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The Current Consensus

Over the summer, the consensus view of the U.S. economy and the domestic stock and bond markets has changed dramatically. In May, the consensus view was for a strong economy, continued energy price increases, inflationary pressures, rising interest rates and continued earnings gains. Ten-year Treasury bonds were selling at a yield of 5.2%. Stocks were hitting new cycle highs.

The current consensus is decidedly different as indicated by the fact that ten-year Treasuries now yield only 4.8%. Most recent economic reports have been weaker than expected. This is especially true in the housing sector and other consumer areas. Oil prices spiked up recently due to the conflict in Lebanon, but they have receded to the levels of last spring.

Responding to the move in the bond market and the weaker economic reports, the Federal Reserve decided to hold overnight interest rates where they have been for a while. Recent producer price indicators have given them a breather on the inflation issue. The stock market has pulled back from cycle highs as concerns about slowing economic activity are beginning to temper earnings forecasts.

The consensus is building for a much slower economy than expected over the next several quarters. Goldman Sachs and others are forecasting that the Federal Reserve will be in a loosening mode by early next year and, in fact, will be lowering rates throughout most of 2007.

If the new developing consensus proves to be correct, 2007 could be a big year for U.S. stocks. Earnings will likely be disappointing, but the effect of lower interest rates and greater liquidity will overwhelm slightly lower earnings forecasts, and PE's will go up in anticipation of a recovery in earnings growth in 2008. This scenario would be consistent with a "typically" good stock market in the third year of the Presidential election cycle.

However, within the market some significant rotation is likely. High quality, large capitalization stocks should do well as rates decline and as people seek to avoid more cyclical companies whose earnings might suffer over coming quarters. And, as we begin to anticipate the other side of this slowdown, the markets should rotate to neglected and beaten down "early cycle" investments such as Information Technology. Recent winners such as Materials, Industrials, and other "late cycle" stocks that depend on pricing power will likely be the source of funds for this buying.

Bond yields probably have further to decline to say, 4.5%. But, if the scenario plays out as expected, bond prices will peak and bond yields bottom about the time that the Federal Reserve starts to lower short-term rates. For a while, stocks and bonds can both do well. But by the middle of next year, bonds will find it tougher sledding.

Currently, sentiment figures indicate a lot of buying power on the sidelines for both stocks and bonds. There are a lot of Bears out there creating a wall of worry for the markets to climb.

Money supply is growing at a good pace again after growing quite slowly over recent quarters. This added liquidity should help the markets.

Valuation for stocks is reasonable. Our model shows the S&P 500 some 15% undervalued in the current interest rate environment. Price earnings ratios are in the mid-teens and could expand as the Fed switches course.

We have enjoyed a short bounce in the stock market. There is probably further to go in this rally.

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A copy of our Form ADV, Part II is available upon request.
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