

3rd Quarter 2005 Review/4th Quarter Outlook (October 5, 2005)
“Shelter from the Storm”

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Hurricanes Katrina, Rita, and Wilma have tested the nerve of many Americans who reside on the Gulf Coast and it will undoubtedly measure the will of the Economy during the 4th quarter. The data stream on the health of the Economy has been muddied as a result of the Hurricanes and predicting its response is increasingly difficult. The “Bulls” and the “Bears” can all find enough to nibble on in the short-term to keep them contented.

First of all, the “Bears” can find comfort in the Michigan Consumer Sentiment Survey, which dipped to levels in the 3rd quarter below the last recessionary period. Second, they will be encouraged by the fact that gasoline and natural gas prices have risen substantially, this should cause discretionary spending to be impacted adversely as we enter the 4th quarter. Third, the Federal Reserve continued to raise its key interest rate, which stood at 3.75% by the end of the quarter. The measured pace in which the Fed has raised rates is showing no signs of retreating, which should curtail the housing market (namely home equity lending), and put the wounded American consumer out of their misery. That is of course, if we have no faith in the lessons of history and the resilience of American consumer to spend money!

We feel that the Bulls have a far more compelling story as we reminisce on the 3rd quarter and look ahead to the 4th. We feel that the shocks of the hurricanes have been mild and will not be insurmountable in the short-term. Although, the energy infrastructure has been rattled by the weather and prices have risen sharply, we expect that they will normalize somewhat by the holiday season and that buyers will have a strong showing. We acknowledge that the housing market has begun to slow and we think this trend will continue. However, we do not feel that the housing market impact will be detrimental for the 4th quarter. Core inflation (excludes oil and food) remained in check for the 3rd quarter, which gives one optimism looking ahead. Real GDP rose 3.3% for the 2nd quarter of 2005 and should come in around 3.8% for the 3rd quarter. One only has to look back to 2001 and 2002 to see levels ranging from -1% to 2%, so the strong growth that has been sustained over the past three years is also encouraging. This is not the first time that pundits have counted out the American consumer, but historically the consumer has found a way to answer the bell.

We anticipate the equity markets to deliver solid returns for the 4th quarter, led by retailers and technology. We anticipate that large-cap companies will do well and pickup steam. As GDP continues to grow at above 3% rates, we expect momentum to continue its swing from small and mid-size companies to larger more established brands. Although we anticipate gasoline prices to normalize some, the onset of the home heating season keeps us bullish on Energy. We also maintain our bullish stance on Healthcare. The bond market should remain less than exciting as the Fed continues rate hikes at a measured pace going forward. The yield curve continued to flatten during the third quarter and the most compelling fixed income play is probably a short-term CD (9mo. – 12mo.).