Sather Financial Group, Inc.
Registered Investment Advisor

Third Quarter 2005 Commentary

Although the last three months saw the stock market indices rebound a bit, the quarter will be best remembered for the devastation of hurricanes Katrina and Rita.

The ***Dow, S&P 500 and Nasdaq all produced positive returns for the third quarter***.

Despite these returns, economic growth and corporate profitability are slowing. First quarter gross domestic product was 3.8% while the second quarter increased only 3.3%. The ***recent storms should trim at least another one point off of near term GDP***. However, growth should bounce back somewhat as the gulf coast rebuilds.

The hurricane damage made a tight oil situation that much worse. Furthermore, this situation has expanded beyond just that of oil pricing and is now affecting gasoline prices substantially. Refiners are operating at more than 95% of capacity and have very little room to increase production. As such, we can ***expect gasoline prices to stay high***.

We have also observed ***natural gas prices spike*** due to high demand and diminished supply. Some of the supply shortage can be attributed to pipeline damage in the Gulf of Mexico and as such we are hopeful that this capacity will be restored relatively soon.

As we have stated many times in the past, there is no way that elevated energy prices (gasoline, oil or natural gas) will not lead to inflation. We are often amused at the governments spin on inflation. They love to quote that the consumer price index (excluding energy and food) is a mere 2%. While this is technically a true statement we find it to be a hollow statement. Since just about all of our clients eat food and use energy we find a “doctored” consumer price index to be meaningless. ***True CPI (including food and energy) is actually running close to 4% on an annualized basis—and even that figure is probably low***. While this is not the runaway inflation we experienced in the late 70’s and early 80’s, it is definitely a bigger issue than our friends in Washington would like us to believe.

In addition to energy, we ***expect increases in other commodity prices***. As the gulf coast rebuilds, demand for wood products, lumber, concrete and steel will most likely increase.

Despite many requests to the contrary, ***the Federal Reserve has continued raising short term interest rates*** in an effort to combat inflationary concerns. Many thought that the effects of Katrina and Rita would cause the Fed to ease their tighter rate policy. After raising the Fed Funds Rate to 3.5%, Greenspan commented that there are enough inflationary pressures (most notably in real estate) to keep the Fed in an aggressive posture to battle looming inflationary concerns. From that, we ***expect the Fed to raise rates at least one more time this year***.

Greenspan’s final task before retirement will prove to be a difficult balancing act. Although there are certainly pricing pressures, the Fed does not want to raise rates too far. If short rates climb too much the yield curve may invert. An inverted yield curve means that short term rates will be higher than long term rates. ***About 60% of the time when the yield curve inverts we are headed for a recession***. Obviously, the Fed would like to avoid a recession.

With overnight Fed Fund Rates at 3.5% a two year U.S. Treasury brings a slim 4.17% and a five year is virtually the same at 4.19%. The ten year has finally climbed a bit and now stands at 4.33% (up from its sub-4% level last quarter). No matter how you analyze it, ***fixed income investors are not getting much return for extending their maturities beyond two years***. We continue to keep our fixed our fixed income assets short term.

The real estate market continues to catch the eye of many in the financial markets—as they should. While many continue to be enamored with what appears to be "easy" money we are very leery of real estate.

In fact, the incremental growth in housing is coming from people with credit scores that are way too low to normally qualify for a mortgage. They are all high risk to begin with and, on top of that, ***many mortgages have more than 90% debt to equity***. Making this house of cards much worse is the fact that many of ***these high risk borrowers are getting adjustable rate or interest only mortgages***. They are playing with fire and will get burned.

Another aspect of consumers being financially stretched has been observed in ***credit card delinquencies. The most recent reporting period showed record levels of default***. The same American Bankers Association study also noted ***an increase in delinquent payments on personal loans, home equity loans and lines of credit***.

The most commonly given reason for these defaults is high gas prices. We speculate that this is only the straw that is breaking the camels back.

Only 20 years ago, the U.S. was a creditor nation. We now owe the rest of the world $2.5 trillion (if you netted out U.S. owned assets abroad with foreign owned assets in the U.S.). Our nation this year will borrow from abroad a sum equal to 6% of its output of goods and services. This is more than in any year in the past 135 for which data are available.

The current debt situation is somewhat benign, however, it can't continue forever. To contend with this, we will most likely face increased taxes as well as a decline in the value of the U.S. dollar relative to other world currencies. Unfortunately, we as a nation, continue to spend more than we earn.

This will keep us analyzing foreign fixed income as well as equity investments. More specifically, we want foreign exposure that is not hedged back to the U.S. dollar. If we are correct about the long term issues facing the dollar many "U.S. only" investors will have a strong head wind.

Finally, and not to sound like a broken record, now is the time to get your financial house in order. Now is the time to ***reduce reliance upon debt***. If you can't pay cash you truly need to do a tremendous amount of soul searching before you spend your money. If tougher times are ahead, ***the investor with cash in hand will be the one who can take advantage of opportunities.***

Please call or stop by with questions.

Sincerely,

Dave Sather

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™