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

NEWSLETTER

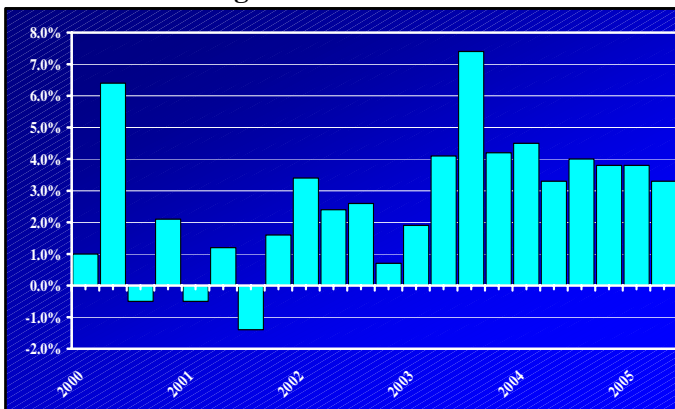
October 2005

LOOKING AHEAD

Can the Consumer Continue to Spend?

The current economic expansion began gradually in 2002, and its growth rate accelerated to a peak of 7.2% in the third quarter of 2003. Since then, its growth moderated – recently to 3.3% (Chart I). This is consistent with the normal maturation of an economic expansion. Actually, business conditions have been remarkably resilient in the face of rising short-term interest rates and exceptionally high crude oil prices.

CHART I
Change in Economic Growth



Over the last 15 months, the Federal Reserve raised short-term interest rates eleven times and the Federal Funds rate (inter-bank borrowing cost) increased from 1% to 3.75%, an increase of 2.75%! The effect of this tightening on the economy has been neutralized, in large measure, because longer-term interest rates have not increased much, if at all. In fact, the ten-year U.S. Treasury yield actually declined during this time.

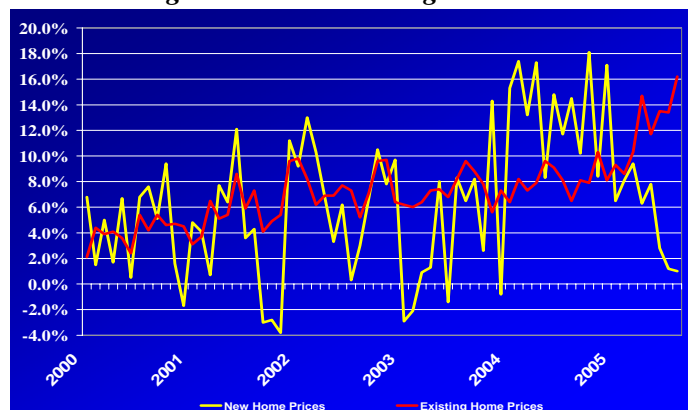
Even rising crude oil prices failed to stem consumer spending. The impact of higher energy costs were mitigated by the increase in household wealth from the extraordinary appreciation in home equity values. Consumers extracted that appreciation through re-financing and home equity lines of credit to support increased purchases of goods and services. Thus, neither the Federal Reserve's monetary

restraint nor record crude oil prices interrupted the economic expansion.

Looking forward, however, deceleration may become more pronounced. First, rising short-term interest rates have a lagged impact on restraining economic activity; as much as a year. Consider, for example, the delay before home equity lines adjust to changes in interest rates. Thus, today's economy reflects an interest rate structure that existed 6 – 12 months ago, more so than current yields. In the same vein, economic activity over the next 6 – 12 months will be impacted by the more recent and higher shorter-term interest rates.

Second, record energy costs are putting a strain on the consumer's pocket book. Even if crude oil prices stabilize at current levels, households will be impacted by gasoline prices that are still 25% - 35% higher than a year ago. In addition, consumers will be facing unprecedented winter heating costs. As a result, consumers, who have been relatively unfazed so far, may finally be required to curtail spending in other areas.

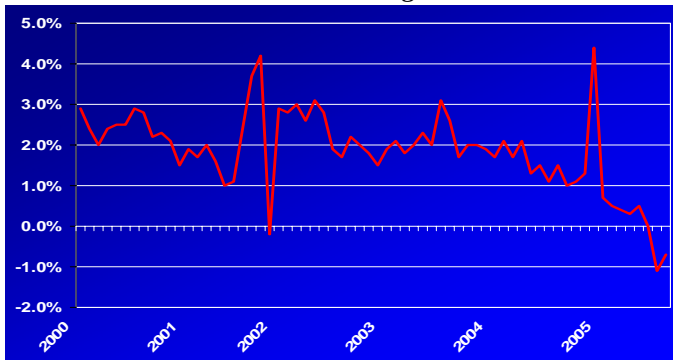
CHART II
Change in New and Existing Home Prices



Third, escalating home values, which have been a major source for funding consumer purchases, are beginning to face the "headwinds" of rising interest rates. Recent trends

in home prices are already mixed (Chart II). While existing home prices are still rising in excess of 15%, price increases for new construction have become marginal. Thus, this source of consumer liquidity may be evaporating.

CHART III
Consumer Saving Rate



This developing strain led to a sharp deterioration in the consumer savings rate (Chart III). During the last three months, households actually spent more than their income, a condition that obviously can't persist for an extended period of time. As home value appreciation continues to moderate, and the Nation's savings rate returns toward more normal levels, and it eventually will, the pace of consumer spending should also moderate.

With the consumer accounting for over 60% of the economy, any slowing or deceleration in that sector will undoubtedly slow overall economic growth in the coming quarters. The degree of overall deceleration will be mitigated by strength in business spending, which has been growing in excess of 10%.

The dislocations from Hurricanes Katrina and Rita will particularly impact this year's third and fourth quarters. As a result, a substantial slowdown in economic growth may occur before year-end. On the other hand, massive Federal spending (and deficits) to re-build the Gulf Coast should positively impact the economy in subsequent quarters with growth returning to 3.0% - 3.5%.

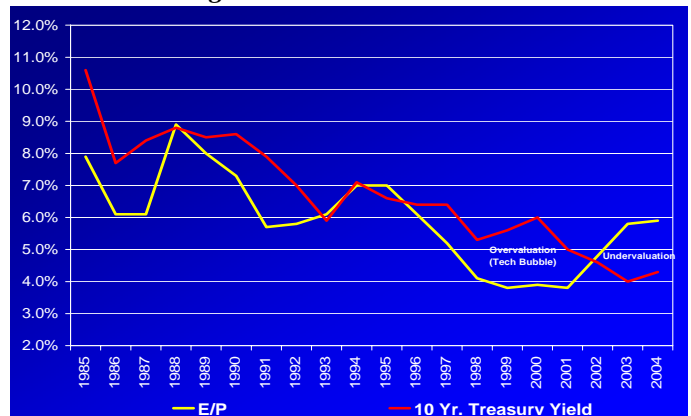
INVESTMENT STRATEGY

In the near-term, stock market volatility is likely to increase as third quarter earnings reports reflect dislocations from the hurricanes. With that said, stocks already appear conservatively valued and any adverse reaction to short-term earnings disappointments should be limited.

Over the last 20 years, there has been a relatively close relationship between stock valuations (price-earnings ratios) and interest rates. Namely, as interest rates rise, price-

earnings ratios decline. For illustrative purposes, Chart IV describes that relationship by inverting the price-earnings ratio to an earnings-price ratio so that both concepts are expressed as yields. Normally, the earnings yield (earnings-price ratio) is less than the 10-year U.S. Treasury yield as stocks benefit from future earnings growth, whereas the interest paid by the U.S. Treasury bond is constant. The extraordinary over-valuation during the 1998-2000 "tech bubble" is readily apparent. Equally apparent is the correction from the "bubble" which took place in 2002. That correction resulted from a combination of declining stock prices along with declining interest rates. In 2003, interest rates declined even further and have not substantially increased since then. While that occurred, the earnings yield rose (price-earnings ratios declined), as corporate earnings steadily increased while stock prices remained sluggish.

CHART IV
Earnings-Price Ratio & Interest Rates



As a result, there is now a positive spread between the earnings yield for stocks compared to the 10 Treasury yield. It is now 1.6% greater, substantially greater than the marginal positive spreads that temporarily developed in 1988 and 1995. On this basis, any near-term weakness in the stock market should be viewed as a buying opportunity.

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

MARKET INDEX	12/31/04	09/30/05	Return
Standard & Poor's 500	1,212	1,229	2.8%
Dow Jones Average	10,783	10,569	-0.3%
NASDAQ	2,175	2,151	-1.1%
EAFE Index	1,515	1,619	6.8%
3 Mth U.S. Treasury Bill	2.2%	3.6%	2.0%
10-Yr U.S. Treasury Bond	4.2%	4.3%	2.2%
10-Yr AAA. Tax-Exempt	3.6%	3.7%	1.2%

*Estimate

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