



## **Baldwin Investment Management, LLC**

### **STRUGGLING**

The first quarter of 2006 as measured by the popular indices did not turn out to be too bad a period of time for equities. The S&P and Dow were up approximately 3.7% and the NASDAQ was up about 6.1%. So all in all, it was a good start to the year. But for investment managers in the “thick of things”, the quarter just didn’t feel good. Before getting into why the quarter “didn’t feel good”, let’s review the noteworthy news of the first three months of 2006.

As usual, retail sales continued to be stronger than expected. So many pundits have worried for years about the health of the American consumer and have declared him/her to be well passed their prime, if not on their death bed any number of times. It has still not happened, nor do we hear a death rattle in the near future. According to economic measures, consumer confidence actually is up. Why? Employment has been strong. Payrolls across the country are growing on a monthly basis at a rate in excess of 300,000. The unemployment rate is at 4.7%. Obviously, for the economy this is good news as more workers have money in their pockets to make purchases at malls and on-line. On the flip side, a number of Wall Street analysts are worried that the Fed would be concerned about the low unemployment rate and possible wage push inflation. To date, this has not happened and it has not happened for years. The unemployment rate has been below 5% for quite a while. The “relief valve”, which bleeds off wage inflation pressures, is the vast pool of labor that is increasingly utilized around the world. So inflation seems to be under control. Businesses have noted some process input cost pressures, but they have not been able to pass these onto the ultimate consumer. In order to maintain margins, businesses have had to become more efficient and effective.

The Federal Reserve has a new chairman. Alan Greenspan retired and has been replaced by Ben Bernanke. Chairman Bernanke has widely broadcast that it will be business as usual at the Fed and in fact, at his first meeting as chairman, the Fed Open Market Committee voted to increase the Fed funds rate to 4 ¾%, (resulting in a prime rate of 7 ¾%), as was widely expected. This sort of predictability is greatly appreciated by the markets, because markets hate uncertainty. If markets can anticipate Fed policy, this will enhance investor confidence.

The area of the economy which has been getting a lot of press for the last several years, but particularly, in the first quarter of 2006, has been the real estate market. There is growing evidence that residential real estate prices have cooled. Houses are on the market longer and brokers and sellers are offering incentives. Buyers are becoming a little more aggressive about pricing. In short, the real estate

market is no longer frothy. It is still healthy and operating at rates that heretofore would have been considered terrific - except for the industry's experience in 2005, which seemed to blow the proverbial "roof off" the business. As we have stated in the past, we do not believe that there is a nationwide real estate bubble and thus would not be concerned about the prospect for a broad based meltdown. There are, no doubt, local markets that have become too expensive and prices in those areas predictably will recede.

During the first three months of the new year, there has been quite a bit of merger and acquisition activity. ATT (itself a recent combination of SBC and ATT) agreed to purchase Bell South, thereby nearly recreating the old ATT; Boston Scientific finally won a bloody battle with Johnson & Johnson for Guidant; Alcatel, a French industrial concern, has agreed to acquire New Jersey based Lucent Technologies; Cisco floated a bond issue to buy Scientific Atlanta; Capital One Financial is purchasing another bank, North Fork Bancorp; and General Motors has finally found a partner for 51% of its GMAC unit. Corporations are not only spending their huge caches of cash on acquisitions, but they are also beginning to spend money on capital expenditures, stock buy-backs, increasing dividends and hiring new employees. Over the past four years, corporations saved \$560 billion. Until recently, most CEOs and CFOs were very reluctant to spend after having been through the bruising recession of 2000-2003. Finally, the purse strings are being untied and corporate America is spending.

So in spite of the fact that the indices ended the quarter on a positive note, it was by no means a straight path to the eventual higher end point. The market started out well in January; in February it went into reverse giving back everything that it had gained. Then the market struggled through the first couple of weeks of March and finally, the market meandered to the upside to finish the quarter. This was all going on when corporate and economic news was generally quite upbeat. No doubt there are worries about Iraq, Iran, the Palestinian situation, reviled eavesdropping by government officials, lobbyists in Washington who played fast and loose with rules, and about politicians who participated in indictable activities. We believe that corporate earnings reports for first quarter of 2006 will continue to be good. The macroeconomic landscape looks healthy. The political landscape has been troubling for some time. Perhaps, with our elected officials so out of favor with the electorate at this juncture, there might be only one way they can go and that is up, hopefully giving a boost to the markets looking ahead to the Fall elections. Overall, we continue to be well disposed towards the equity and fixed income markets and would recommend that our clients stay fully invested.

## PREDICTIONS FOR 2006

## COMMENTS

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|---|--|
| 1. The dollar will continue to be strong (\$1.15-\$1.20/E)                          | Trading at \$1.22                          |
| 2. The Fed will stop raising interest rates in Q1 2006                              | Raised rates in Q1, as expected            |
| 3. Republicans will lose seats but maintain control of Congress and the State House | Too early to tell, but still believe       |
| 4. Troops will be drawn down in Iraq by 20%   | A lot of political pressure                |
| 5. Japan's economy will continue to gather steam                                    | Yes  |
| 6. Exchange Traded Funds (ETF's) will boom as an investment vehicle                 | Yes, over \$300 billion now!               |
| 7. More U.S. money will flow to international markets                               | Yes, Foreign markets are hot!              |
| 8. Corporations will continue to hike dividends                                     | Yes  |
| 9. The U.S. Stock Market will do better than in 2005                                | So far, so good                            |
| 10. Politics in Europe will remain confusing; a negative for equity markets there   | Yes, bit it was a good quarter nonetheless |
| 11. Osama will be sold out and captured (we're <i>still</i> sticking with this!)    | Not Yet                                    |

## A FINAL THOUGHT



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A list of our Proxy voting procedures is available upon request.

A current copy of our ADV Part II is available upon request or at [www.baldwinim.com/disclosure.htm](http://www.baldwinim.com/disclosure.htm)

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