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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

October 1, 2006

Outlook & Trends

Outlook & Trends often comments upon financial issues that are being written about in the financial and general media, trying to help you see the larger picture by looking at the issue from a different perspective. One such story may be about to appear, as the Dow Jones Industrial average is poised to reach a new all-time high, surpassing the last peak posted in January 2000. In addition to our review of the current economic environment, this issue of *Outlook & Trends* discusses why this milestone can be considered both important and irrelevant to your financial health at the same time, depending on your perspective. We will also present another topic that you are not likely to read about in the newspapers, the Presidential Election Cycle, which could be significant right now.

On October 25, David will be presenting a class through the Concord-Carlisle Community Education entitled "Understanding & Using Exchange-Traded Funds". If you would like to find out more about what ETFs are, and how you can use this low-cost, tax-efficient investment innovation, please join us. You can get registration information at http://ace.colonial.net or call (978) 318-1540.

Economy

The economy continues to grow, although at a slower pace than before. The deceleration prompted the Federal Reserve to put its interest rate-raising program on hold, because inflationary pressures have diminished. That is not to say that inflation has gone away. The Consumer Price Index has risen 3.8% over the last year, much of it due to increases in energy prices. The cost of gasoline, which spiked during the summer, put more of a damper on people's attitudes than actually hurting the economy. Coincident with the normalization of gasoline prices, consumer confidence has also improved recently. Interestingly, while retail sales recently grew at about a 4% rate, in line with inflation, sales by gas stations increased at an annual rate of almost 20%!

The slowdown in the housing market is old news, but no change in the downtrend is visible yet. Existing home prices have dropped about 2% since last year, and pressure on sellers continues to grow, evidenced by the increasing inventory of homes for sale, which has reached 7.5 months worth of sales, a 57% increase since last year.

On the other hand, stock market investors will be glad to know that corporate profits, a prime determinant of stock prices, are up 20% since last year. In fact, profits have grown between 9.7% and 25.4% every quarter since 2002. This growth is the reason why the Dow Industrial Average is nearing a new high.

Financial Markets

The market rose 5% during the 3rd quarter! Or did it? Well, the Dow Jones Industrial Average and other large cap stocks were up 5%, but what about the rest? The Russell 2000 small-cap index was up only ½%. Middle and small capitalization stocks, which have doubled the gain in the Dow Industrials for the last three years, took a breather. Likewise, broadly diversified portfolios under-performed during the quarter. They have been outperforming the standard allocation recommendation that emphasizes large-caps for several years now. Smaller stocks have become over-valued versus the large-caps. It will be important to watch to see if this shift to big company stocks continues.

There was also a big change in the bond market. High quality bond prices have been under pressure since 2003 as the Fed raised interest rates. Bonds rallied with the recent Fed rate pause. In fact, it is probable that the change in rate policy was the force that lifted the large cap stocks, since stock valuations rise as interest rates fall and earnings rise. This performance was significant, because it occurred during the weakest period of the year for stock prices.

Thoughts on a New Market High

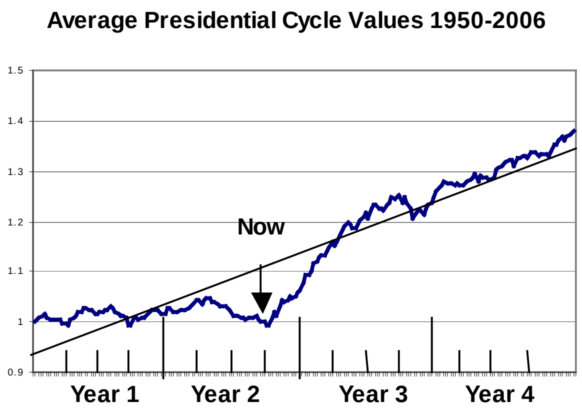
The Dow Jones Industrial Average began as a simple average of the prices of 30 industrial stocks in 1896. Of course at that time there were no computers, so the calculations of the average had to be done by hand. It can be argued that the Dow Industrials do not represent the market as well as other, more sophisticated, measures available today. While this is true, a new high in the Dow is still important for three reasons:

1) Most people think that the Dow *is* the stock market, and a new high is likely to cause at least some amount of additional buying, lest an investor miss the boat.
2) A market that is moving up will set new highs. Setting new highs is indisputably the most bullish thing the market can do. The Dow Theory says that when the Dow Industrials and Dow Transports both reach new highs, a bull market is in force. The transports did their part by setting a new high almost two years ago.
3) A new Dow Industrials high says the bear market that started in 2000 is over, and implies that the markets and economy are mended.

For other than psychological reasons, however, the Dow is largely irrelevant. If you consider the dividends that have been paid, the Dow's new high was set two years ago. Beyond that, the Dow Industrials is really only a good representation of large-cap value stocks. Divergence of performance, during both the last several years and last several months, between the DJIA and other stocks, shows the venerable measure does not represent the rest of the market very well. If you have a well-diversified portfolio, it will not represent your personal experience either.

The Presidential Election Cycle

There are historical patterns in the market that tend to repeat themselves. The period from November to May is usually stronger than the rest of the year. September is often the weakest month. Likewise, there is a repeating pattern that follows the Presidential Election Cycle, since presidents like to get their recessions over with early in the term and have a robust economy near election time. I have plotted the following graph using data back to 1950. You can see that mid-way through the term is usually the farthest away from the average growth trend and is often the beginning of the strongest period.



It is important to note that this is historical data, not a prediction of the future. Just as the Dow Theory suggests, but does not guarantee a bull market, the four year cycle does not guarantee higher prices. Having said that, however, I find it impressive that the large cap stocks performed so well last month, during a period that is historically a drag on the market

To learn more about *LFM&P* investment management and financial planning services, our client goal-centered financial philosophy, and to better understand the value we can bring to your financial life, we encourage you to contact us or look at our website, www.linnardfinancial.com.

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