



## **Baldwin Investment Management, LLC**

### **MISSED BY A QUARTER**

The big news on the economic forefront of late has been that the Fed has decided at the last two Open Market Committee meetings to hold its federal funds rate at the current 5.25% level. In addition, “less inclined” to increase interest rates was part of the language accompanying the latest rate decision. The Fed comments appear to give increasing recognition of a slow down in the U.S. economy and that slow down’s concurrently beneficial dampening effect on inflation. So, we believe that a “soft landing” is on the horizon. With productivity still historically high, American industry strong, international economies growing and the U.S. consumer still pretty buoyant, we think that our economy will slow to a measured pace, but not fall into recession – i.e. a “soft landing”.

Everyday in the newspaper or on TV there continues to be rather down beat news about the state of housing construction in America. Clearly the residential construction industry is “off the boil” and will not be a growth driver for 2006 or probably 2007. We do not believe that there is a national problem - but certainly particular cities (Los Angeles, Las Vegas, New York often cited) are going to suffer a come down from rather “giddy heights” achieved in the last building cycle. Helping on the inflation front is a lower price for crude oil and natural gas. Prices at filling stations for gasoline have retreated quite nicely and below \$3 dollars a gallon for gasoline is becoming more common place than it was even just a few weeks ago. The price of natural gas has also declined very significantly from a high of approximately \$15 dollars/MCF to less than \$5 dollars/MCF as markets have become comfortable that there is sufficient supply for the winter heating season. Luckily so far we have had a very quiet hurricane season in the gas rich Gulf of Mexico.

The midterm elections are coming up in a few weeks. The Republicans are concerned that they are going to lose control of the House and only maintain slim control of the Senate. We had earlier thought that the Republicans would maintain control of both houses. But as time has gone by, this would seem increasingly improbable. Events in Iraq in particular have swayed peoples’ opinions about Republican policies. Interestingly, very little credit is given to Mr. Bush and his colleagues for the present rather healthy state of the American economy. In spite of the fact that unemployment is low and that many new jobs have been created, the focus of voter attention seems to be offshore rather than onshore. If the Democrats do gain control of the House, it will result in a divided legislature. This could mean more legislative logjams - not a happy prospect!

With the Fed on hold, the markets have rallied since mid July. Earnings reports from corporate America for the 2<sup>nd</sup> quarter were stronger across the board than what Wall Street had expected. So with a strong corporate underpinning and what has become an increasingly benign macroeconomic outlook, equity investors decided to take on more risk and returned to the stock market. The yield curve in the fixed income market place has remained pretty flat and historically pretty low. Also in the fixed income market place investors have assumed more risk as spreads (i.e. yield difference) between risky and riskless securities tightened.

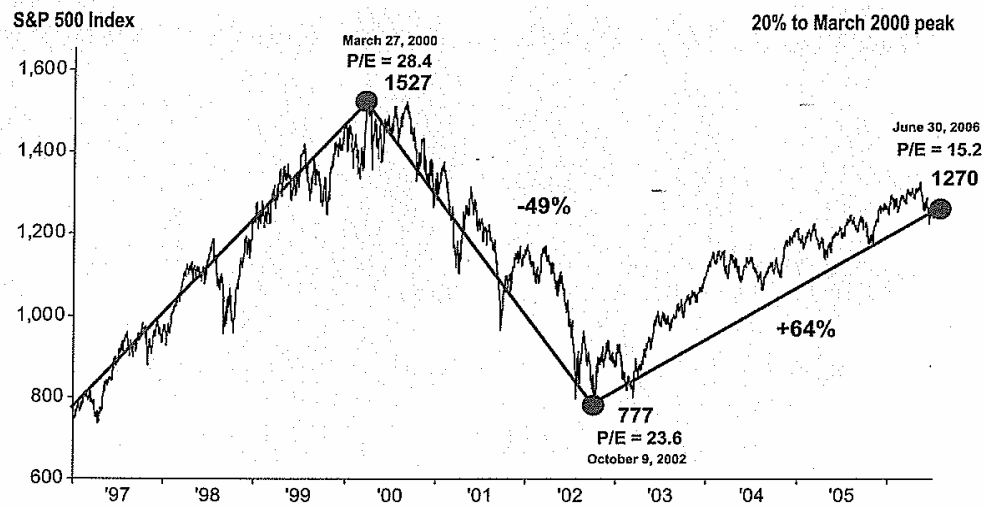
Corporate earnings should continue to be strong in the 3<sup>rd</sup> quarter and we believe for the remainder of 2006. Outside the residential real estate business, the U.S. economy seems to be doing just fine. As per usual, there are worries about the health of the U.S. consumer. But, as per usual, the American consumer continues to defy the bears and consumption continues to roll along. Corporations are also very healthy. Companies have huge amounts of cash on their balance sheets and shareholders are pushing managements to more efficiently manage the corporate coffers. Consequently, there have been, and will continue to be large stock buy backs and increases in dividends in order to better utilize corporate cash. There is a growing force in private equity funds. These are huge unregulated “seas of cash” which are being directed towards mergers and acquisitions - taking public companies private, making them more efficient in a private setting and then reselling the “new and improved” old public company to a new shareholder base in a few years time. Also, corporate managements are looking at their own merger transactions either as an acquiror or an acquiree. So with still historically low interest rates, healthy balance sheets, good earnings and, lots of cash in private equity dealmakers’ hands, we would expect that the stock market should continue to move ahead throughout the remainder of 2006 barring any unforeseen huge tragedy. Stock prices are still not expensive and relative to alternatives, equities seem cheap.

## S&P 500 Index at Inflection Points

Market Insight Series

Equities

Surprisingly, stocks are 35% "cheaper" following a 64% run in stock prices (75% including dividends).



Source: Standard & Poor's, First Call, FactSet, JPMorgan

P/E data is calculated based on a top-down methodology as provided by First Call, and represents the 1-year forward estimated P/E ratio of the S&P 500 index as of each respective date. Returns are cumulative and based on S&P 500 price movement only and do not include the reinvestment of dividends. Past performance is not indicative of future results. Data is as of 6/30/06.

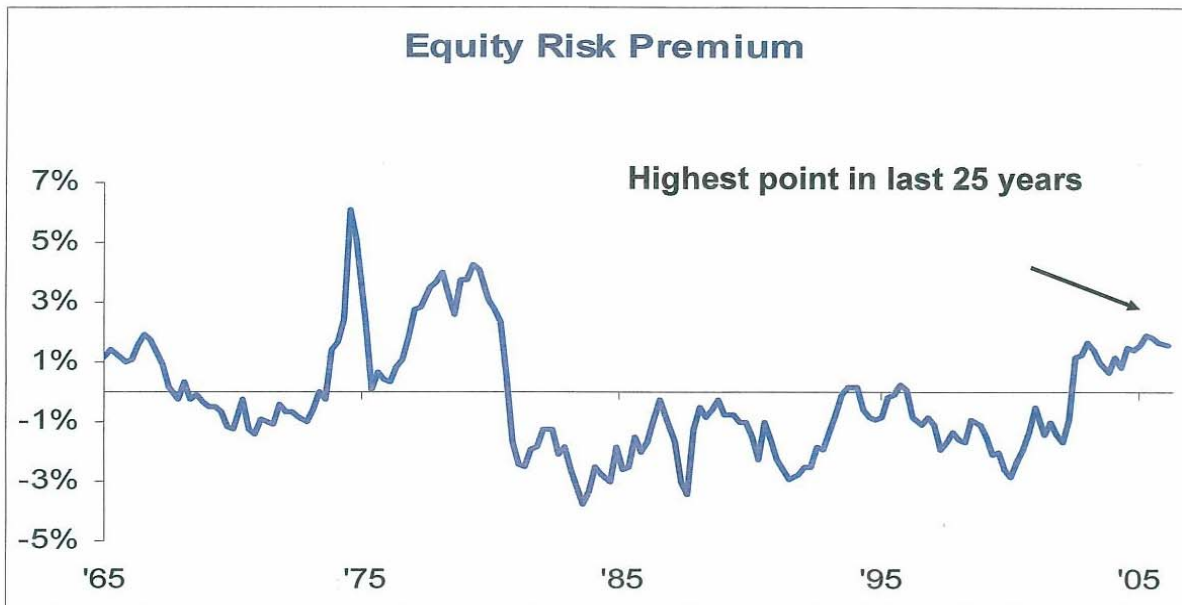
JPMorgan  
Asset Management

**A much lower P/E ratio today than either at the peak or the trough of the market!**

## EQUITY RISK PREMIUM

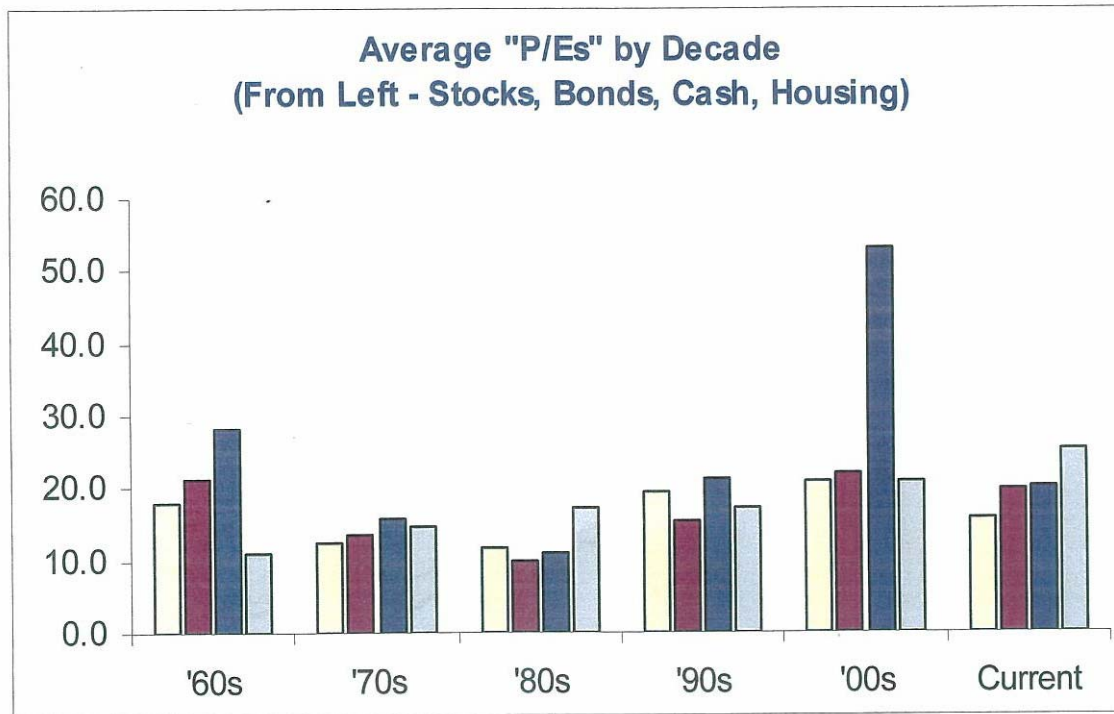
EARNINGS YIELD ON STOCKS LESS 10-YEAR TREASURY YIELD

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**Investors are getting well paid to own stocks!**

**Average "P/Es" by Decade**  
(From Left - Stocks, Bonds, Cash, Housing)



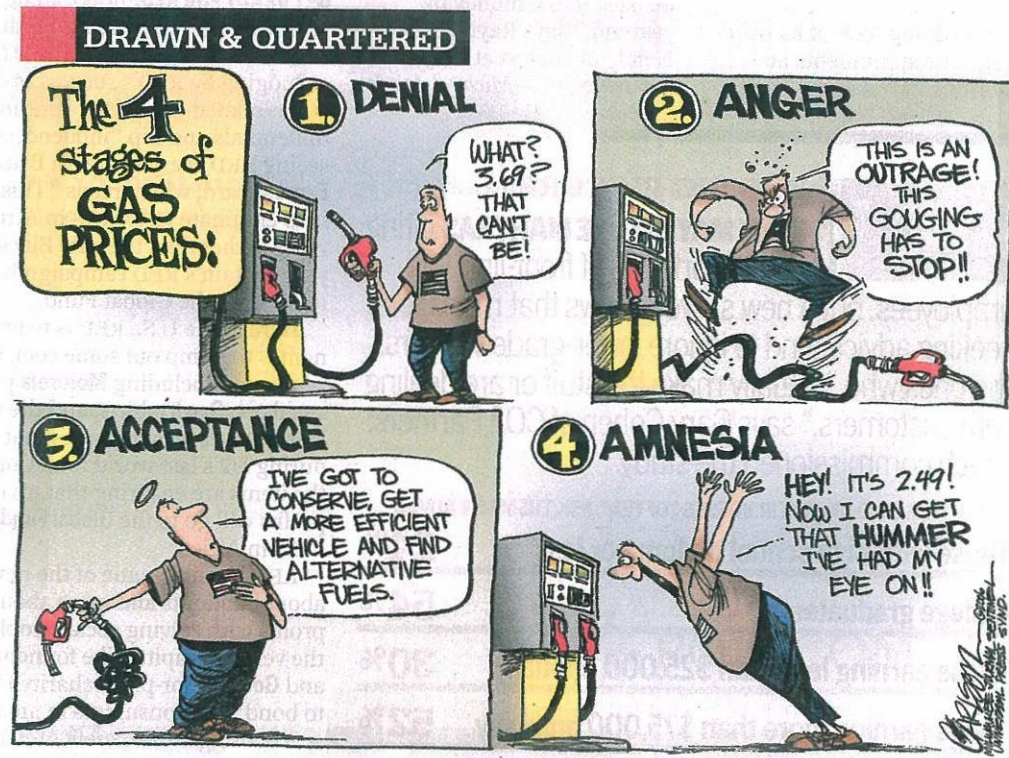
**Stocks are cheap!**

## PREDICTIONS FOR 2006

## COMMENTS

- |   |   |
|---|---|
| 1. The dollar will continue to be strong (\$1.15-\$1.20/E)                        | Trading at \$1.27 - weaker than expected                  |
| 2. The Fed will stop raising interest rates in Q1 2006                            | Got this wrong - Raised rates in Q2 – but on hold now     |
| 3. Republicans will lose seats but maintain control of Congress                   | GOP looks to lose the House                               |
| 4. Troops will be drawn down in Iraq by 20%                                       | Not yet   |
| 5. Japan's economy will continue to gather steam                                  | Yes   |
| 6. Exchange Traded Funds (ETFs) will boom as an investment vehicle                | Yes, over \$300 billion now                               |
| 7. More U.S. money will flow to international markets                             | Yes, foreign markets have been hot!                       |
| 8. Corporations will continue to hike dividends                                   | Yes   |
| 9. The U.S. Stock Market will do better than in 2005                              | Up & down – But up now                                    |
| 10. Politics in Europe will remain confusing; a negative for equity markets there | Yes   |
| 11. Osama will be sold out and captured (we're <i>still</i> sticking with this!)  | Getting closer - reputed #2 Zarqawi is killed by US bombs |

## A FINAL THOUGHT



The opinions expressed in this Commentary are those of Baldwin Investment Management, LLC. These views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed.

The reported numbers enclosed are derived from sources believed to be reliable. However, we cannot guarantee their accuracy. Past performance does not guarantee future results.

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)

9/30/06