

QUARTERLY
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

10 LARGEST HOLDINGS AS OF
DECEMBER 31, 2005

Large Cap Equity:

Motorola Inc. (MOT)
AFLAC Inc. (AFL)
McDonald's Corp. (MCD)
Amgen Inc. (AMGN)
ConocoPhillips (COP)
Citigroup Inc. (C)
JPMorgan Chase & Co. (JPM)
American International Group Inc. (AIG)
Microsoft Corp. (MSFT)
CVS Corp. (CVS)

Mid Cap Equity:

Bear Stearns Cos. (BSC)
Fiserv Inc. (FISV)
Staples Inc. (SPLS)
Affiliated Computer Services Inc. (ACS)
Reebok International Ltd. (RBK)
HCC Insurance Holdings Inc. (HCC)
Laboratory Corp. of America (LH)
BJ Services Co. (BJS)
PerkinElmer Inc. (PKI)
Office Depot Inc. (ODP)

RORER
ASSET MANAGEMENT, LLC

THE RORER REVIEW

THE WIND AT OUR BACK

In the last issue of the Rorer Review, titled *Housing: Irrational Exuberance Part II*, we explored the potential cooling of the U.S. housing market and its effects on the consumer. Specifically, we surmised that rising interest rates and Fed jawboning about risky mortgage instruments would take some of the wind out of the housing market sails. This, in turn, would result in the consumer having less home equity with which to continue feeding his or her heretofore voracious appetite for discretionary items as we move into 2006. While we do not feel a recession is in the cards for the U.S. in 2006, this certainly will result in slower economic growth in the year ahead.

The above thoughts may sound familiar to loyal readers of the Rorer Review. We have surmised for some time that the twin forces of rising interest rates and higher energy prices would result in slower economic growth in the U.S. In fact, last year at this time we felt fairly certain that the Fed would cease hiking interest rates in the first quarter of 2005. Instead, thanks in part to the continued strength in the housing market, the economy chugged along at a healthy clip in 2005 and the Fed raised rates eight times during the year. Currently, the Fed Funds rate stands at 4.25%, up from 1% when the Fed began its tightening program in 2004.

For those readers still interested in our prognostications on interest rates, we're ready to take another shot at predicting the ultimate end to the Fed's tightening program. We strongly believe that there will be at most two more rate hikes, which would bring the final Fed Funds rate to 4.5% or 4.75%. This report will explore why we think this is so, and how we believe it will affect the equities market in 2006.

It appears that rising rates and Fed concerns about risky mortgage instruments are finally starting to cool the red hot housing market. In late December, the Mortgage Bankers Association reported that mortgage loan

applications had fallen 6.8% for the latest week compared to the same week a year ago. This was the lowest reading for that index in three years. There's also ample evidence of rising inventories of houses for sale in areas throughout the country as fewer buyers are willing to pay the inflated prices to which sellers have become accustomed.

In addition, it appears that it will become increasingly more difficult to obtain Interest Only mortgage instruments, or IOs, in the future. These types of mortgages require the borrower to make only interest payments on their loans, typically ending with a large principal payment at the term of the loan. As we stated in the last issue of the Rorer Review, any weakness in the housing market during the course of such a loan can cause the final principal payment to be larger than the value of the house, causing serious problems for the borrower. Further, as interest rates rise, the payments on these loans increase accordingly. Since the borrower interested in an IO is often stretching to afford the property he or she is buying, this increased cost can be troublesome. In 2001, IOs constituted less than 2% of all mortgage loans. In 2005, it is estimated that they will have ballooned to roughly 50% of loans written! It's no wonder, then, that government regulatory agencies will put new rules in place in 2006 mandating a crack-down on these types of loans. Thus, the speculative and marginal buyer will increasingly be removed from the housing market as we move forward, putting continued pressure on housing prices and softening demand.

Higher energy prices will also exert pressure on the economy in 2006. Oil prices rose steadily throughout 2005, peaking at about \$70 per barrel in the wake of hurricane Katrina. Prices have come down a bit since that time, but still stand at a relatively high \$60. Some of the effect of higher oil prices is felt immediately in the form of higher gasoline and heating oil prices for the consumer. Historical analysis, however,

shows that changing energy prices has a lagged effect on the economy by as much as 12 months. Put another way, the rising oil prices we experienced throughout 2005, will exert the greatest pressure on the economy in 2006.

Pressure on the housing market and higher energy prices will, in turn, cause the consumer to retrench. By almost any measure, the U.S. consumer has been on a tear. Spurred on by low prices and home refinancing, demand for all types of goods, from automobiles to home furnishings, has been strong for several years. Statistics show that consumers tend to spend roughly half of the money obtained through home refinancing. This has been a huge boon to the economy. However, the party looks like it is beginning to thin out. The latest anecdotal evidence of the consumer cooling off includes aggressive pricing at retailers during the holiday selling season and recent unit sales levels at GM and Ford falling to 10-year lows. Due to rising interest rates, house refinancings are well off their highs of 2004. This trend seems likely to persist in 2006 with the crackdown in Interest Only loans, making it probable that the consumer will continue to scale back his purchases. Because the consumer comprises roughly two thirds of the U.S. economy, any meaningful pullback would certainly get the Fed's attention.

Another factor that favors a near-term end to the Fed's tightening cycle is the clear lack of inflation in the global economy, including the U.S. Recent reports out of Europe show inflation well below 1% in several countries. Most of Asia is undergoing this same trend, with Japan actually experiencing deflation. After enduring a short lived spike during the third quarter owing mostly to the devastation caused by a heavy hurricane season, inflation numbers in the U.S. have resumed their moderate growth trend. While there will continue to be short lived episodes that can cause near-term spikes in prices, we believe the increasing use of technology, the globalization of the work force and rapidly growing level of low-cost exports from cheap labor markets such as China, will keep this tepid inflation outlook in place for the foreseeable future.

Finally, we would like to point to some anecdotal evidence that indicates the end of the rate cycle is close at hand. History shows that the Fed stops raising rates when the Fed Funds rate is roughly equal to the long-term bond yield. Further, the final rate increase tends to place the Fed Funds rate at a level approximately equal to the bond yield when the Fed began the tightening cycle. In the 4.5% to 4.75% range, both of these scenarios will likely be in existence. Finally, as we write this, the yield curve is on the verge of inverting. This atypical situation occurs when the yield on short-term bonds is actually greater than that of long-term bonds. In the past, this has been a strong sign of future economic weakness, a sign that most economists take very seriously. For all of these reasons, we feel comfortable in our prediction of an end to the tightening cycle in the first quarter of 2006, and perhaps even a cut in rates toward the latter half of the year in response to an economic slowdown, coupled with mild inflation readings.

THE MARKETS

Typically, the stock market will anticipate the end of a Fed tightening cycle several months in advance. As the Fed raises rates, the markets will normally reward those stocks that will fare well during an economic slowdown, such as health care and consumer staple issues. Conversely, the equities of more cyclical companies will usually weaken in anticipation of the slowdown. Once the markets sniff the end of a tightening cycle, however, the reverse will be true. In other words, the stock market will begin to look beyond the looming economic slowdown and toward the next upturn. In the final three months of 2005 we believe this latter scenario began to play itself out. During this period, the health care sector, which had been a strong performer for the first nine months of the year with the exception of the large cap pharmaceutical stocks, trailed the market as defined by the S&P 500 Index. Conversely, finance issues, which will benefit from an economic pickup down the road and perhaps even lower interest rates in the future, were among the best performers in the quarter.

2006 may not play out like a normal post tightening year, however. As the market wades through a tightening program, it is typical for growth stocks to outperform value stocks and for large capitalization equities to outperform their small- and mid-cap brethren. This occurs because growth and large-cap stocks tend to provide more reliable earnings growth during tough economic times. This time around, though, both growth and large cap have lagged value and mid-to-small cap. In fact, amazingly enough, 2005 will mark the 6th consecutive year that the performance of large cap stocks has lagged! This has occurred because earnings growth over the past several years has remained robust despite rising interest rates. As we look ahead to 2006 and beyond, we expect earnings growth will continue, but at a slower pace, due not only to the expected economic slowdown but also because of the tougher comparisons versus today's extremely high corporate profitability.

As we write this, the large cap stocks have the lowest valuations and the fastest expected earnings growth of any market sector. Examples of these attractive valuations range from the large cap pharmaceuticals, many of which trade at 10-12x earnings, to large cap technology companies such as Cisco Systems, which trades at 15x 2006 estimates even though its growth rate is slated to be in the 13-15% range. This is especially attractive when compared to the S&P 500 trading at 16x 2006 earnings that are estimated to grow at just 6%-8%. Needless to say, these issues are not without some ongoing risk, especially pharmaceuticals where the concerns range from generic competition to government regulation. However, these factors are well known by investors at this point, and a lot of the risk seems to be priced into these stocks. When we see equities at these valuation levels our mouths water! At Rorer Asset Management, we have always concentrated on high quality large cap names where we have confidence in future fundamentals. In this market, where the best companies in the world today are also the least expensive, we can hardly contain our enthusiasm for our portfolio. We look forward to the wind being at our back as we navigate a market led by large cap stocks in 2006.

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