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## **Barnyard Forecast: Review and Preview**

The Barnyard Forecast has its work cut out for it in making a prognostication about prospects for stocks in the year ahead. From natural disasters to oil and natural gas spikes, to eight Fed rate hikes, 2005 brought a lot of surprises and challenges to the economy and the markets. As the new year begins, the financial markets might be even more confusing than they were at this time last year.

As you remember, the Barnyard Forecast's name is taken from the acronym of its components: Economy, Inflation, Earnings, and Interest Rates. We believe the interplay of these measures of the financial environment equal Opportunity for stocks. Thus our simple Barnyard Forecast looks like this: E + I + E + I = O. Although we say the Barnyard Forecast is a rule of thumb method for forecasting the primary direction of the stock market, at its heart, it is a good Federal Reserve monitor. It attempts to "see" things the way the Fed sees them, and then make a simple call on each component as to whether it will encourage the Fed to move in one direction or the other. In the era of Alan Greenspan, the major market indices have moved counter to the direction of Fed rate actions in 7 of the last 8 periods when the Fed was changing rates.

Before we offer our Barnyard Forecast for 2006, as is our custom, we will review its predictions for 2005.

### **2005 Review**

**Economy:** *"We believe GDP growth in the coming year will again approach 4%."*

That was what we said in January of 2005 and, although the final figures have not been released, from what we know now, our forecast appears to be right on the money.

**Inflation:** *"Although the trend is worrisome, the level is not in the danger zone, and therefore, we rate inflation as Neutral for stocks."*

The view we stated a year ago was a little too optimistic on inflation. Even though the "core" rate of inflation, which excludes food and energy, was tame for 2005 at just over 2%, the nominal rate did reach 4% after Katrina, and, in our judgment, did have a negative impact on stocks in 2005.

**Earnings:** *"Our earnings growth target for the coming year is 12% [very positive for stocks]."*

It looks like the final earnings growth for the S&P 500 will be near 13%. Our estimate, which was based on our belief that the economy would be stronger than most people were thinking, may turn out to be very close to the actual tally. This is particularly noteworthy, when the average S&P 500 Wall Street earnings estimate in January of 2005 was 9%.

**Interest Rates:** “. . . we believe the Fed has some catching up to do and they know it. \_That leads us to give interest rates a NEGATIVE rating for stocks in the year ahead.”

We actually got this one correct in principle, but we admit that short-term interest rates went much higher than we believed they would, and long-term rates stayed lower than we thought they would. To define our view more tightly, this year we will make specific short and long-term estimates.

**Opportunity:** “Thus, even though we are forecasting higher interest rates, if inflation remains under control, stocks will ultimately be driven more by the strong earnings growth we expect than rising interest rates.”

We were close on all the elements of E I E I = O, but our belief that inflation would remain tame was our stumbling block. It is, however, our strong belief that had Katrina and her siblings not spiked oil prices, nominal inflation would have been closer to our prediction, and stocks would have had a double digit increase. But the hurricanes did come, producing a spike in oil prices that stoked inflation, which poked a hole in stock prices. But, having said this, we think stocks are now even cheaper than a year ago, and the value gained in earnings and dividends will be recognized in stock prices sooner or later, as you will see in our predictions for 2006.

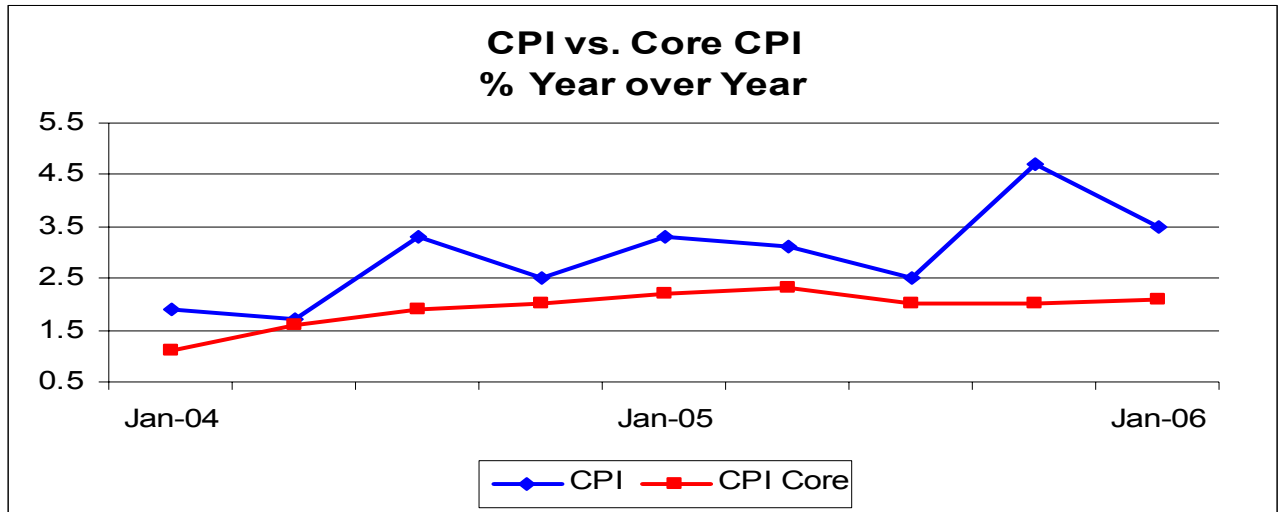
## **2006 Barnyard Forecast**

**Economy:** Last year we predicted that GDP growth would be near 4% because we were convinced that the Fed had not been aggressive enough, up to that point, in hiking rates to slow the economy. That is evidenced by the fact that they raised Fed Funds eight more times during the year. We believe the Fed has now caught up and is very close to ending this round of rate increases. Today, Fed Funds are at 4.25%, or about 2.25% above the closely-watched core rate of inflation. During Greenspan’s time the average inflation-adjusted level of Fed Funds has been about 2%. Thus, Fed Funds are slightly above a neutral reading. Since the economy has been growing faster than the generally accepted optimal rate of 3%, we believe the Fed will push rates just a little higher to slow GDP growth toward the optimal rate.

In our judgment, the economy will be on a slow glide path trending toward 3% growth for 2006. This trending toward the optimal rate is very positive for stocks, especially if readings of below 4% occur soon. We rate the economy Positive for stocks in 2006.

**Inflation:** Chart I on the next page shows the year over year rates of inflation including food and energy (CPI) and excluding them (Core CPI). Food and energy are very volatile commodities and most economists, including the Fed, pay more attention to inflation data excluding food and energy, the so-called “core” rate. While this may seem counterintuitive, particularly when the difference is great, as it is today, economists say that the real danger of inflation is when the rising costs of food and energy are being passed through to consumers. This happens when manufacturers believe food and energy prices are in a consistent trend higher.

Chart I



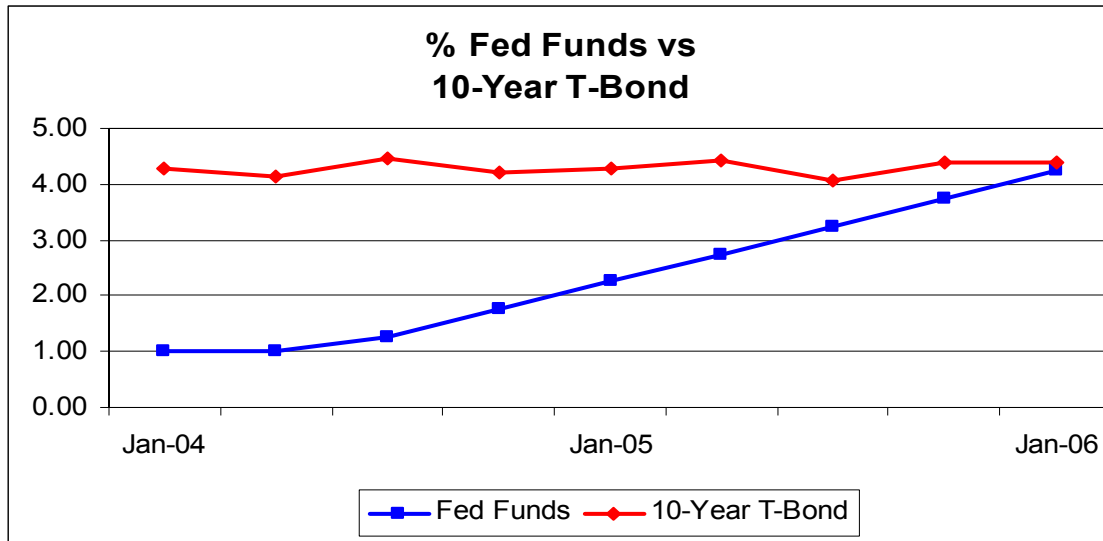
The Chart shows that while the CPI has had a rather bouncy ride over the past two years, including a big spurt right after Hurricane Katrina, the Core CPI has been remarkably steady.

If you were to have one of the Fed Governors over for dinner, we think you would be surprised to find that he or she is not very concerned about inflation. Even though the CPI has risen steadily in 2005 and has grabbed a lot of headlines, the flat Core CPI strongly indicates that the rise in food and energy costs is not bleeding over into the rest of the economy. We realize there are many anecdotes to the contrary, but the data just do not support any other conclusion – the true underlying inflation is tame. The inflation of 2005 was a temporary aberration, and it will trend toward the Core CPI rate over the next year. We believe the Nominal CPI will end 2006 near 2.5%. This will be a surprise to the markets and a strong positive for stocks in 2006.

**Earnings:** Wall Street estimates for 2006 earnings growth for the S&P 500 are about 10%. We agree with this estimate. We also expect a similar hike in dividends. Earnings and dividend growth of this magnitude are well above their long-term averages of 6.5% to 7%, and with the S&P 500 selling at about its long-term average P/E of 14.5, we believe solid earnings and dividends growth will be the major driver of stock prices in 2006. We rate earnings Positive in the year ahead.

**Interest rates:** As we indicated earlier, for 2006, we will make interest rate forecasts for both short and long rates. Chart II below shows the yields on 10-year Treasury Bonds and Fed Funds over the past two years. In 2005, because nominal inflation was higher than had been expected, the Fed pushed short-term rates higher than most observers were looking for. We believe these two unexpected events, taken together, were the main reasons for the flat stock market.

Chart II



### Short-term Interest Rates:

The blue line on Chart II shows that Fed Funds were at about 2.25% in January of 2005. After eight quarter point hikes, they are now at 4.25%. If the Fed's rate hikes were the main flatteners of stocks in 2005, as we believe they were, the most important question we need to answer is – where are Fed Funds likely to go this year? The question behind the question, of course, is – where is inflation likely headed? We said earlier that we believe nominal inflation will trend back toward the core rate of inflation. We also showed that the core rate has been very stable, even in the face of the hurricanes and the spikes in oil prices and other commodities.

We have done some modeling of Fed Fund rates compared to the CPI, Core CPI, and GDP. Using today's data, the model computes that the appropriate Fed Funds level should be about 4.20%, very close to the current level of 4.25%. This is the reason that we believe the Fed is very close to ending its string of rate hikes.

If, as we believe, nominal inflation and GDP are trending back towards 3% by the end of 2006, we forecast that the Fed may well be cutting rates by year end. We rate short-term interest rates Positive for stocks in 2006.

### Long-term Interest Rates:

Chart II shows something very puzzling, the action of the yield on 10-Year T-Bonds. This is the famous "conundrum" that Alan Greenspan has been talking about for the last year. If you study the charts, you will see that Fed Funds (blue line), which have a very short maturity, have risen in yield from 1% at the beginning of 2004 to 4.25%, today. Ten-year T-Bonds yields (red line) are much more sensitive to inflation and would have been expected to also have risen along with Fed Funds. But the chart shows that 10-Year bonds completely ignored the run up of inflation and remained flat. T-bond yields staying low caused a similar effect in mortgage rates, which continued to lift real estate prices. But Mr. Greenspan's conundrum is not a puzzle to us. He, himself, is the answer to the puzzle. We wrote about this in our January 2005 Barnyard Forecast.

“Let’s just call it the “Greenspan Effect.” Investors have become so confident in Mr. Greenspan’s ability to do the right thing for the economy and inflation that, as we will show, current long-term interest rates are ignoring the recent uptick in inflation.”

The long-term bond market was watching the Core CPI and not the nominal CPI because long-term investors were confident that Greenspan and Company would do the right thing to keep inflation low.

As we said earlier, we believe inflation increasingly will be seen as benign, and thus, we believe that long-term T-bonds are likely to stay below 5%. Because of this we rate long-term interest rates as Neutral for stocks.

### Opportunity:

The Barnyard Forecast is very simple this year. Economy, Inflation, Earnings, and Interest Rates are all positive for stocks. In all the years we have tallied the Forecast, that has never happened, and we have even said that it was not possible. However, as we read each component, we see many more positives than negatives. Because the Barnyard Forecast has had a very good track record over the years, we don’t think it wise to bet against it, particularly when most of its components’ ratings are so clear cut. A year ago, we said our best valuation model was targeting a level of 11,600 for the Dow Jones 30 Industrials. The Dow Jones ended the year at 10,700. If the components of the Barnyard Forecast perform as we have determined here, we believe the Dow could have a mid-double digits or even higher total return in 2006.

This is a very bullish forecast, but we want to emphasize that we are mindful of all the challenges the markets face. There are caveats aplenty. You can name them as easily as we can, but the truth is that the real value of American corporations has been rising dramatically for the last three years, with little price appreciation to show for it.

Chart III

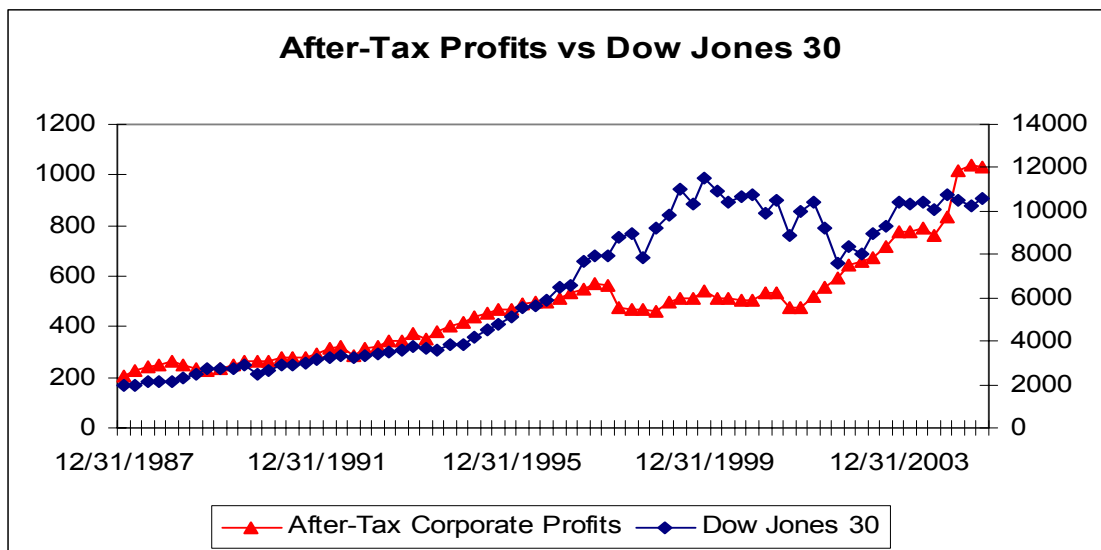


Chart III shows After-Tax Corporate Profits versus the Dow Jones Industrial Average. You will notice that Profits and the Dow Jones moved in tandem from 1988 to 1995. From that point through 2002, prices diverged dramatically from profits, as profits surged and prices moved sideways. The chart now shows that the “fair value” of the Dow Jones 30 is currently near 12,000. That figure is

likely to go higher after fourth quarter profits are added to the chart. Moreover, if 2006 profits continue to grow as we project, by the end of the year the fair value will approach 13,000.

We must admit it feels just a little over the top to be talking about a Dow Jones at 13,000, because stocks have been so stuck in the mud for the last few years, but we are just showing you the math. Our method of investing is based on the notion that prices follow values and not the other way around.

Values are plentiful in the stock market; they are growing; and they have gone largely ignored for the last three years. Chart III shows the reverse of the current phenomenon in the years 1996 through 2002, when values were falling and prices were rising. We believe the time is very near when the current valuation gap will be closed.

Blessings,

Greg Donaldson  
Director of Investment Strategy

Mike Hull  
President

**Addendum:** This month, a new Federal Reserve Chairman takes over for Alan Greenspan. More than a record of solid growth and tame inflation, Greenspan's legacy includes showing all of the world's central banks how to manage economies for growth while controlling inflation. We think the new man, Ben Bernanke, is a perfect choice to build upon Greenspan's record. He fully understands when and how to pull and push the same levers and buttons that Greenspan did. From the looks of the markets, they appear to view Bernanke like we do.