MARKET LETTER
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Not-so-lovely....“Rita”

Apocalyptic. Biblical. A war zone. Rita, and her sister Katrina, were all of that and more. It is somewhat ironic that our nation's most significant disaster in the post 9/11 era was indeed "*natural*" and not man-made ... but to the residents of the Gulf region, this really does not matter. It will take substantial amounts of time and money to restore the Gulf Coast region to its former self. Our only hope is that this happens quickly and with as little suffering as possible.

In as much as a disaster of this proportion exposes both the best and worst in people and their governments, we would be shirking our responsibilities as stewards of capital if we did not take a look at the impact of these twin hurricanes on our nation's economy.

Hurricane Rita struck at the beating heart of the American oil infrastructure. As of this writing, the US Minerals and Management Service reports that 593 platforms and 64 rigs still remain evacuated. That is 72% of the 819 manned platforms and 48% of the 134 rigs in the Gulf of Mexico. Fully, 99% of daily US oil production and 80% of natural gas production remain off-line in the Gulf. This accounts for one-quarter of US oil and gas production.

Hurricane Rita caused more damage to rigs and platforms in the Gulf than any previous storm including Katrina. As one oil industry executive stated on CNN, "*Stephen King couldn't have written a better horror story.*" Hurricane Rita “shut-in” 27% of the nation's capacity to refine crude oil into gasoline, heating oil and other products. Katrina shut down an additional 10% of our capacity. As the Wall Street Journal editorial page said recently, "*Things are now slowly getting back to "normal," though normal is not a synonym for good.*" How right they are, after all ... who would have thought a few years ago that we would be "hoping" for a $50 per barrel price?

Twenty years ago there were 325 refineries in the US with a capacity of about 19 million barrels per day. While gasoline demand has increased more than 20% over the same time frame, the number of refineries has in fact *decreased by a whopping 54% (now 148).* Why did this happen? Very simply, economics. While the return on investment for the S&P 500 industrials was just shy of 13% from 1993 to 2002, the return on investment for the refining industry was less than half of that, at 5.5%[1]. Markets do work and without the financial incentive to build new capacity, no refineries were built.

The other components of this dilemma are regulatory and environmental. It is no secret that it is extremely difficult to site, permit and build a new refinery in the US. The industry has spent *$47 billion* over the past dozen years meeting the demands of the Clean Air Act, the Clean Water Act, the Toxic Substances Control Act and the Safe Drinking Water Act to name only a few. Going forward (from 2006 to 2012), refiners will need to comply with an additional slate of no fewer than 14 new programs that have been put forth by Congress[1]. While we are quite sure that most of these are well-intentioned exercises in good environmental stewardship, one has to ask ... with an industry operating at 95% of capacity on a good day, what's going to give?

In the short run, it seems highly unlikely that we will *conserve* our way out of this problem. We would hope (and we are really quite sure) that over the long term, the impact of conservation will be significant. Market forces will eventually work, and the fastest path to a low(er) price is *always* a high price. But this will take time, quite possibly a long time. Although world demand will

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ebb and flow, it is not an unreasonable assumption that the incremental demand from China and India alone will bias prices upward for many years to come.

There is some change occurring around the edges, however. There is a movement within the halls of Congress to speed up the refinery permitting process. Abandoned and retired former military bases are also being sized up as potential sites for refineries. But these are at best *band-aids.* With the secular demand for refined products unlikely to adjust sufficiently in the short-run, we will get little relief from this side of the ledger. With the extraordinary lead times involved to increase our productive refinery capacity, it is even more unlikely that the supply-side will offer much comfort in the near term. These twin hurricanes exposed the Achilles heel of our domestic refining infrastructure. As a result, our energy forecast remains very much unchanged. Energy prices will be biased upward and will remain "*higher, longer*" *...* for the foreseeable future. With this in mind, we remain bullish on energy in general, particularly those companies with refining and marketing exposure.

But what of the even bigger picture? It strikes us as fairly remarkable that the cumulative impact of these extraordinarily high prices has been *less than what we would have expected*. There is some evidence that current energy price levels are starting to bite, although this is far from conclusive. If a few years back you had asked any member of our investment team to forecast economic growth a few years hence with crude prices up from $12 to $70, and gasoline prices north of $3 (now at or above inflation adjusted levels last reached in the 1970s), you would have received answers ranging from, "*recession*" to very anemic GDP growth at best. In fact, with "*oil doing the Fed's work,*" and with 11 Fed interest rate hikes under our belt, it is quite amazing that the economy (GDP) has grown at an impressive 3.6% since the Fed began tightening rates. In fact, as some of the pre-Rita and Katrina data roll in for the late summer period, it appears that the economy had quite a head of steam. Durable goods orders were up 3.3% in August and these gains were broad based. Durable goods orders tend to lead changes in overall economic growth, so these numbers are quite encouraging. Capital spending is on track for third quarter gains of about 5%. Another good sign as well. But more significantly, it seems that there are two important paradigms at work here, and both are key to the near-term outlook for the economy.

The first paradigm is the critical role of the Fed. The Fed must balance *four* important variables: 1) the impact of 11 rate increases, 2) higher energy costs for both consumers and businesses, 3) the economic fallout from the twin hurricanes and 4) the housing market/bubble. So far, the Fed has done an excellent job of balancing many of these, and they have been successful in not "*spooking*" either the stock or bond markets. The second paradigm is the *semi-virtuous profit cycle* that we have now experienced for *three and a half years.* In fact, corporate profits have risen at a *16% clip for 14 quarters*. This in spite of 11 interest rate hikes and soaring energy costs. How can this be? In a nutshell, companies have continued to cut costs, which has widened margins, enabling them to increase profits without resorting to price hikes (to "pass-through" their higher costs). This has worked very well for quite some time, and it is most probably the principal reason why stocks have not reacted to the negative news from both the energy patch and the steady drumbeat of higher interest rates.

Needless-to-say, we will monitor both of these phenomena with great interest. We continue to believe that a low-to-mid single digit gain for the broad stock market indices is indeed possible for this year, and in this regard, our forecast for the full year remains unchanged.

(1) "Refining Incapacity" - The Wall Street Journal Editorial, September 28th, 2005

Sources:
1. "Rita's Rig Damage Tops Katrina's" - The Associated Press, September 27, 2005
2. Morning Briefing - Dr. Ed Yardeni - September 30, 2005
3. "Still Monitoring Consumers" - Weekly Commentary - Dr. Jeremy Siegel - September 30, 2005
4. International Strategy and Investment (ISI) - Background Data
5. Bloomberg - Background Data

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Market Outlook

- Gulf coast hurricanes dominated the headlines as well as the market in the third quarter. The combined impact of Katrina and Rita resulted in oil prices rising over 17%.

- Convinced that any slowing in economic growth due to the hurricanes would likely be "transitory," the Federal Reserve Board continues its "measured pace" of pushing short-term interest rates higher. The Fed funds rate now stands at 3 ¾%, up 2 ¾% since May of 2004.

- In the face of higher energy prices, rising interest rates and deteriorating consumer confidence, stocks still managed to post gains in the third quarter, with the S&P 500 rising almost 3.6%.

- Fear of inflation may push short and long-term rates higher. However, in view of the prospects for slowing economic growth, the yield curve should continue to flatten due to short rates rising faster than long. This leads us to a "barbell" fixed income strategy; buying both short and long maturity fixed instruments.

- With an already tight energy supply exacerbated by the gulf hurricanes, our largest relative commitment remains in the energy sector, with particular emphasis on natural gas and refining companies.

- We continue to be cautious on the consumer sectors. Unlike recent years where consumer spending has largely driven the US economy, we believe that business spending will be the catalyst for growth as individuals feel the pinch of higher energy bills and greater borrowing costs.

- Japan posted GDP growth of 4% in the first half of 2005. We believe Japan is starting to turn the economic corner. Investment spending and participation in the growth of China has propelled this recovery. In international portfolios, we are maintaining our overweight to Japanese and Southeast Asian equities.

- Even though there is risk to a slowdown in the economy, we believe that at current valuations and with sustained corporate earnings growth, equities should still achieve our forecast total return of 5% - 8% for calendar 2005.

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