

INVESTMENT OUTLOOK

Year 2005 Review and Outlook for 2006

By Whitney Brown

- Stocks neutral for the year.
- Big gains in energy and foreign markets.
- More Fed rate hikes.
- Economy steady with inflation under control.



The stock market finished out the year in much the same way it spent the greater part of the past twelve months, drifting sideways. A respectable rally off the October low petered out in late November leaving nothing but ashes and switches for those in hopes of a December “Santa Claus” rally. The saving grace of the fourth quarter rally was that it did pull the major market averages up to neutral for the year.

The table above makes it clear 2005 was a flat year for U.S. stocks, as flat as we’ve seen since 1994. According to a recent article in *Barron’s* the Dow’s -0.6% return was only the fourth time in its 110-year history that the index moved less than 1% in a calendar year. Foreign stocks easily outdid U.S. stocks for the third year in a row.

Investment management by style such as value vs. growth or large cap vs. small cap offered some advantage, but a recent study by Ned Davis Research indicates that the spreads among the various styles were as narrow in 2005 as they have been since 1994. The edge went to value and mid cap for the year by investment style. Even among the major asset classes, stocks, bonds and cash, the returns were compressed. For the S&P 500, capital appreciation plus dividends brought about 5%. Total return on the 10-year

<u>Market Returns & Rates</u>	<u>4th Quarter</u>	<u>Year 2005</u>
S & P 500	1.6%	3.0%
Dow Jones Industrial Average	1.4%	-0.6%
NASDAQ Composite	2.5%	1.4%
Morgan Stanley EAFE	3.8%	10.9%
Lehman Bros. Intermediate T-Bond Index	0.6%	1.6%
	<u>12/31/05</u>	<u>12/31/04</u>
10 Year Treasury Bond Yield	4.39%	4.26%
90 Day Treasury Bill Yield	4.08%	2.22%

Treasury bond was around 2%, and money market funds averaged approximately 3%.

Despite the neutral tone to the markets, there were certain sectors and industry groups both at home and abroad that offered clearly superior returns. Portfolios of carefully selected stocks from key areas of the market fared well. Energy stocks had another banner year reprising their performance from last year. Many stocks related to commodities such as mining

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companies did very well for the year. Emerging markets such as Brazil and South Korea also offered generous returns. At long last, Japan's stock market has come roaring back to life after a lengthy bear market dating back to 1989. Even gold continued its winning ways.

The Federal Reserve continued the campaign to return short-term interest rates to a more neutral stance by raising the Federal funds rate steadily in ¼-point increments throughout the year. Curiously, longer rates such as the 10-year Treasury bond yield failed to make a sustained move higher and finished the year more or less where they started. The yield curve became progressively flatter over the course of the year, meaning the difference between short-term yields and long-term yields became smaller. At this writing, the yield curve is actually inverted with 1-year Treasury yields slightly exceeding the 2, 5 and 10-year Treasury yields. Please see the related article on page 3 for more on the yield curve. The bond market apparently does not share the Fed's concern about potential inflation. In fact, outside of energy prices, inflation remained tame over the course of the year.

The outlook for 2006 and beyond contains both promise and peril. While the U.S. economy remains on solid footing, corporate earnings have likely peaked. The housing boom, both new construction and appreciation of home prices, is slowing with negative implications for consumer spending. The ballooning of home values over recent years provided a considerable wealth effect to homeowners much as the stock bubble of the late 1990's did. These factors along with the pattern of economic cycles call for a temporary slowing of economic growth, not a recession, in the coming year for the U.S.

On the other hand, capital spending by businesses to improve productivity and remain globally competitive is expected to remain strong. In a recent commentary a long time market strategist anticipates the coming "build-out" phase of the

Technology Revolution. He likens it to a similar phase of the Industrial Revolution when industrial giants such as General Motors became the most important companies in the world. He further anticipates a profound shift toward democracy and capitalism by countries all over the world, thereby pumping up demand globally to the tune of several billion new consumers. Pretty heady stuff, but it certainly bodes well for a dynamic global economy in the years ahead.

Inflation is likely to remain contained as productivity through technological innovation and global competition keep prices for goods in check. Energy prices may be a wild card in the short run, but higher prices have yet to have a significant impact on the global economy. Consumers of energy have a way of adjusting their needs to the price. As a recent commentator on crude oil prices flatly stated, "There's no cure for high prices like high prices." Indeed, current oil prices are well below the post-Katrina peak of \$70 per barrel.

At this time last year we warned ourselves not to grow complacent, and that goes double for '06. It's not likely the stock market will be as dull over the coming year. The question is whether the bulls or the bears will win the day. There are convincing arguments for either case. Our best estimate calls for a correction of some substance early in the year followed by a significant bottom and then strength into the later part of the year. The 4-year cycle composite compiled by Ned Davis Research has been a reliable indicator of the stock market trend over the past three years and calls for another fairly neutral year but with more volatility along the way.

Our best approach will be more of what works: Explore pockets of opportunity and avoid areas of weakness while controlling risk with diversification and high quality securities. As *The Chartist* market newsletter recently summed up, "We will take it one day at a time. The market will tell its own story, and we will adjust to the scenario as it unfolds." Believe me, we'll be listening closely for the story. Best wishes for peace and prosperity in the year ahead.

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The Inverted Yield Curve

by Watt Dixon



It is a common misconception that all interest rates move in the same direction all the time. Short and long term rates often move in opposite directions. The overall pattern of rates is what is important. The relationship of interest rates with different maturities is known as the yield curve or the term structure of interest rates. The shape of the yield curve will be different depending on what varying maturities are yielding.

Normally, short-term bonds have lower yields than longer bonds to reflect the fact that the investors' money is at less risk. The longer your money is tied up, the more you should be rewarded for your risk. Therefore, a normal sloping yield curve should look like the graph below on the left: The longer the maturity, the higher the yield.

At times, the yield curve may begin to flatten when the

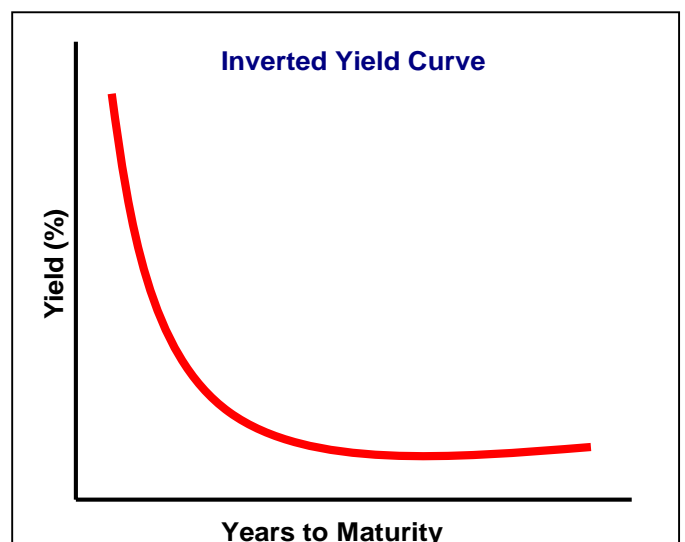
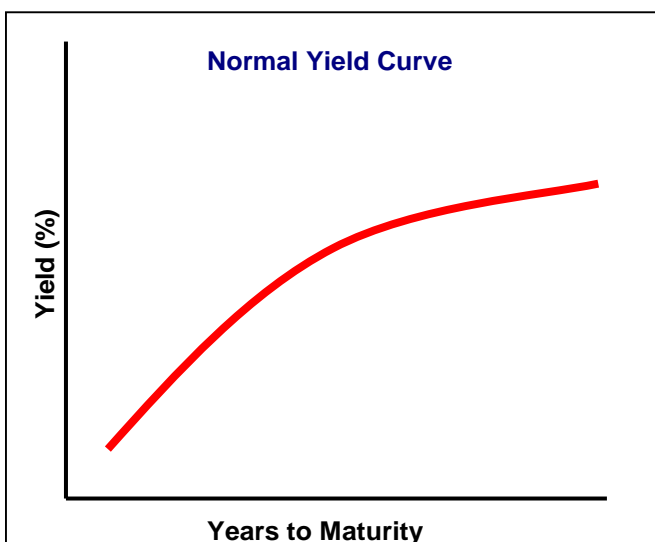
market environment sends mixed signals to investors. With a flat yield curve, investors' opinions vary greatly on what direction rates will move. Long and short maturities will have close to the same yields.

We wrote last April about the flattening yield curve and its implications. During the last week of 2005 we saw the yield curve become slightly inverted for the first time in five years. An inverted yield curve occurs when shorter maturities actually carry higher yields than longer bonds, as shown in the graph below at left. Historically, an inverted yield curve has been a leading indicator of an upcoming recession. The inverted yield curve indicates that the market currently expects interest rates to decline as time moves further into the future, due to reduced economic activity and lower inflation, which in turn means the market expects yields of long-term bonds to decline.

Even when the yield curve is inverted, some investors will

make a case to purchase longer bonds due to the fact that they expect a recession and even lower rates in the future. Better to lock in current rates than to have to buy bonds in the future at even lower yields.

Some analysts believe that the reason why past inverted yield curves have been effective leading indicators of recessions is due to short rates rising faster than long rates, but with all rates still rising. This most recent inverted yield curve is slightly different than others. While short rates have risen over 300 basis points, longer rates have actually fallen. The shape of the yield curve only matters to banks and other lenders who live off net interest margin by borrowing short and lending long. The rest of us operate under the cost of credit. Due to the fact that longer rates have fallen, keeping borrowing costs low for consumers and businesses, many economists believe that we are in for a brief economic slowdown rather than a full blown recession.



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Tax Changes for 2006

By Ted Feinour



With the beginning of 2006, several tax changes became effective. Among them are some law changes that were passed a few years ago, such as allowing many high-income taxpayers to claim more itemized deductions and personal exemptions.

Other changes that one might want to discuss with their accountant include a large cut in federal estate taxes, an increase in the annual gift tax exclusion and higher limits on how much individuals can put away in tax-favored retirement plans.

For estate taxes, the basic exclusion from the federal estate tax increases to \$2 million from \$1.5 million for 2005. The top federal estate tax rate decreases to 46% from 47%. There has also been a change for the annual gift tax exclusion from the level that has been in existence since 2002. One may now give away as much as \$12,000 to anyone without

having to report it to the Internal Revenue Service. There is no limit to the total amount an individual may distribute.

For retirement savings vehicles, the maximum amount that workers can contribute to a 401(K) plan has also increased. For an individual under age 50, the top amount will be \$15,000 up from \$14,000 in 2005. Individuals 50 or older at any time this year may put away an additional \$5,000 (up from \$4,000 in 2005) for a total of \$20,000.

Tax Change Spotlight

- Estate tax basic exclusion increases to \$2 million
- Top federal estate tax rate decreases to 46%
- Annual gift tax exclusion now \$12,000 per individual (\$24,000 for joint spousal giving)
- Retirement savings ceilings raised