

# REVIEW & OUTLOOK

## ALL EYES ON THE FED

The quarter ended June 30 was a tough one for most investors. From its peak on May 5 through the end of the second quarter, the S&P 500 Index of large cap stocks declined by about 4%, erasing most of its gain from the first four months of the year. Mid and small cap indexes fared progressively worse since the correction began, and foreign stocks, especially emerging markets, generally declined even more. Bonds failed to gain ground when investors exited stocks, hinting that rather than shifting from one asset class to another, many investors simply shed risk wherever they perceived it. It was, to be sure, one of those times when the sidelines seemed like an appealing place to be.

A detailed look at stock performance reveals that the sectors that led the powerful market advance between October of last year and early May, most notably, Basic Materials, Energy, Industrials and Information Technology, were the biggest decliners in the recent sell-off. By contrast, traditionally defensive sectors such as Consumer Staples, Telecommunication Services and Utilities, which had lagged behind as the market rose, were better performers when the trend reversed.

Thompson, Siegel & Walmsley, Inc. (TS&W) believes that widespread concerns about a deteriorating global economic environment are over-blown and that stock prices remain generally attractive. We are maintaining a constructive outlook which we will explain in more detail below.

## A Short-lived Correction or the Beginning of Something Worse?

The recent unease in financial markets is attributable to a pair of closely related economic factors that are effects of economic growth. First, an extended period of remarkably widespread economic expansion has produced an increase in inflation rates and inflation expectations around the globe. Higher inflation has been evident for some time in energy and commodity prices as burgeoning demand outstripped available production capacity. More recently, prices have risen for a broadening array of goods and services, including apparel and rent. Inflation expectations are a key determinant of interest rates and rising inflation is associated with falling values for both stocks and bonds.

The pickup in inflation from very low levels is not a surprise given the strength of the global expansion. Central banks around the world, including the US Federal Reserve, The People's Bank of China, the European Central Bank, the Bank of England, the

Bank of Japan, the Reserve Bank of India, and others have responded by raising short-term interest rates and tightening monetary policy. The Federal Reserve has increased short-term interest rates 17 times in the past two years, from 1% in the summer of 2004 to 5.25% today. Longer term interest rates, which are controlled by market forces, not central bankers, have also risen, but not as rapidly as short-term rates. Over the past year, the yield on the benchmark ten-year Treasury bond has risen from around 4.0% to just over 5.2%, and a 30-year conventional mortgage has gone from about 5.5% to 6.7%. These are significant increases, but it is important to note that rates are still below levels reached in 2002.

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The fact that bond yields are not even higher in the face of rising inflation data is attributable to the market's second major concern. Some investors worry that in their zeal to curb inflation, central banks will raise rates so high that they inadvertently choke off

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world economic growth, producing a recession that saps corporate profits, erodes stock values and triggers debt defaults.

This concern is compounded by

the retirement earlier this year of Alan Greenspan, who had earned tremendous investor confidence and rarely made statements that surprised market participants after eighteen years as Chairman of the Board of Governors of the Federal Reserve. The new Federal Reserve Chairman, Benjamin Bernanke—who lacks

Greenspan's grandfatherly capacity to reassure nervous investors—has rattled markets with unexpectedly tough talk about fighting inflation, fueling speculation that the Fed is about to overstep the line between neutral and restrictive monetary policy.

There is little doubt that the conditions described here add up to a tougher environment for investors. Higher interest rates and a pickup in the inflation rate are not typically associated with bull markets for stocks and bonds. This does not mean, however, that investment opportunities have become scarce or that investors should abandon long-term strategies. Thompson, Siegel & Walmsley sees good reasons to maintain a constructive, if careful, outlook. We do not believe that worst case scenarios about inflation and interest rates or a global economic recession are likely to play out, and we are encouraged by stock prices that are inexpensive relative to earnings and cash flows, suggesting that further downside risk is limited.

## Higher Rates, Slower Growth, but No Catastrophe

In considering the outlook for inflation, it is essential to recall that the increase in consumer and producer prices originates from a historically low level. The core inflation rate, which has averaged 4.2% per year since 1960, is currently “only” 2.4%, up from a barely noticeable low of 1.1% in early 2003. Most of the structural conditions that reduced worldwide inflation rates over the last quarter-century remain in place. Cost pressures arising from higher commodity and energy prices will continue to be offset by factors such as technology-driven productivity gains and the competition from manufacturers and even service industry players in low-wage countries like India and China. In the U.S., we have not seen an acceleration of labor costs that would be a warning sign of more entrenched inflation. Also, it is likely that the gradual tightening of monetary policy implemented over the past two years is only just beginning to be felt. While inflation measures—which lag behind the level of economic activity—may continue to tick up for the next few months, we do not envision a sharply higher inflation rate a year from now.

Interest rates have moved high enough to temper the pace of economic growth. This is already evident in a slow down in home price increases and a noticeable increase in new claims for unemployment insurance.

Consumer spending, which is more sensitive to home prices and interest rates than in the past due to the prevalence of home equity lending, should be the next area to exhibit softer trends. As this sort of evidence accumulates, we believe the Federal Reserve will take a break from its rate-hiking exercise, even as its leaders continue to voice a tough anti-inflation message. When this happens—probably by this fall—we believe investors' concerns about a central bank policy error will recede, setting up a more confident environment for both stocks and bonds. By then, investors may even be feeling a bit more comfortable with Mr. Bernanke.

Of course, economic postulating is of little value unless it helps us make investments that provide a favorable tradeoff between risk and opportunity under a variety of likely economic scenarios. We believe that the current level of stock prices generally reflects the widely anticipated risks that we have discussed above, presenting a favorable opportunity for our clients. One measure of this can be taken by comparing earnings yields (the earnings per share divided by the price, which is the reciprocal of the price/earnings ratio) with the level of bond yields. By this measure, the S&P 500 Index of large cap stocks is presently at its most attractive level since the early

1980s. In addition, the price to earnings ratio of large cap stocks has declined to the low levels reached in 2002 during the bear market. Both valuation measures strongly suggest that worries about interest rates and the pace of economic expansion are already reflected in prices.

As we have said for several quarters, TS&W anticipates that the pace of corporate earnings growth will moderate, but we think a sudden collapse of corporate profits or cash flow is highly unlikely. In each of our product categories, including large cap, small and mid cap stocks, our investment teams are identifying attractively valued securities that should produce good earnings growth and cash flow under an array of the most likely economic settings. Our portfolios continue to emphasize energy, materials and producer sectors of the economy because we find good value and expect above average profit growth here. Although we are mindful that they can be volatile in the short run, we continue to have a bullish long-term view on energy and materials prices. On the other hand, we generally have less exposure to consumer and financial services stocks than our benchmarks because we expect these sectors to be pressured by the increase in interest rates. Our bond team continues to favor issues that offer a yield spread above Treasury rates. This is the strongest argument we have for maintaining current portfolio allocations rather than indiscriminately fleeing from risky assets in hopes of returning to the market after the mythical “all-clear” whistle sounds.

The second quarter of 2006 provided another reminder of how changing perceptions of economic reality—either optimistic or pessimistic—can, for a time at least, overwhelm carefully considered fundamental research. When investor emotions run high, as they did during May and June, thorough understanding of the fundamentals that ultimately determine prices in financial markets and a disciplined approach to valuation become far more valuable, because market prices can move dramatically away from intrinsic value. This is precisely why TS&W focuses its resources and efforts on factors such as corporate earnings, cash flow, and return on invested capital, and not on correctly predicting macroeconomic variables like the unemployment rate or every nuance of Federal Reserve policy. This approach does not always spare us from bouts of underperformance, but we are confident that it keeps us open to opportunities to deliver long-term results that exceed benchmark returns.



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