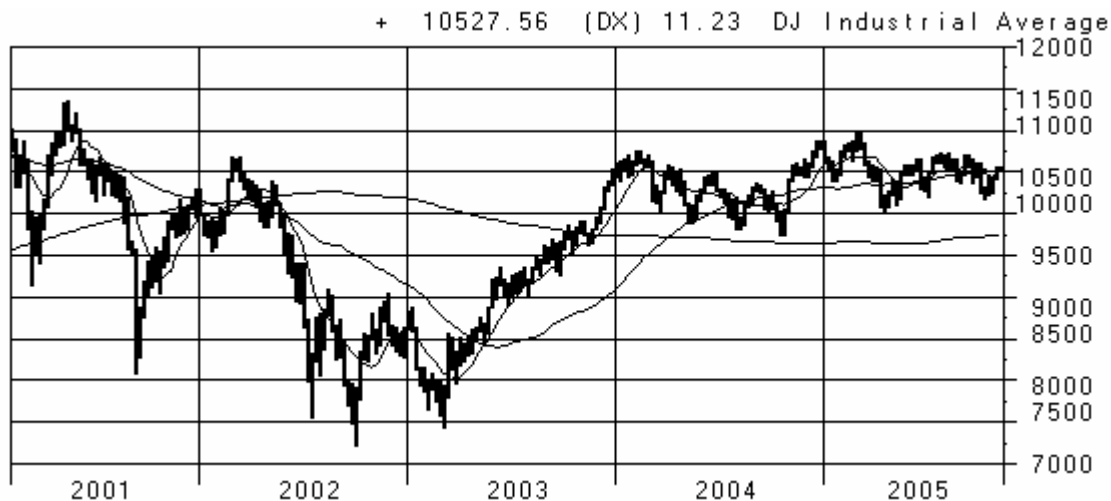




THE TOP TEN REASONS THE MARKET IS HEADING HIGHER IN 2006

©Prepared for Physicians' Money Digest 11 08 05 by Joan E. Lappin CFA

1. The **U.S. Stock Market has been flat for two years**. It's either a huge ceiling or more likely a wonderful floor from which to launch a new upward move. This market has withstood body blows of major significance and it hasn't faltered: skyrocketing oil prices, hurricanes, the recent whiff of scandal inside the White House, indicted Congressional leaders, rising interest rates, more corporate scandals (AIG, et. al.) What's that old expression: "What doesn't kill you, only makes you stronger!" The chart says it all. There has been no forward stock market progress for five years. No wonder people were buying real estate and art. But that's due for a change.

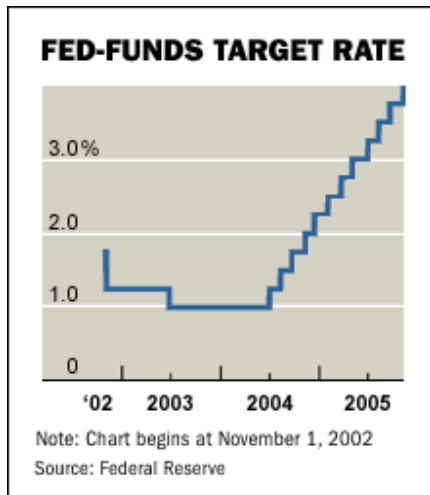


2. Frightened investors still remembering how much they lost in common stocks in 2000-2002 have squirreled **\$5.7 trillion into money market funds waiting until they felt stocks offered a good alternative**. Many of them missed the move off the bottom in 2003. GC believes that another big move lies ahead for which one should be positioning one's portfolio before year end. Those sitting in money market funds will also miss this major move upward if they don't take another look at the values being offered in the U.S. stock market.

3. The **attraction of Real Estate as an alternative investment is waning**. Flipping properties to buyers who are willing to pay higher and higher prices seems to be near an end due to a combination of rising interest rates and prices that are no longer affordable to the typical buyer. The cost of ownership now exceeds the cost to rent ending the allure of buying one's first home. Another huge concern is the Bush Administration's recent proposal to remove the deductibility of mortgage interest on your tax return. This would be a severe penalty to middle class taxpayers just as they are being squeezed by the Alternative Minimum Tax.

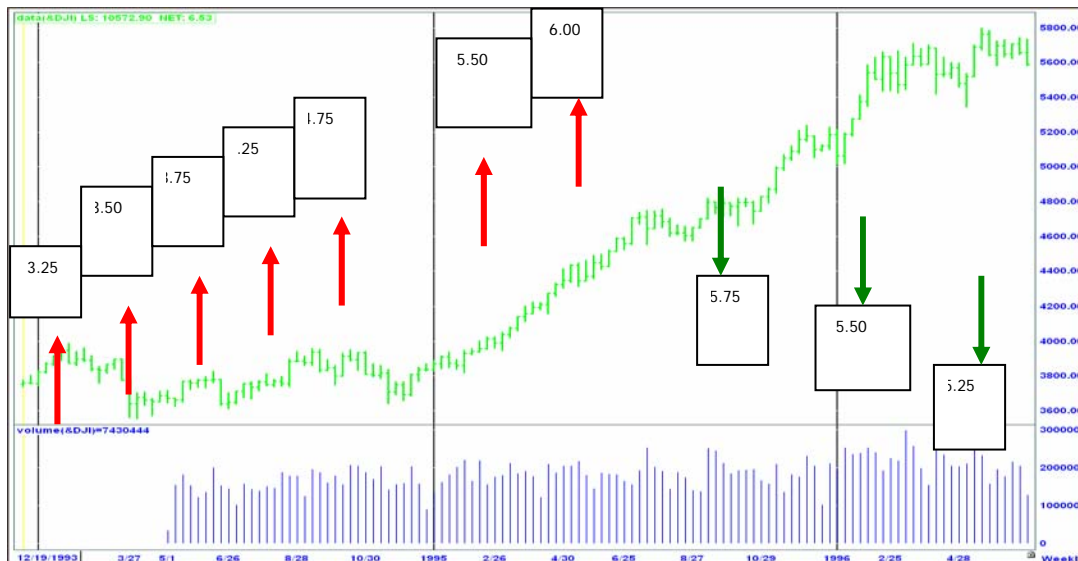


4. The November rate increase brought to 12 the number of rate increases the Fed has undertaken in the last year or so to restore rates to more normal levels. In 1994 when the Fed stopped raising rates, the stock market took off sharply (see chart below)



I don't know if we are in the 8th inning, 9th, or 12th inning but I do know **we are near the end of the rate increase cycle.** Judging from the rally that followed the announcement of Ben Bernanke as successor to Alan Greenspan, The Street seems to approve of this choice. Bernanke was a member of the Federal Reserve Board for a few years before he was moved by Bush to be Chairman of the Council of Economic Advisors to the President last year. At that time, it was viewed as further preparation for this role. He is a highly respected academic who has made monetary policy his life's work.

Notice How The Dow Took Off in Q1 '95 Before The Final Interest Rate Increase Occurred in April '95!

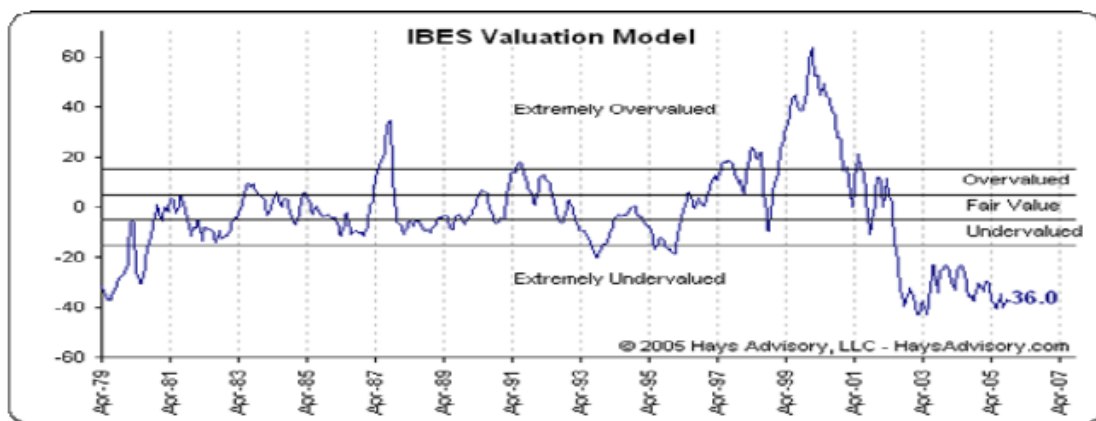


Weekly Chart of DJIA 12/93 to 6/96 + Fed Funds Rate Changes
Source: Reuters, Federal Reserve ©Gramercy Capital Management Corp



5. **Economic growth will continue in 2006.** Despite the high price of oil, predictions of imminent doom after the horrific hurricane damage to our Southern Coast, and rising delinquency rates, the consumer has not stopped spending. Most economists expect a slower rate of economic growth, maybe 2-3% next year but not a recession. Surely, that would be a slower rate than this year's 3-4% growth and it favors smaller and mid-sized companies that can grow in a less robust economy. The NASDAQ has a long way to go (a gain of 140%) before it returns to its peak level of 5132 reached in March 2000. That is where I see the best opportunity.

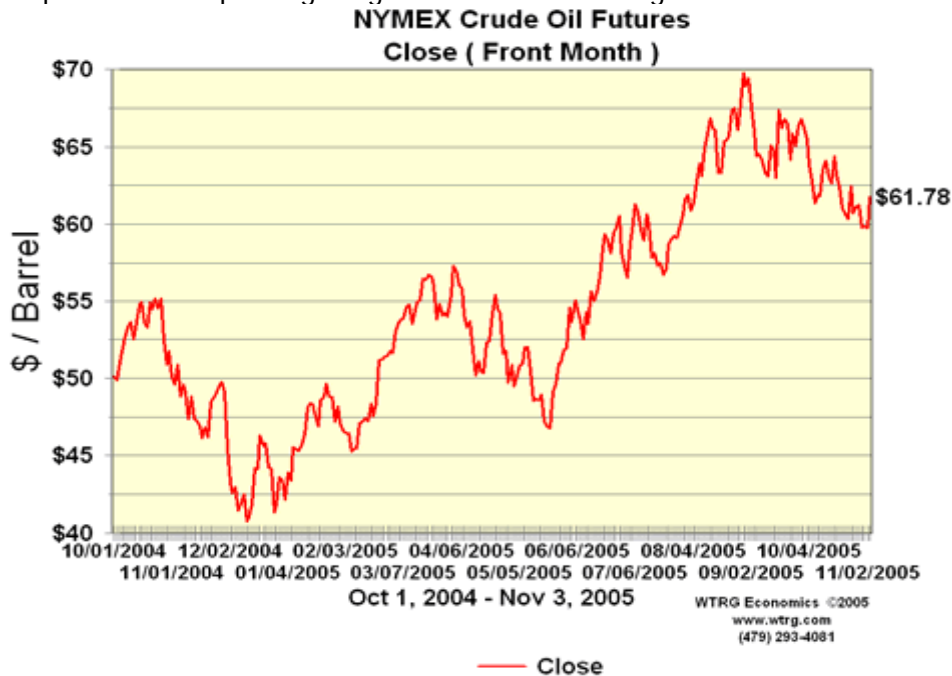
6. Corporate earnings have grown significantly over the last two years but the stock market has been stuck in the mud. With flat stock prices and rising earnings, the **P/E multiples have compressed to the lowest levels in a decade.** This chart below, courtesy Hays Advisory, shows it best. What will trigger the upturn is harder to discern than that an upturn is just around the bend if not imminent. When interest rates stop rising, multiples will begin to expand again. Stocks will rise reflecting better corporate earnings and then also enjoy the double whammy of rising P/E multiples



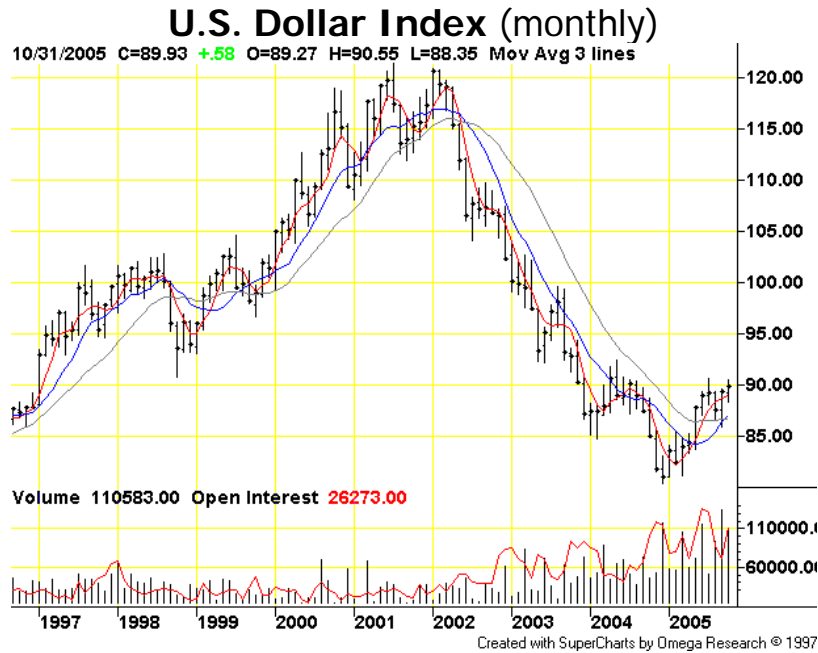
7. When interest rates were depressed by the Fed to help the economy recover from the stock market collapse and then 9/11, individuals refinanced their homes to reduce their interest costs. Many people did it more than once as they chased interest rates lower. Corporate America did the same thing. Many companies with junk bonds at double digit interest rates were able to refinance them at half the interest cost. In general, companies have much **cleaner balance sheets** today than they did five years ago. Also, the big spend on technology equipment in preparation for Y2K has put a lot of companies into a position where they didn't really need to spend a lot on technology upgrades in the last few years. That is one reason the consumer has been fueling the economy and not corporate spending. Even if the consumer is soon tapped out, corporations will soon need to upgrade and improve their technology to keep their operations streamlined for the digital age. Computers are now almost disposables as their cost to replace is so low as to be written off in a year.



8. **Oil prices** recently hit record levels. Beyond pure supply and demand, some of the price rise was fueled by hedge funds that were not making money in the stock market and decided to speculate in oil and other commodities in the hope it would aid their otherwise poor performance. In just a couple of weeks, oil prices have dropped 15% and natural gas prices have dropped 20%. That cannot be explained only by improved inventory numbers. I don't have a crystal ball so I can't reliably predict oil prices any better than anyone else. That said, I would be less surprised to see oil prices retreat to the mid-\$40's than to see them in the \$80's as some have predicted. I see opportunity in companies that service the oil patch. Our country will be really stupid if it does not legislate incentives to encourage exploration and development of deep drilling opportunities within the U.S. and in the Gulf of Mexico. Years ago, it was a big deal to drill a well that was 5-10,000 feet deep. Now wells to depths beyond 20,000 feet are common. New drilling technologies and smaller exploration companies with superior geologists will be the winning combination.



9. **Strengthening Dollar:** Foreign investors have shunned U.S. stocks this year as the markets here lagged foreign opportunities. Part of the reason is that they also expected the dollar to continue its downtrend compared to foreign currencies. It hasn't! Just this week, the esteemed Warren Buffett's Berkshire Hathaway announced that it had sustained \$900 million in losses this year betting against the dollar. Maybe losses of that magnitude are okay in Omaha but, as they say in New York, that's not "chopped liver." As fiscal restraint returns to Washington in 2006, it will cause the dollar to strengthen further. That, in turn, will draw foreign investors back toward the U.S. markets. They will make money on undervalued U.S. stocks as they rise and also on the dollar vs. their home currency. When money from abroad starts flowing here once again, it will only enhance the market gains we expect. The chart on the following page shows the rebound in the Dollar Index since January 2005.



10. Last but not least, **Fiscal Responsibility** is just around the bend. Both GOP's and DEMS are demanding it. We spent the 1990's under-going a tax increase to dig out of the budget deficit that was worrying most Americans. By 2000, we were happily contemplating a budget surplus. In just five short years, we have swung to the largest U.S. budget deficit of all time. The deficit clock is back up on Times Square. There is a long laundry list of things about which voters are not happy but this one is at the top of the list. It affects everyone by leaving a financial mess for our children to solve. As bad as Bush's poll numbers are now, those for the Congress are worse. Despite gerrymandering, GOP stalwarts now expect to lose seats in the 2006 election. It is well documented that split power leads to the most robust of stock markets as both parties are forced to work together for the best solutions to the problems of the country. That's why we anticipate that a **realignment of the Congress in the mid-term elections will be very bullish for stocks.**

So there you have it: our panoply of reasons that U.S. stocks are cheap and more attractive than they have been in years. To profit from this analysis, you must remember we are likely to remain in a stock pickers market. I don't expect the index funds to match the performance of skilled investment advisors. This environment will favor smaller and medium sized companies that can prosper and grow in a less robust economy by taking market share from others or by introducing new technology or services to the market place. Growth should outrun value although both are to be prized: either growth at reasonable prices or value accompanied by good growth prospects will combine to produce a winning year in 2006.

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