

Popping the lid in 2006

In the world of investing, it's downright lethal to your financial well being to extrapolate the recent past into the future. As they say: "Trees don't grow to the sky", but the inverse is true too. The consensus of the investment cognoscenti is for single digit returns for U.S. stocks in 2006 and the rest of the decade. In my opinion, these predictions will turn out no more accurate than double-digit returns for stocks past 2000 or real estate prices growing past Neptune without interruption. Change, change is coming.

Summary: The first week of January provided more returns for stocks than the sum of 2005. There can be no doubt the trend is up for stocks and October was likely the "last good entry point". Expect returns to exceed 15% in '06.

It's time for the U.S. markets to play catch-up with Asia, S. America and Europe. Easing monetary policy in the U.S. with the potential for corresponding weaker dollar should create an attractive environment for a reversal of fortune between world stock markets and the U.S. stock market.

time to laugh). **Any selloff of significance in the early weeks of January would be a gift with the impending shift by the Fed, any selloff should be short and shallow.**

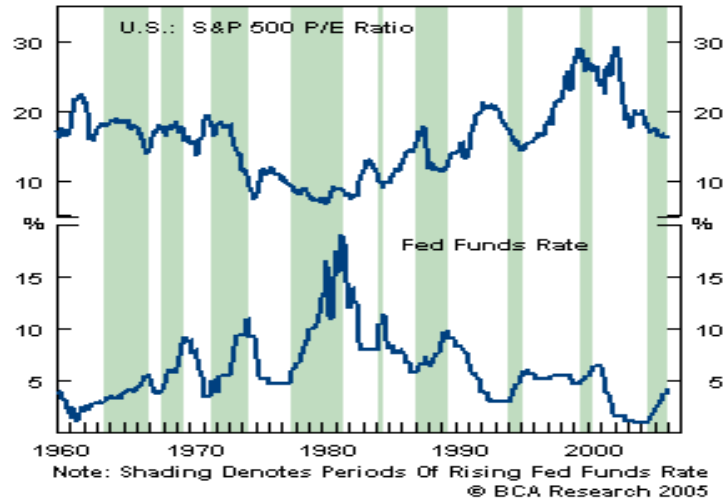
I may have watched many of the Twilight Zone reruns over the holidays but I assure you, my estimates were not created by Rod Serling. The foundation to my conclusions is fairly simple **Expect returns over 50% to equity investors over the next 3 years.** (Now would be a good with significant historical precedent.

What counts now is not the past, the future is setting up well for a revision of the stock markets P/E (Standard and Poors 500 earnings divided into its price, the result is a multiple of how many times investors are willing to pay for those earnings). At present, the PE of the S&P 500 is 14.9 (the lowest multiple in 9 years) using 2006 estimates, this figure could reach 16.5 in '06 which would provide a return in excess of 20%.

When the Fed raises interest rates, the PE of the market declines. People won't pay up for stocks when they know the Fed may ruin the economy. When the Fed is finished they will pay-up knowing they have clear sailing ahead. As I've said many times previously, the Fed has kept a lid on stock prices by raising interest rates, this lid will be removed in early 2006.

As the chart below reveals, the PE of the U.S. stock market contracts when the Federal Reserve is raising the Federal Funds interest rate, and expands when they finish or lower interest rates. Put another way: When the Fed is raising rates, stocks stagnate or decline, when the Fed is finished raising rates or lowering them stocks increase in value.

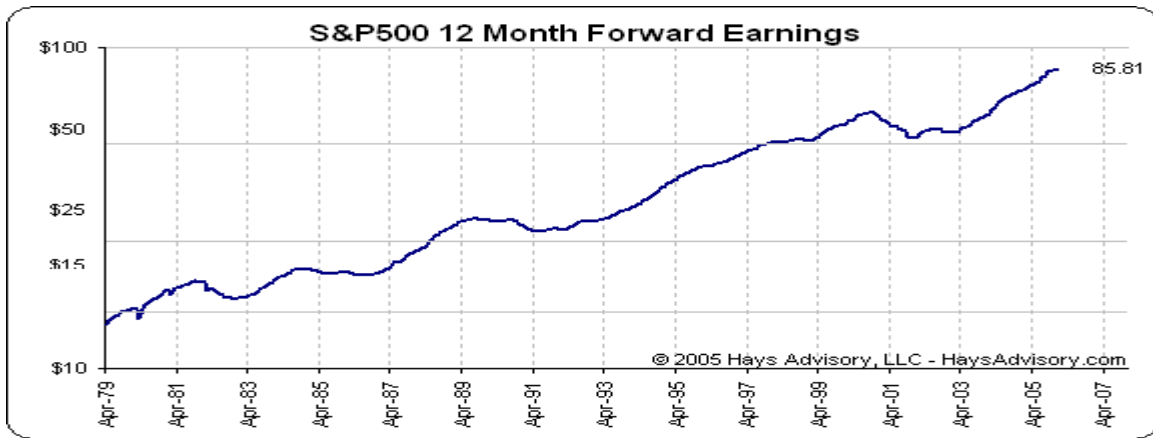
Since 1980, the time period when interest rates were steady or declining has been fairly consistent at approximately 4 years. Further back to 1960, with the exception of the anomaly of 2000-2002 (the markets PE never got low enough to rally till 2003) PE's have expanded sharply when the Fed is finished. There is no reason not to expect the same reaction this time as well.



One difference to the chart and my estimates is that I prefer to use Forward Earnings, whereas the chart by Bank Credit Analyst uses trailing earnings.

However, if I convert the calculation to that of the BCA trailing earnings format and use an estimate of \$85.81 (the current estimate for 2006) with a very conservative estimate of 17 the 12-month return of the SP 500 would be 16.88%. But what should really pique your eye would be if we use the current trailing PE of 19, then the return would rise to 29.6%.yikes...all of this is done with no increase in earnings whatsoever, which is unrealistic but I don't want you to start laughing too hard.

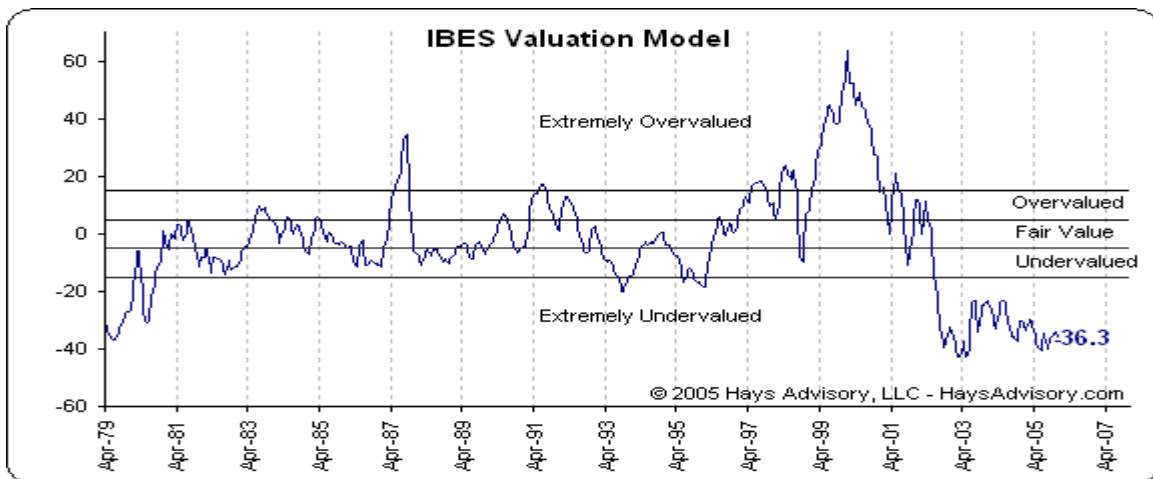
The chart below shows that since the end of the recession in 2003, earnings growth has been outstanding. However, shares of stocks have not kept up with the increase in earnings. Why? Investors fear that the Fed by raising interest rates would trigger another recession as they did in 2000. The biggest difference between 2000 and today is that stock prices today are very inexpensive. Historically, valuations this low to compared to bonds have triggered major rallies.



Earnings growth by year

- 2002: +6.0%
- 2003: +15.2%
- 2004: +21.2%
- 2005: +10.5%
- 2006: est. +10.9%

Have any domestic portfolios produced gains comparable to the earnings growth? Few if any would be the answer. Despite significant earnings stocks, stocks have been relatively stagnant with combined gains of just 10% for '04 and '05. This leaves lots of room for catch up.



Once the Fed is finished raising rates early in 2006, expect 2006 to 2008 to be a reversion to the historical mean relationship between stock prices and interest rates.

Last years estimates and predictions worked quite well as I expected a stagnant market and very modest returns. 2006 should be quite different.

Predictions for 2006

Good: 45% probability: 9% to 15% returns

Earnings growth comes in at 7% and the markets PE on forward earnings rises from 14.9 to 16. Commodity prices are relatively stable. Ben Bernanke, the new head of the Federal Reserve hikes rates 50 basis points.....then puts the Fed on hiatus for the rest of the year.

Real estate stagnates or dips but not precipitously as US immigration policy continues to provide a basis for real estate demand.

Foreign corporations realize their markets and currencies are too strong to create value and instead, look to the US companies for friendly and hostile mergers.

Better 35% probability: 15%+ returns

Falling dollar and punished real estate speculators return to U.S. stock markets as the U.S. market plays catch up to World markets. The US ranked only 29th out of 32 World Markets in '05, a feat not likely to be repeated, especially with valuations at 9 year lows.

Fed goes on hiatus by March, but a weakening economy causes the Fed to lower interest in the second half of the year thus igniting a major rally.

Earnings growth comes in at 5% and the markets PE on forward earnings rises from 14.9 to 16.5.

***Worse 20% probability: 9% or below**

Anti-American rhetoric in South America gives way to broadening Socialism and Nationalistic tendencies, forcing higher commodity prices. Terrorist fears on U.S. water supplies create higher crop and food prices. Asian oil and natural gas demand continues unabated.

Retail sales take a big hit as the US consumer finally slows down due to declines in real estate.

The White House wiretap scandal is found to be wider than previously thought after Senate Judiciary committee investigations. A special prosecutor is appointed and Dick Cheney takes the fall for the White House.

Memories of Watergate depress investors as U.S market valuations continue to stagnate or become even cheaper, this of course could lead to an explosive 2007.

For individual stock information see the accompanying RMHI stock list.

Warmest Regards for 2006,
Brad Pappas

*Special thanks to Doug Kass of Seabreeze Partners and Street Insight, short-seller extraordinaire for the Bearish scenarios. Rocky Mountain Humane Investing, Corp. (RMHI) does not guarantee the accuracy or completeness of this report nor does RMHI assume any liability for any loss that may result from reliance

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