



# MEMO

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**To:** WFR Clients and Friends  
**Subject:** Third Quarter Economic Trends

The third quarter of 2006 played out positively for equity and bond markets. Much of this is thanks to the Federal Reserve's recent action, or more appropriately, inaction. After two years of the Federal Reserve raising short term rates to quell the expectation of eventual inflation fears and an overheating economy, the Fed has not raised short term interest rates since June 29, 2006. Additionally, remarks over the quarter by Federal Reserve Chairman Ben Bernanke expressed his belief that the growth of the economy has tempered enough to instill a wait and see attitude, although inflation is still a concern. The halt of rate increases has reduced uncertainty for the equity and bond markets and resulted in a rally for much of the third quarter.

Economic indicators portray a more mixed picture. The yield curve has been inverted (short term rates are higher than longer term rates) for much of the third quarter. Three of the last four inversions of this type (Fed Funds rate being higher than the 10 year Treasury rate) have lead to recession within 12 months. Both the severity and the length of time the yield curve is inverted increase the likelihood of an economic slowdown.

The housing sector continues to cool at a rapid pace. Housing starts have decreased 21% since the peak in January this year. Building permits have decreased 21% from this time last year. Existing home sales have decreased significantly and the Months Supply of houses has increased to its highest leve since April 1983. It's not hard to imagine a potential cash crunch in the future due to these trends and the fact that Americans have used the equity in their homes and/or entered into more aggressive financing arrangements (for example, Adjustable Rate Mortgages, Interest Only mortgages, a proliferation of home equity loans and second mortgages, etc.) to support their lifestyle. Should a cash crunch rear its ugly head, this would force US consumers to reduce their spending at the malls of America and encourage recessionary pressures.

In the third quarter, this has not been the case. High employment, strong income growth, falling energy prices, rallying equity and bond markets, temperate interest rates and increasing productivity (although slowing) have helped US consumers maintain their level of spending... at least in the short term.

<u>% Returns as of 09/30/2006</u>			
<u>Equity Indexes</u>	<u>Q3</u>	<u>YTD</u>	<u>3 Yrs</u>
S&P 500	5.7	8.5	12.3
Russell 2500	0.5	6.9	16.1
MSCI EAFE	4.0	14.9	22.8
Emerging Markets	5.0	12.7	31.0
NAREIT (equity)	9.3	23.4	26.0
<u>Bond Indexes</u>			
TIPS	3.6	1.7	4.9
Aggregate	3.8	3.1	3.4
Governments	3.5	2.6	2.8
Mortgages	3.6	3.6	4.0
Intermediate Credits	3.7	3.2	3.0
Long-Term Credits	7.2	1.9	5.2
High Yield	4.1	7.3	9.1
Municipals	3.4	3.7	4.4
<u>Cash Equivalents</u>			
3-Month T-bill	1.3	3.7	2.9

## **Equities**

U.S. stocks have so far reacted as expected given the maturing phase of the economy. In a maturing economy, larger higher quality companies typically outperform smaller companies. For the third quarter, the Standard & Poor's 500 index rose 5.7% while mid (Russell Midcap) and small caps (Russell 2000) gave up 2.1% and 0.4%, respectively over the quarter. Additionally, this quarter value stocks have outperformed growth stocks with the Russell 3000 Value index returning 5.88% and the Russell 3000 Growth index 3.44%.

Diversifying investments outside the U.S. continues to bode well for portfolios. The MSCI EAFE Index, which measures the performance of stocks in the developed markets of Europe, Australia, and the Far East, was up 4.0% for the quarter. Emerging markets have rebounded from the second quarter with a 5.0% return.

## **Real Estate**

The NAREIT equity index rebounded in the third quarter from a slight loss in the second quarter. The NAREIT produced a positive return of 9.3% for the quarter and 23.4% for the year. This seems to follow the equity and bond markets, which appear to have digested the end of Federal Reserve rate increases.

## **Fixed Income**

All fixed income asset classes performed favorably in the third quarter. All bond classes are now in positive territory for the year due to a very strong bond rally this quarter. The longer term bonds received a major boost with long term corporate bonds returning 7.2% for the quarter bringing year-to-date returns to 1.9%, as measured by the Lehman Brothers Long Term Credit index. Much of the performance of longer term bonds is due to yields dropping on the longer end of the yield curve. Since bonds yields and bond prices are inversely related, prices went up causing positive returns.

The next best performer for the quarter was high yield bonds measured by the Lehman Brothers High Yield index. High yield bonds returned 4.1% for the quarter. This added to their already positive return through the second quarter for a total return year-to-date of 7.3%

## **Implications**

Although much of the above is meant to be informative and educational, investment portfolios should be designed with proper time horizon, risk tolerance, cash flow requirements, legal constraints, suitability and personal circumstances and goals kept in mind.

Thank you for the continued trust you place in us. I look forward to meeting or speaking with you soon. In the meantime, please call with any questions.

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Source of data – – Wall Street Journal , Econometrics.com, Conference Board, US Department of Labor, Bureau of Economic Analysis, Lehman, NAREIT, Bloomberg, The Economist, MPI Stylus, Oppenheimer Funds, Strategic Times. The performance of an unmanaged index is not indicative of the performance of any particular investment. It is not possible to invest directly in any index. Past performance is no guarantee of future results. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Treasury Inflation Protected Securities (TIPS) have principal values that grow with inflation if held to maturity. Traditional bonds have fixed principal value and yield if held to maturity. TIPS and traditional bond prices can fluctuate before maturity. Stocks can have fluctuating principal and returns based on changing market conditions. The prices of small company stocks generally are more volatile than those of large company stocks. International investing involves special risks not found in domestic investing; including political and social differences and currency fluctuations due to economic decisions. Investing in emerging markets can be riskier than investing in well-established foreign markets.

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