



# EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

## NEWSLETTER

January 2006

### OUTLOOK FOR 2006

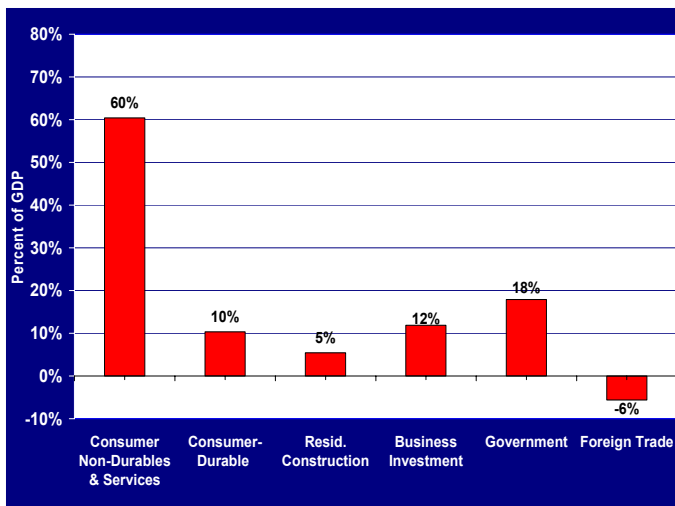
#### *Economy Decelerates, But Stocks Should Do Better*

The current economic expansion was initiated and driven by the American consumer who benefited from the 2001 tax rebates, the 2003 tax cuts, rising employment, historically low interest rates, and escalating home values. All of which more than neutralized the impact from the sharp rise in energy costs.

face the combined impact of gasoline prices and home heating costs that are dramatically higher than a year ago.

As a consequence, the 2006 consumer is more likely to inhibit economic growth than lead, as they have done for the last several years. With that said, much of their curtailed spending will be felt in the durables sector. Spending for less discretionary items such as non-durables and services, should continue to expand, but at a more modest pace (Chart II).

**CHART I**  
**The Economy By Sector**  
2005

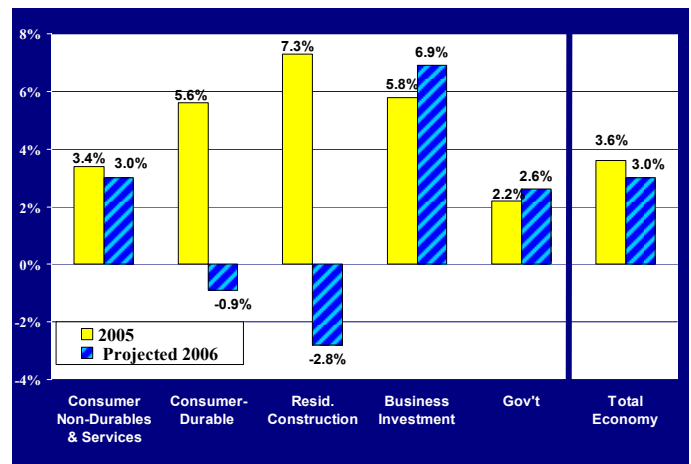


\*May not add due to rounding

Looking ahead, consumer spending, which totals 70% of the economy (See Chart I), should moderate. First, its growth over the last several years was enabled by a sharp decline in personal savings rates. Last year's savings rate was actually negative, household spending exceeded disposable personal income! Such a condition is unsustainable, and consumer caution should develop in 2006 as households restore a more normal balance between income and spending. Second, there will be the lagged effect from last year's interest rate increases. Approximately 45% of outstanding mortgages have adjustable rates that have a delayed increase in a rising interest rate environment. Third, households will have to contend with high energy costs. Consumers will

Deceleration will be more dramatic in residential construction. Housing starts peaked early last year at the highest level in more than a quarter of a century. With the 30-year fixed mortgage rate at 6.0%, negative household savings rates, and a recent softening in single family home sales, home construction should decline by at least several percent in 2006.

**CHART II**  
**Economic Growth By Sector**  
(Inflation Adjusted and Excluding Foreign Trade)  
2005 vs. 2006



Nevertheless, the remaining economic sectors should be quite resilient. Business investment, accounting for 12% of the economy and twice as large as residential construction, could have accelerating growth. Employment is rising,

capacity utilization rates are increasing, and new orders for capital equipment are firm. Moreover, inventory sales ratios are at the leanest levels in several decades, and current production levels may need to increase to prevent a further depletion of inventories.

Government spending is also expected to accelerate; albeit, modestly. Federal spending, 7% of the economy, should continue to expand at the same 2.5% - 3.0% pace as last year. Spending at the state and local level, which is 11% of the economy, should accelerate from its sub-par 1.7% growth in 2005.

In addition, firmer economic conditions overseas, in conjunction with a less robust American consumer, is likely to cause our foreign trade deficit to increase less than it has over the last several years.

With close to 90% of the economy remaining buoyant, consumer non-durables and services, business investment, and government, this year's economic growth is projected to be 3.0%, the mid-point of a 2.7% - 3.3% range. Growth should be at the upper end of the range during the first half of the year and in the lower portion during the second half. On an annual basis, this represents a deceleration from an estimated 3.6% in 2005 and 4.2% in 2004.

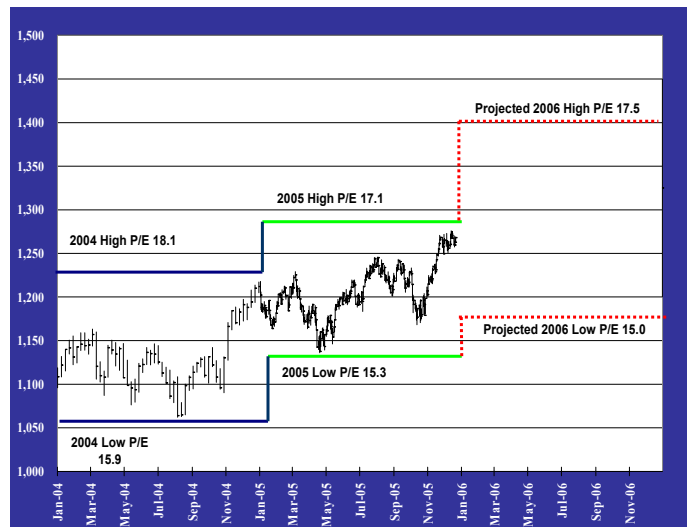
## INVESTMENT STRATEGY

Stock market gains were disappointing in 2005. The Standard & Poor's Index had a minor price gain while the Dow Average closed the year lower. With dividends, both had a positive return.

Last year's investor returns were inhibited by nine increases in the Federal Funds rate (13 increases since June 2004) and a sharp rise in crude oil prices. This caused the stock market to ignore double digit percent gains in dividends and earnings as well as substantial increases in per share revenue and book value.

As the economic recovery matures further in 2006, gains in revenue, earnings, dividends, and book value are unlikely to match those of last year. Nevertheless, their increase should be considerably stronger than overall economic growth due to rising exports (foreign earnings), increased worker productivity, and a reduction in outstanding shares as companies buy back their stock with surplus cash. This should permit company earnings to increase in the 5% - 8% range. Dividends, as a percent of profits, are still quite modest, and should continue to rise at a double digit pace.

**CHART III**  
*The Standard & Poor's Index*



Short-term interest rates are expected to rise further, but the magnitude and frequency should abate from last year. With 13 interest rate increases already behind us along with a decelerating economy, the Federal Reserve could complete its process of raising rates before year-end, and perhaps as early as mid-year. On this basis, and contrary to 2005, stocks may then be able to rise at a faster pace than underlying earnings.

More specifically, the Standard & Poor's Index is expected to fluctuate in a range of 1,175 - 1,400 most of the year. This range is premised on price-earnings ratios consistent with their low and high values for the last several years. Exceptions to this range are expected to be temporary.

Based on a 2005 closing of 1248, the Standard & Poor's Index has about 6% downside risk (4% with dividends), but that risk is out-weighed by 12% (14% with dividends) on the upside. If stock prices rise in line with earnings, investor returns, including dividends, could be in the 7% - 10% range. This compares with a 4.9% return last year.

**TABLE I**  
*Market Performance Comparison*  
(Including Interest and Dividend Income)  
Year to Date\*

MARKET INDEX	12/31/04	12/31/05	Return
Standard & Poor's 500	1,212	1,248	4.9%
Dow Jones Average	10,783	10,718	1.7%
NASDAQ	2,175	2,205	1.4%
EAFE Index	1,515	1,696	11.9%
3 Mth U.S. Treasury Bill	2.2%	4.1%	2.9%
10-Yr U.S. Treasury Bond	4.2%	4.4%	2.8%
10-Yr AAA. Tax-Exempt	3.6%	3.8%	2.0%

\*Estimate