴⁰

Compare that to what happened after 1999, a year in which four out of five of the fund categories capturing the most cash were growth- and/or technology-related, according to a study by the Schwab Center for Investment Research.⁴¹ With the crowd piling into technology and Internet names, the time had finally come to exit the sector. Although the Nasdaq would continue to run higher during the first three months of 2000, the next two-and-a-half years would witness the worst bear market ever suffered by technology stocks, with the Nasdaq falling nearly 80% before finally bottoming in the fall of 2002.

We believe that the massive outflows seen in technology funds last year marked a significant long-term turning point for the sector. “Since 1987, the mutual fund rating service Morningstar has ranked the nation’s three least and most popular fund categories each year by their cash flows as a percentage of their net assets,” we wrote in the February 2003 issue of *FCNOTES*. “Over the next three years after each new ranking, the least popular funds by this measure have outperformed the average stock fund 75% of the time and have beaten the three most popular fund categories more than 90% of the time.”⁴²

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Sentiment Timeline

Economy & Earnings

“Many adverse forces are now converging: higher energy prices, higher interest rates and debt payments, higher inflation, falling wealth gains. None matters much alone, but ‘their combination is creating more consumer risk,’ writes Susan Sterne of Economic Analysis Associates. For two decades, free-spending American consumers have anchored the **U.S. and world economies**. If they no longer play that role, it’s an open and worrisome question of who will.”

Robert J. Samuelson [Newsweek]³⁴

“Higher rates won’t cause a big slump next year, but expect them to pour some sand into the **economy’s** gears.”

BusinessWeek, 10/17³⁵

“For the quarter ended Sept. 30, companies in the S&P 500 are expected to boost earnings by 15% compared with the same period a year ago, marking the 14th consecutive quarter of double-digit profit growth—a new record.... Alas, this robust growth spurt seems destined to end soon. Wall Street analysts forecast that **corporate profits** will rise 14% in the fourth quarter, but for 2006, they expect growth will gradually drop to a more traditional rate, somewhere in the high single digits.... [And] with new problems continually popping up—from plunging consumer confidence to rising inflation fears—a few market watchers are now warning there’s big trouble ahead. ‘We could be in store for 1%-ish growth next year,’ says David Rosenberg [Merrill Lynch]. He’s taken his estimate for S&P 500 profit growth down to 2% next year. ‘Something tells us that **equity valuations** are not priced for such an outcome.’” Fortune, 10/17³⁶

“US company executives have become more pessimistic about domestic **economic prospects** than business leaders in any other country, a McKinsey survey of business confidence reported yesterday. Questioned in September, just after Hurricanes Katrina and Rita tore through the US Gulf coast, only 44 per cent of US business leaders held positive views about the economic outlook, compared with 69 per cent in March.” FT, 10/20³⁷

“Since this economic upturn began almost four years ago, the consumer has powered the gains in demand. But now this Energizer Bunny looks to be slowing down.... Considering that household buying accounts for more than two-thirds of real gross domestic product, any turn in this sector changes the direction of the **overall economy** as well.... This is no temporary downshift. Higher fuel prices aren’t going away, and the growing fear is that they are seeping into the prices of other goods and services. The Fed seems intent on raising short-term rates further, and inflation worries in the bond market are pushing up long rates, too. All this will put a strain on households, especially low-income families, at the same time that huge heating bills hit monthly budgets this winter.... For years, consumers have been a resilient lot. Terrorist attacks, corporate scandals, and Fed tightening have not swayed them. But the latest spike in energy prices may prove to be one blow too many.” BusinessWeek, 10/24³⁸

Commentary

Compelling odds indeed.

Follow The Money

Beyond the historical significance of retail funds flows, there is an abundance of evidence that valuations are exceedingly attractive in the technology sector, and one need not waste time studying stock tables and financial reports to find it. From eBay putting up \$2.6 billion to acquire internet-phone company Skype, Oracle offering nearly \$6 billion to purchase enterprise software rival Siebel Systems, and, just in the past week, Cisco spending \$6.9 billion to buy cable TV equipment maker Scientific-Atlantic, it is easy to see that software, hardware, and communications stocks look cheap to the group of investors who know the most about this sector – those who run the companies.

In the second quarter of 2005 alone, corporations spent more than \$86 billion to acquire technology companies, and the number of deals – 695 – represented a new quarterly record.⁴⁸ With the fourth quarter still remaining, technology industry merger and acquisition activity from January through September has already surpassed total M&A activity in 2004, making 2005 the busiest year for M&A in recent history, both in terms of dollars spent (\$219 billion) and total deal activity (2,013 transactions).⁴⁹

Retail investors may have dumped their technology funds last year in favor of more popular categories like natural resources and international stocks, but the tech companies themselves have been more than happy to be on the other side of the trade. These firms have been snapping up their own shares at a breakneck pace, with the 80 tech companies in the S&P 500 stock index already having bought back nearly \$50 billion of their own stock in the first half of 2005 alone – nearly equal the record \$52 billion of shares repurchased by the technology sector in all of 2004.⁵⁰ And the trend shows no sign of slowing down. Indeed, just two weeks ago the world's largest semiconductor manufacturer, Intel, announced the biggest share repurchase plan in the company's history, allotting \$25 billion to its buy-back program. This follows a record \$7.5 billion spent last year on share buy-backs.⁵¹

Other savvy investors who see value in the technology space are private equity firms such as Kohlberg Kravis Roberts & Co. and Silver Lake Partners, who earlier this year won an auction to acquire the semiconductor business of Agilent Technologies for \$2.7 billion. That deal came on the heels of the largest leveraged buyout of a technology

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Sentiment Timeline

Economy & Earnings (continued)

“Concerns about the investment climate are reflected in the perceptions by most investors (66 percent) that the **US economy** is either in a slowdown (52 percent) or a recession (14 percent). Two thirds of these investors predict that economic recovery will not come for at least two years. These economic assessments are significantly higher than they were at the beginning of the year, when 57 percent of investors felt the economy was in a recovery or sustained expansion, and only 42 percent judged the economy to be in a slowdown (31 percent) or recession (11 percent).” UBS/Gallup Index of Investor Optimism, 10/24 ⁴³

“The American consumer -- who, since the bursting of the technology bubble in 2000, has been the main engine of **global economic growth** – is hurting. And even though many money managers, investment strategists and economists aren't ready to predict his ultimate demise, they warn that investors must understand the global repercussions should the U.S. consumer become tapped out.” WSJ, 11/3 ⁴⁴

“The **U.S. economy** has been on an impressive run, logging its most stable stretch of expansion ever. But the bond market is signaling trouble ahead... After steepening in the wake of Hurricane Katrina, the yield curve has started flattening quickly... If the trend continues, as many market professionals expect it to do, short rates could rise above long rates in what is called an inverted yield curve, an event that typically precedes economic recessions.” WSJ, 11/16 ⁴⁵

Bonds, Interest Rates & Inflation

“For the 11 leading world economies as a whole, the weight of equities has fallen from 60 per cent of pension fund assets at the height of the bull market in equities in 1999 to 51 per cent (after touching 49 per cent in late 2002, the low point for share prices). Can this last? There are plenty of bond bulls who insist it can... ‘There is regulatory pressure for a shift into **bonds** at the moment... and an expectation that inflation will stay low,’ argues Alan Budd [former chief economic advisor, UK Treasury]. ‘The regulatory pressures and demographics pushing people into bonds, not equities, are likely to stay there.’... ‘The shift from equities to bonds will be gradual. But it is going to be inexorable,’ argues Pimco’s [Bill] Gross.” FT, 10/10 ⁴⁶

“The Fed's inflation hawks are sharpening their talons. High energy prices, a potential shift in public psychology toward accepting higher prices, signs that businesses are using up spare capacity and a steep federal budget deficit combine to make Federal Reserve policy makers more nervous about the **inflation outlook**. A pause in **rate increases** the next few months, considered a real possibility after the economic disruption caused by Hurricane Katrina in late August, looks increasingly unlikely. Indeed, the Fed may raise rates even further than it had thought likely before Hurricane Katrina struck. Futures markets have responded by signaling they expect the federal-funds rate, the amount financial institutions pay on overnight loans, to reach 4.5% in mid-2006... Some economists say rates could even exceed those market expectations.” WSJ, 10/10 ⁴⁷

Commentary

company ever seen, when SunGard Data Systems was taken private by a group of private equity firms for \$11.4 billion. In 2005 alone, the money spent on \$1 billion-plus technology deals has quadrupled to \$38 billion.⁵⁸

With corporations and private equity investors sitting on record levels of cash, and with cheap money still readily available in the form of low long-term interest rates, we expect the merger, acquisition, buy-back, and privatization boom to continue for some time. The technology companies in the S&P 500 have well in excess of \$200 billion in cash and equivalents on their balance sheets, more than twice what they had at the end of 1999 (and in spite of increased buy-backs and dividends, the cash continues to accumulate). Meanwhile, private equity firms are amassing huge war chests to fund takeovers. Warburg Pincus, which last year was part of the group that purchased tech company Telcordia Technologies for \$1.3 billion, recently took the wraps off a new fund with \$8 billion in capital. Earlier this year, Goldman Sachs announced an \$8.5 billion fund, Carlyle Group unveiled a fund that crossed the historic \$10 billion barrier, and Blackstone Group is raising money for a new equity buyout fund that would be the largest ever at \$12.5 billion. Through September, buyout funds have already raised money at a \$68 billion annual rate, compared with \$48 billion in 2004.⁵⁹

All of this money has to go somewhere, and given recent trends, we expect a fair amount to flow into the technology sector. And as we have advised our readers in the past, you want to buy before they do.

The Thrill Is Gone

Sentiment with respect to technology stocks remains disinterested at best – always a good sign. We have already described the huge outflows from tech funds last year, an indication of extreme pessimism among retail investors, and there is no shortage of skepticism among professionals. Many see the rapid accumulation of cash, the explosion of M&A deals, and the increasing share buy-backs and dividend payments as evidence that growth in the tech sector is slowing. “Maybe the folks who say the industry has matured are right,” says Milton Harris, a professor of finance and economics at the University of Chicago’s Graduate School of Business. “Maybe there aren’t good growth opportunities out there.”⁶⁰ Or to quote the title of an article in *BusinessWeek* this summer, “Too Much Cash, Too Little Innovation.”⁶¹

Not all media reporting on technology is bearish, and we

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Sentiment Timeline

Bonds, Interest Rates & Inflation (cont.)

“Gold edged closer to an 18-year high.... Alan Williamson [HSBC]... said US **inflation** is lower now than it was four years ago when gold prices were at a 20-year low of \$255. ‘It simply doesn’t add up.’” FT, 10/13⁵²

“As signs of **inflation**, spurred in part by soaring energy prices, surface around the world, central banks are signaling that the era of unusually cheap credit is coming to an end. The implications for markets and the world economy are significant: Investors may retreat from risky assets and air could leak out of the global housing boom. A recession seems unlikely but can’t be ruled out since world central bankers seem determined to raise rates as much as needed to keep inflation low.... A move to tighter global monetary policy could finally produce the long-predicted rise in **bond yields** and slowing in housing, both in the U.S. and elsewhere.” WSJ, 10/13⁵³

“Has the **bond market** blinked? After more than a year of resistance to rate hikes by the Federal Reserve and continued economic strength, bonds finally seem to be giving some ground. And unlike other short-lived sell-offs that pushed bond yields higher, this recent pickup in long rates appears to reflect a more lasting shift in bond market sentiment.” BusinessWeek, 10/17⁵⁴

“The era of cheap money was fun while it lasted. But now investors would be wise to think about dealing with the end of that era, strategists say. Otherwise, it could prove costly. The past few years of low **interest rates** world-wide have helped stock markets recover from their tech-bubble funk. Yields on U.S. Treasury bonds fell to four-decade lows, those on German Bunds to record lows.... No more! ‘Financial-market risk is rising,’ warns Michael Belkin [Belkin Ltd.]... adding that the increased risk likely signals ‘the end of a period of complacency and the beginning of a big shakeout.’” WSJ, 10/20⁵⁵

“Bond shorts have gotten clobbered in the past year as **long-term interest rates** have remained low. But amid predictions from the pros that long-term rates will rise, at least three new funds that short bonds have hit the market this year. And the tide finally seems to be turning.... Long-term rates are ‘incredibly resilient right now, but it seems like they’re poised to move higher,’ says Greg Peters [Morgan Stanley].” WSJ, 10/21⁵⁶

“Until recently it looked as if **inflation** had been defeated in most rich countries. But it has risen sharply this year in America, the euro area and Britain.... The Fed, the European Central Bank and the Bank of England are suddenly sounding more hawkish... worried that higher oil prices could feed into other prices and wage demands. According to a closely watched survey by the University of Michigan, American consumers’ expectation of inflation 12 months ahead jumped to 4.6% in early October from 3.1% in August.” The Economist, 10/22⁵⁷

Commentary

would be remiss were we not to mention the recent cover story in *Barron's*, "The Great Tech Revival." But examples of this kind of positive coverage on technology have been few and far between during the past two years, and what little we do come across remains a far cry from that of early 2000, when there was a clear consensus in the media that tech stocks were part of an unprecedented "New Economy," one in which old rules no longer applied.

Back then, the pundits believed that the biggest risk an investor could take was *not* owning a piece of the action in the technology and communications revolution, but America's cultural perception of technology has shifted dramatically since those heady days. Earlier this year, an article appeared in the business section of *The New York Times* titled, "They May Be Mundane, but Low-Tech Businesses Are Booming." The thesis of the author was that entrepreneurs would do better to avoid technology startups and instead consider landscaping, child-care centers, janitorial services, and hair and nail salons – the four business categories showing the strongest growth according to the Census Bureau's Economic Census.⁶⁹ "Forget Web sites and molecular imaging," the article admonishes those looking to start their own companies. "The biggest fields of opportunity for aspiring entrepreneurs are the same mundane ventures that have been kicking around for decades."⁷⁰

Such a dour mindset on Main Street points to much better times ahead for technology stocks on Wall Street, and today's unprecedented level of short interest on the Nasdaq suggests that the big gains we have been expecting are just around the corner. We first addressed the significance of short selling in the March 2003 issue of *FCNOTES*:

Because short sellers profit when stocks fall, they are often the media's favorite scapegoat in a bear market.... [But] the media has it backwards; rather than causing markets to fall, short sellers actually help stocks recover by stepping in to buy shares when no one else will (short-sellers borrow shares of stock and sell them with the objective of repurchasing the shares later at a lower price). If stock prices rise, shorts can get "squeezed," a vicious cycle in which short sellers themselves cause prices to rise as they scramble to cover their positions ahead of other shorts.... The very act of shorting a stock creates demand, since short sellers pay interest on the borrowed shares and are therefore eager to buy them back relatively soon. The more shares the short sellers borrow, the more latent demand there is in the market.

"Where Demand Meets Supply," *fcNOTES*, March 31, 2003

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Sentiment Timeline

Currencies & Other Markets

"Have you heard about Peak Oil yet? The idea – that the world is maxing out on its ability to produce oil and will soon be faced with a dwindling supply – is capturing the popular imagination. The Peak Oil concept is now being discussed in academic circles, in books and in cover articles for reputable magazines such as *National Geographic* and *The New York Times Magazine*."

Financial Planning, 10/2005⁶²

"Despite the dollar's recent strength, most foreign-exchange analysts remain undeterred that an Asian currency rally simply has been delayed -- not derailed. A recent Dow Jones Newswires survey of 20 leading currency dealers sees the **dollar** holding its gains for the rest of the year but the **yen** surging back in 2006. 'I still believe **Asian currencies** are glaringly undervalued,' says Christopher Wood [CLSA Asia-Pacific Markets]. 'They will rally when the Fed stops tightening.'" *WSJ*, 11/2⁶³

"**US dollar** bears are likely to capitulate,' says Mansoor mohi-Uddin [UBS]. 'While short-term momentum funds and commodity trading advisers are long the greenback already, macro hedge funds, asset managers, corporates, and private clients are not yet positions for further dollar upside from here.' That may cause further dollar strength, as investors try to jump on the bandwagon." *FT*, 11/8⁶⁴

"For years, great sections of this nation have watched in fascination as **home prices** marched ever upward.... That era is drawing to a close. We're not predicting a bust in home prices. But hot markets should see steadily moderating price increases, and prices in some areas will flatten and show modest declines. Gradually rising interest rates and higher energy costs are bound to affect home affordability." *Kiplinger's*, 11/2005⁶⁵

"Market pundits remained reluctant to predict that the attraction of the **US dollar** would continue in 2006. 'If US growth begins to surprise on the downside, however, it is easy to see why the dollar could fall – and, possible, very sharply,' Ian Harwood, from Dresdner Kleinwort Wasserstein, said." *FT*, 11/14⁶⁶

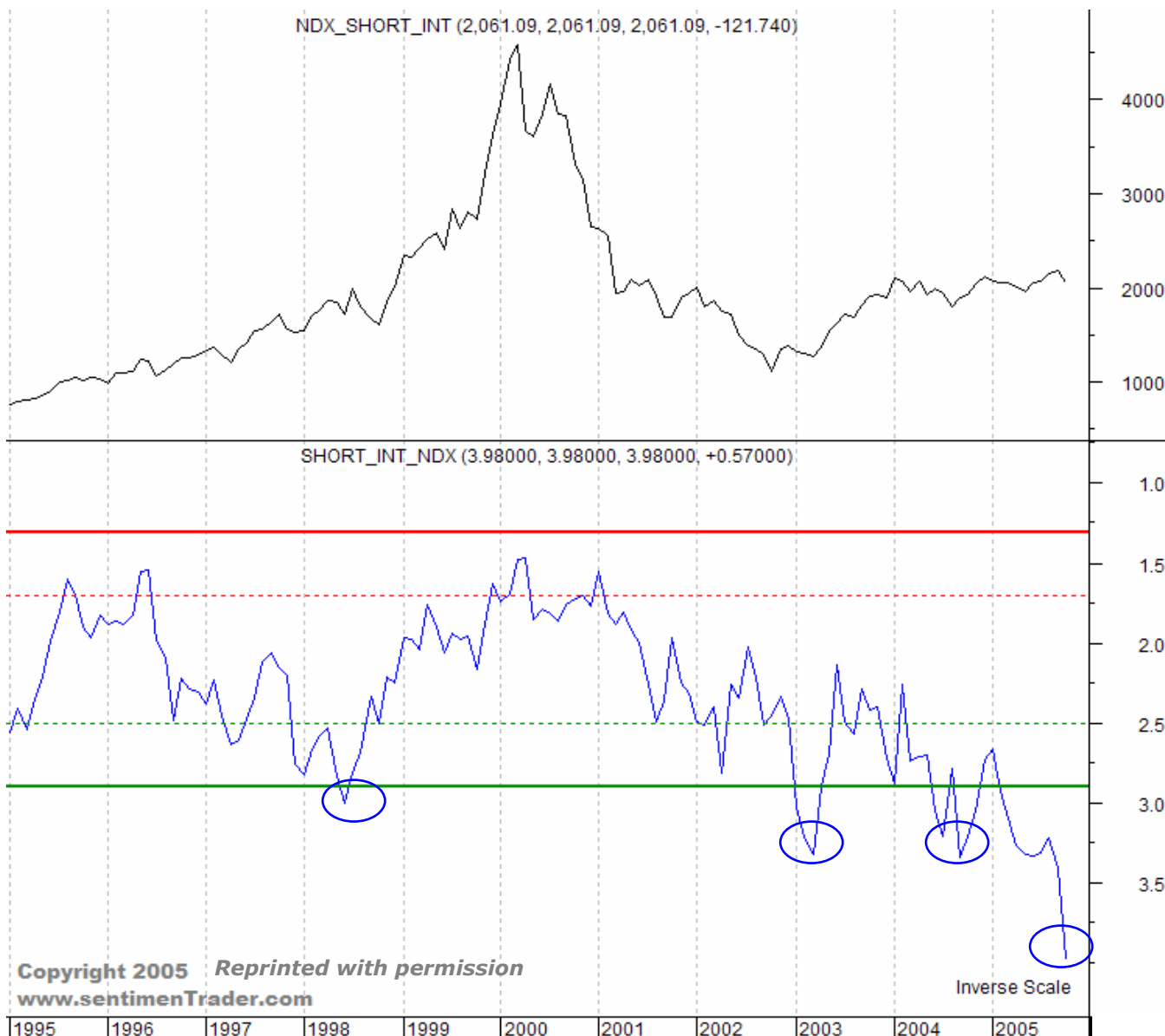
"Most everyone on Wall Street predicted the dollar's three-year bear market would get even worse this year. And, despite its impressive rally in recent months, most are again calling for **dollar** declines in 2006.... [But] there are nascent signs the bearish consensus may be splintering. A few analysts are even arguing that the dollar could strengthen further next year.... A Dow Jones Newswires survey of 18 banks last week showed a median forecast for a dollar decline of about 9% against the euro and the yen by the end of next year. These dollar forecasts are rosier than ones made three weeks ago, reflecting a broad, if modest, shift in thinking that the dollar can at least hold its gains longer than expected." *WSJ*, 11/14⁶⁷

"Even some of the biggest boosters of **housing** agree that the market has finally moved out of the boom phase.... 'The air is coming out of the balloons,' says David Lereah, chief economist at the National Association of Realtors.... 'We believe the market has peaked,' says Doug Duncan, chief economist of the Mortgage Bankers Association." *WSJ*, 11/15⁶⁸

Looking at short selling from this perspective, the potential for an explosion of demand in the technology sector has perhaps *never* been greater. Based on one measure of the Nasdaq short interest ratio that is “seasonally normalized” to adjust for the tendency of short selling to be lower in the early months of the year and higher in later months (perhaps because of tax strategies that utilize shorting), we see that the total number of shares sold short on the Nasdaq divided

by the average daily volume over the previous twelve months is much higher today than it was in early 2003 (the Nasdaq would end the year with a gain of 50%) and mid-1998 (before the huge run that saw the Nasdaq gain 39.6% in 1998 and 85.6% in 1999). It also worth noting that short interest was unusually low at the peak of the tech bubble in early 2000 – not a sell signal in-and-of-itself, but a good indication of the overall lack of fear in the market at the time.

Nasdaq Composite – Monthly Closing Prices (top chart)
 Normalized Nasdaq Short Interest Ratio (bottom chart, inverted scale)
 January 1995 – October 2005



Beyond representing a very real source of future demand, the extreme level of short interest on the Nasdaq is indicative of the overwhelming consensus among market participants that tech stocks are headed lower. Expect the market to do what it always does – prove the consensus wrong.

History Repeating?

One year ago, we alerted our readers to the remarkable resemblance between the Nasdaq bubble of the late 1990s (and subsequent multi-year bear market) and the 1920s Dow Jones Industrial Average bubble (and secular bear market that followed). Both the Dow and the Nasdaq experienced hyperbolic gains in the 1920s and 1990s (respectively, of course); both entered multi-year bear markets that ultimately destroyed more than three-quarters of their respective market caps; both witnessed huge rallies in the first calendar year following the bear market bottom (50% for the Nasdaq in 2003 and 64% for the Dow in 1933); and both remained mired in a choppy, sideways correction for a prolonged period following the initial powerful one-year rally.

The extraordinarily tight correlation of

today's Nasdaq with the chart of the 1930s Dow has persisted throughout 2005, and hindsight being 20/20, perhaps we should have recognized from this historical parallel that tech stocks might not break out to the upside until 2006. In our defense, we are unaware of any study that has ever demonstrated that chart patterns can predict future stock prices on a consistent basis, and we therefore relied on our primary methodology when we formulated our 2005 outlook. Having said that, it seems increasingly likely to us that the astonishing similarity between the two charts might be a reflection of fundamental investor psychology playing out in a similar fashion following the bursting of a massive speculative bubble. If this is indeed the case, the prospect for a tremendous rally of as much as 70% in the Nasdaq over the next two years looks pretty good to us, and such an outcome is certainly supported by the investor sentiment and supply-and-demand fundamentals that we have already described.

Pessimists love to obsess over the Great Depression-era secular bear market, and they can always find plenty of



reasons to believe that another one is just around the corner (among their favorites today is the so-called “credit bubble” in the United States). The next time you meet one of these delightful folks, we suggest that you have a little fun at their expense by *agreeing* that this decade is likely to be a repeat of the 1930s, at least when it comes to the equity markets... and then show them why that conclusion is such wonderful news for tech stock investors, at least until 2008.

Concluding Thoughts

It remains to be seen if our decision to overweight technology in 2005 was in fact early rather than wrong. But notwithstanding the lackluster performance of U.S. stocks this year, we think we have performed well since sending the first FCNOTES to our friends in December of 2001. There is no investment decision more important than determining when it is necessary to “go defensive” in an equity portfolio, and we are pleased to have kept our readers on the right side of the stock market year-in and year-out – 2005 included. Indeed, near the low point of the year for stocks, on May 16, we alerted investors to the tremendous opportunity to accumulate additional shares: “Rarely have we seen market conditions more beautiful than they are today.... This is as good as it gets.”⁷¹ *Since then, the S&P 500 has risen more than 7%.*

Although we continue to believe that stocks have a long way to run, our record demonstrates that we are not “permabulls” – we have advised our readers to avoid equities in the past, and we will do so again when it is appropriate. On December 30, 2001, in the very first issue of FCNOTES, we declared that, “The bear market is not over,” and we recommended that investors “stay in cash.”⁷² To say that this was a minority view would be an understatement. Following a big rally off the post-9/11 lows, strategists were convinced that 2002 would be a terrific year to own stocks, and *BusinessWeek’s* annual survey of Wall Street’s most prominent names was one of the most bullish we had ever seen – the *average* forecast was for a gain of 13% in the S&P 500. *Instead, the index plummeted 23% the worst yearly decline since 1974.*

Our bearish outlook began to shift in the summer of 2002. “If everyone already knows that things are going to get worse,” we wrote on July 31, following what would turn out to be the worst downleg of the long bear market, “then the odds are good that the next big surprise in the market will be a positive one, as stocks move much higher for much longer than anyone expects.” But we remained concerned about “embers of optimism and hope,” and we warned our readers that, “as long as there is any bullish sentiment remaining in the media, the possibility exists that panic selling could flare up yet again. For this reason, we are recommending that even long-term investors start small by allocating no more than one third of their cash reserves to stocks at this time.”⁷³

This was good advice. The summer rally soon stalled, and

after a dreadful September, the major market averages failed to hold their respective July lows in early October. As had been the case a few months earlier, we saw more than enough reasons to believe that the bear market had finally bottomed (hindsight would later prove this view correct), but we were still bothered by lingering bullishness in the media – not something one should see around a bear market bottom. So once again, we advised our readers to add to stock positions but also continue to hold some cash reserves, and we raised our recommended equity allocation to 60% in the October issue of FCNOTES.

The rally off of October’s lows proved to be almost as short-lived as that seen in July, and stocks appeared to resume their bear market trend in early 2003. This time, however, the misery in the media was overwhelming, and we urged our readers to stay the course. “One year from now, it will likely be as obvious that you should have bought stocks today as it is apparent in hindsight that you should have avoided them one year ago,” we wrote on February 28, 2003.⁷⁴ *Over the next twelve months, the S&P 500 returned 38.5%.*

In April of 2003, we finally recommended that our readers boost stock holdings to 100% after all of the major U.S. market averages closed above their respective 200-day moving averages – the first time since the fall of 2000 that every broad market index had traded above this significant long-term bull-market support level. Although technical indicators like moving averages are secondary to our primary top-down contrarian methodology, it was important for us to see a technical confirmation of our bullish outlook before returning to a fully-invested position. *Since making the recommendation to allocate all remaining cash to stocks, the S&P 500 has returned nearly 40%.*

Throughout 2004 and 2005, we remained staunchly bullish in our outlook for global equities. While staying fully invested during the past two years may have been difficult at times, it was the right decision, and because of it we believe that our portfolios are already well-positioned for 2006. “If you can protect capital in a bear market, you don’t have to be a hero in bull markets,” legendary money manager Martin Zweig once said. “You just have to be there.” With investors growing impatient (and fearful) after what has seemed like an eternity of sideways action, Mr. Zweig’s sage words are more important than ever.

Of course, only you can decide whether our overall track record over the past four years is worthy of your trust following an admittedly mixed record of market calls in 2005, but rest assured that we will never take your confidence for granted. This being Thanksgiving week, we want to take the opportunity to express our enormous gratitude for the support of all of those who have made our progress possible.

Thank you, and Happy Thanksgiving!

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