October 2005

DHJ&A
DAVIS HAMILTON JACKSON & ASSOCIATES

Rally Time?

Since our last letter the Standard & Poor's 500 has declined about 5%, more or less the expected pullback to the bottom of what seems to be an interminable trading range in which the equity market has been stuck for many, many months. The question now is whether the trading range will hold this time, or will higher interest rates and concerns about higher inflation and lower profit growth lead to further declines. Our guess is that it holds, and we are set up for a rally through January back to 1250-1300 on the S&P 500.

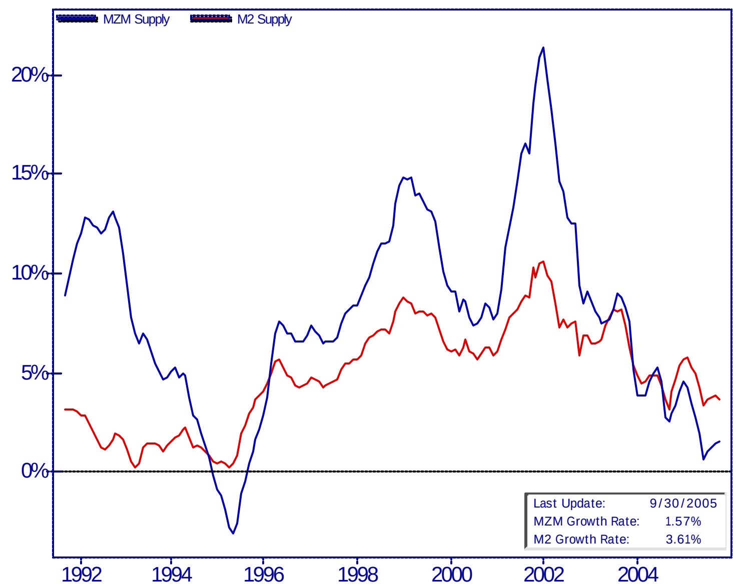
As long time readers of these tomes know, we believe that the short run direction of the market is most affected by sentiment. The intermediate term is dominated by monetary factors, and the longer run is a function of valuation. Recently, sentiment has moved to a much better position to support the market.

Investors Intelligence measures sentiment by surveying the market views of over one hundred market newsletters and reports the percentage of advisors that are bullish, bearish or expecting a correction. Advisor sentiment is viewed as a contrary indicator; that is, bearish sentiment tends to be positive for the market and bullish sentiment tends to be negative.

This week, the percent of bullish advisors on the equity market was reported at 45%, down from 60% not very many weeks ago, while the percentage of bears rose to 29% over the same timeframe. The ratio of bulls to bears is similar to that which existed when the market began a rally to the top of the trading range back in the spring.

So, there is now enough money on the sidelines and a wall of worry for the market to climb. In addition to sentiment, valuation has become more attractive with the recent pullback, and November/December should be influenced as usual by Santa Claus. These factors suggest that October should mark the low for the US equity market in 2005.

Although a near-term rally is likely, don't expect the market to establish a new bull market trend just yet. The yield curve is flat by historical standards and, as the chart below shows, money supply growth is poor. So despite valuation and sentiment, current monetary factors do not support a breakout above the trading range we've been in. However, it doesn't take much imagination to see a very good stock market in 2006.



Source: St. Louis Federal Reserve, DHJA Research

For example, suppose that Fed Governors want to get the dirty work of tightening out of the way before the new guy takes over from the Maestro, Chairman Greenspan, at the end of January. Oil and natural gas prices are already down significantly from their highs and the current inflation scare could be history by March. With housing activity slowing and home pricing a little soft, it wouldn't be surprising if the Fed reverses course and begins easing by spring. If so, stocks could be a lot of fun next year. The Federal Reserve is the key!

Robert C. Davis, CFA
October 27, 2005

A copy of our Form ADV, Part II is available upon request.
FIVE HOUSTON CENTER 1401 MCKINNEY ST., SUITE 1600 HOUSTON, TEXAS 77010 PHONE: (713) 853-2322 FAX: (713) 853-2308