



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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July 2006

Patience, Patience, Patience!

Patience is a virtue, seek it as you can;
Rarely found in women, and never in a man!

19th Century Yankee Doggerel

Our intention is not to dive into the gender wars waged in our culture or to address which sex has more patience. The main point is that investors in the U.S. stock market – male or female – are in special need of a healthy dose of patience at the moment. And being patient is neither easy nor fun, because it means that we are not attaining our goals and objectives in the time frame that we set. *Webster's New Dictionary of Synonyms* indicates that patience “stresses calmness or composure in awaiting an outcome that seems unduly or inordinately delayed.” A synonym for patience is long-suffering, and long-suffering is indeed how many investors currently feel.

The year started off so well. By early May, 2006, the S&P 500 Index was showing a year-to-date gain of 6%+, and other more volatile markets had double-digit gains. Investors were optimistic that the long stretch of interest rate increases engineered by the Federal Reserve would soon be over, or they thought that the Fed would at least pause in the cycle of raising the Fed Funds rate. These hopes were dashed on May 10th as Chairman Bernanke and a cohort of Fed Governors spread the word that inflation was not yet completely under control, and that the unpalatable medicine of further interest rate hikes might need to be ingested for some time to come. The results were not pretty!

The NASDAQ Composite fell 12% from its high in April, ending down 1.51% for the first half of the year. The broader S&P 500 Index fell 8% from its peak in early May, recovering somewhat by the end of the quarter to finish the first half of 2006 with a modest gain of 2.70% (including dividends). The best news was that the old stalwart, the Dow Jones Industrial, ended the six-month period with an increase of 5.22% (including dividends). This was the first time in a long while that the large capitalization and mega-cap stocks turned in a superior performance to the broader S&P 500 Index and the NASDAQ Composite. Much more significant pain was felt in the emerging markets which had delivered such good results during the past three years. Most plunged, with markets such as India and Russia down 30%+ in less than a month. Some of the smaller markets fell as much as 10% in a day. Some commodities such as gold, which had worked so well, sold off 20% or more in several weeks. And, to add to investors' woes, bonds turned in another terrible performance. The ten-year U.S. Treasury Note had a total return of -3.41% for the first six months, while the shorter duration Lehman Brothers Aggregate Index was down .72% for the period. In all, the first half of 2006 was disappointing – especially with hopes having been raised by a good start to the year. Widespread uncertainty currently exists as to whether the bull market is over, and if not, which sectors and stocks are the new market leaders. At Bradley, Foster & Sargent, Inc., we believe that investors need to exercise patience, that the bull market is intact and that high quality growth stocks, which we favor, are just at the earliest stage of outperforming other asset classes.

The Stock Market as a Three-Legged Stool

As we have written in these commentaries before, the stock market does not necessarily reflect the state of the economy or of corporate earnings – in the short run. In fact, it often doesn't. It does, however, invariably follow the path of corporate earnings over the long term. Perhaps it is helpful to think of the stock market as a three-legged stool. One leg of the stool is the growth of corporate earnings. The second leg is interest rates, which are most influenced by inflation. The third leg is investor sentiment, which generally is most affected by aggregate demand for stocks and the liquidity to pay for them. Let's look at each of the three legs in turn.

First Leg: Corporate Earnings

As the charts below show, U.S. corporate earnings have never been better. Not only are aggregate corporate earnings (after tax) at an all-time high, but operating margins are as well. The earnings of the S&P 500 Index in 2006 have almost doubled since 1998.



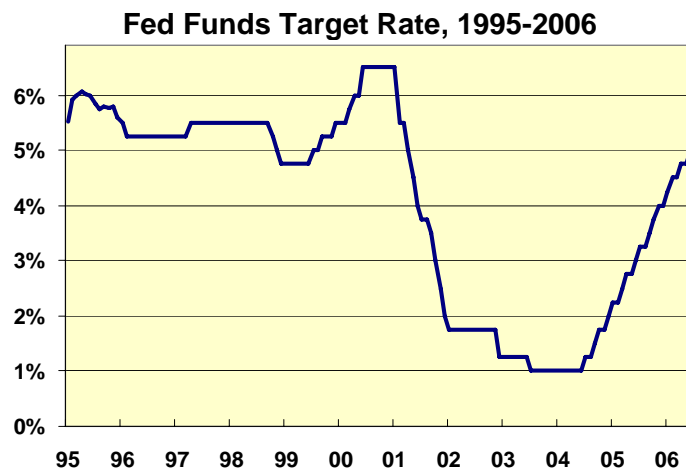
Source: StockVal



Corporate earnings are influenced by factors including fiscal and monetary policy, U.S. and global GDP growth, globalization, technology, productivity, and political climate. The good news is that U.S. corporate earnings are robust and have been growing at double digit rates since 2003. The bad news is that the political climate and media attitudes in the U.S. are currently so toxic that this fact is not fully appreciated by the investing public.

Second Leg: Interest Rates

The chart below delineates the Fed Funds rate for the past ten years. There are several important points. The first is that the Fed Funds rate fluctuated between 4.75% and 6% from 1995 through 1999. During this period, these interest rate levels did not slow the economy at all. Only when short term interest rates exceeded 6% in 2000 did the economy get into trouble. From 2002-2004, the Fed cut interest rates dramatically to avert possible global deflation. Since mid-2004, the Fed has been raising short term interest rates in a measured fashion. Interest rates are now at the same level as they were during the great bull market from 1995-1999:



Source: Federal Reserve

The most important factor that influences interest rates is inflation. If inflation is low, then interest rates are generally low. Interest rates (and inflation) are mainly affected by monetary and fiscal policy but also by the strength of a country's currency and political factors. Investors watch every change in inflationary expectations and their effect on interest rates with great attention, as high interest rates do great damage to stock market valuations. Core inflation

(the CPI index less food and energy price increases) has been a modest 2.4% over the past twelve months. This is slightly above the 1-2% level with which the Federal Reserve is comfortable. However, the CPI index itself (including food and energy) has risen 4.1% over the past year. And it is this upward trend in inflation, playing itself out in surging prices in the commodity markets, which has worried the Fed. Oil at \$75 a barrel, gold at \$700 an ounce, and a weak dollar have caused the Federal Reserve, in our opinion, to focus more attention on restoring a strong dollar and curbing commodity prices than on sagging housing prices in the U.S. In general, investor worries about higher inflation and how long the Fed will stay the course in raising interest rates have been the biggest negative factors on stock prices over the past 18 months.

Third Leg: Investor Sentiment

The third leg of the stool is investor sentiment or psychology. Investor sentiment is greatly affected by the aggregate demand for equities which depends on adequate liquidity in the economy (a factor of monetary policy), the general level of employment in the economy, the flow of retirement funds into equities, and the demand for U.S. equities by foreign investors. Moreover, the stock market's valuation (P/E ratio) plays an important role in creating investor confidence. Finally, it is influenced by investor views on the U.S. political situation and foreign policy, fiscal and trade policy, and the current geopolitical situation (like Iraq, Lebanon, Iran and North Korea). In this regard, it is not an exaggeration to assert that the majority of the mainstream media currently regard the glass very much as half empty. A good example of this is the U.S. annual budget deficit. The media have been unremittingly negative in their focus on the U.S. budget deficit. But what are the facts? The deficit for the fiscal year ending September, 2006 is now projected at \$296 billion – 2.3% of GDP. This has been the average budget deficit as a percentage of GDP for the past 40 years, and is lower than that of the U.K., Italy, France, Germany, and Japan, which range between 3.8% and 7%. The chart below shows the total U.S. debt as a percentage of GDP for the last century. Clearly the most precarious time for the U.S. in terms of fiscal leverage was after World War II and during the Korean War when our national debt was 120% of GDP. Currently the U.S. has a Debt/GDP ratio of 63% which is one of the lowest of the industrial world. Nevertheless, investors currently view the fiscal deficit as a major problem.



P/E Compression in Large Cap Growth Stocks

Two legs of the stool are reasonably strong – corporate earnings and interest rates. The third leg – investor sentiment – is a bit wobbly. This has caused the seat of the stool – stock market valuation – to be lower than normal. While small and mid cap stocks have rich valuations, the broader market of large capitalization growth and value stocks is at a modest valuation. The table on the following page indicates the remarkable P/E compression that has taken place since 2000 in large cap growth stocks. In most cases, the earnings per share for these stalwart companies have more than doubled during this period:

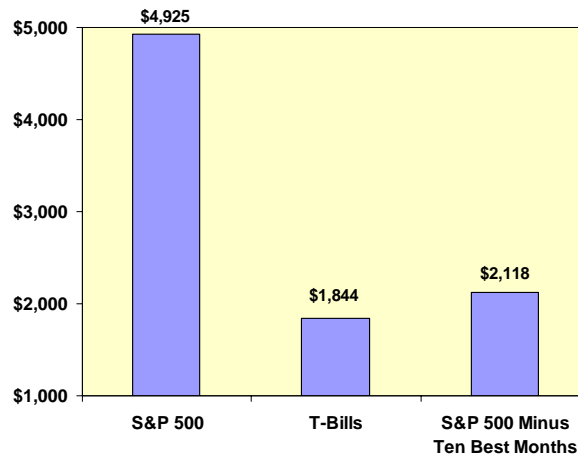
	2000 EPS	Estimated 2006 EPS	2000 P/E	2006 P/E
Amgen	\$ 1.04	\$ 3.68	59	18
Johnson & Johnson	\$ 1.60	\$ 3.68	33	16

Pfizer	\$.98	\$ 2.01	47	12
AIG	\$ 2.47	\$ 5.48	40	11
3M	\$ 2.25	\$ 4.65	27	17
Wal-Mart	\$ 1.41	\$ 2.93	42	16
Home Depot	\$ 1.10	\$ 3.08	43	11
GE	\$ 1.37	\$ 1.99	35	16
Microsoft	\$.88	\$ 1.37	32	17
S&P 500 Index	\$56.13	\$ 82.88	24	15

Time in the Market

As we are fond of saying, critical to making money in the stock market is not “timing the market” but *time in the market*. This is where patience reaps great rewards. The chart below shows that \$1,000 invested in the S&P 500 Index (with all dividends reinvested) would have grown to \$4,925 between 1987-1996. However, if an investor did not participate in equities for the ten best months of the market over these ten years, the \$1,000 would have only increased to \$2,118 – barely ahead of the return from T-Bills. In other words, the returns from stocks in 8% of the months provided almost 72% of the upside.

Timing the Market, 1987 – 1996



Source: Fidelity Investments

In conclusion, we have not changed our projection of 1360 for the S&P 500 Index at the end of 2006 – a gain of 7-8% from its level on July 11. We believe that the U.S. economy, bolstered by strong growth in China, India and Japan, will continue its upward trajectory, overcoming the troublesome conflicts in the Middle East. When the Fed ceases to raise interest rates sometime this year, we think that the market will resume its climb, reflecting both good earnings growth and also a mild expansion in P/Es. The average P/E ratio on forward earnings for the S&P 500 Index over the past 40 years has been 17. Currently this ratio is at 14.7. Large growth stocks have begun to outperform in 2006, and we believe that patience will again be rewarded during the next several years.