

# The Economy and the Markets

## Advantus Capital Management, Inc.

### The Economy

The economy put on a show of surprising strength in the fourth quarter of 2005, shaking off generally low expectations that followed Hurricane Katrina. There was positive news on the employment front even as core inflation numbers came in lower than anticipated.

The third quarter gross domestic product increase of 4.1 percent cleared up doubts about the economy's ability to overcome challenges. The final quarter went down in the books as the year's strongest.

Positive forces behind the show of strength included continued strong consumer spending and a drop in oil prices from the \$70-a-barrel peak. Retail cash registers rang in the holidays with moderately pleasing sales increases, although the middle-market retail segments were somewhat soft.

Unemployment continued to hover around five percent, and job growth was particularly strong in November with 215,000 new jobs added to payrolls. While it was a positive quarter on the jobs front, the monthly average increase in jobs was below the 200,000 figure that has been adopted as a benchmark for a "jobs-rich" economy.

Overall, the economy ended the quarter in fine shape, with no significant storm clouds on the immediate horizon.

### The Markets

**Stock Market:** The markets benefited from a good finish, which pushed some indexes up to reach modestly positive numbers for the year. Over the quarter the Dow Jones rose 2.06 percent, and finished up 1.72 percent for the year. The Standard & Poor's 500 Index increased 2.09 percent over the quarter, and was up 4.91 percent overall in 2005. The NASDAQ Composite Index went up 2.50 percent in the final quarter and ended up 1.38 percent for the year. While it was not a particularly strong year for stocks, the fourth quarter finish cast an "all's well that ends well" mood over the market.

The strong ending was fueled by anticipation that the Federal Reserve's string of 13 consecutive rate increases will cease in the year ahead. Part of the market's jitters over the past year reflected a concern that the Fed would take things too far, a fear that has been at least partially allayed.

**Fixed Income Market:** The yield curve ended the year inverted, traditionally an indicator of a future slowdown. The fixed income markets appear to be anticipating that the days of consumers tapping the equity in their homes for cash are coming to end, and that the economy will suffer as a result.

With the flat yield curve, bond investors are not getting compensated for going out longer on the curve. The difference between two- and ten-year Treasuries, 112 basis points (1.12 percent) at the start of the year, has shifted to the point where the two-year yield ended the year one basis point (0.01 percent) higher than ten-year Treasuries.

Continued record-setting foreign demand for U.S. securities may be keeping longer term rates down. With the higher competitive yields of U.S. fixed income instruments and continued surpluses in foreign accounts, foreign bond holders are less driven to require greater compensation for holding longer duration investments.

**Real Estate Market:** Commercial real estate continues to be dominated by good news. There is considerable strength in the apartment segment, the retail market is stable and office space is holding its own. The hotel sector is stellar, with rates going up and occupancy reaching full capacity in a number of markets.

In the residential housing market, inventory increased and price appreciation slowed in some areas. There is still plenty of activity, with transactions continuing at a high level. Housing has moved from “red hot” to robust. This is a positive development, making it less likely this sector will undergo a more painful adjustment in the future.

## Outlook

Overall, we believe the economy is in excellent shape. Positives abound, negatives are few and far between. Stocks are up, bond returns are middling and cash is up. For the economy and the markets, life is good.

In the months ahead, observers anticipate that one of three scenarios will play out. In Scenario One, the economy feels the effects of the Fed's rate increases and drops into a big slowdown, or possibly a recession. In Scenario Two, the economy continues to grow at a rapid pace and additional Fed increases will be required to rein in inflation. Scenario Three plays out with growth moderating, the Fed tightening one or two more times as inflation fears stay subdued, and the investment environment remaining favorable.

With all of the economy's positive forces, it's hard to believe Scenario One will play out, at least in the short term. Scenario Two, marked by continued strong growth and no foreseeable letup in rate increases, also seems less likely to take center stage. To us, Scenario Three (modest growth, the Fed's streak ending after one or two more hikes, and generally positive investment conditions) appears to have the highest potential to become reality.

The S&P 500 dividend-adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make each company's influence on the performance of this index directly proportional to that company's market value.

The Dow Jones Industrial Average is a measure of the relative price of 30 widely held stocks traded on the New York Stock Exchange. The value of the DJIA is determined by dividing the sum of the per share prices of the 30 stocks in the index by an adjusted denominator that accommodates for splits and changes in stock composition.

The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S. based common stocks listed on The Nasdaq Stock Market. The index is market-value weighted (each company's security affects the index in proportion to its market value). The Nasdaq Composite includes more than 5,000 companies.

Risks associated with real estate investing in addition to other risks include rental income fluctuation, depreciation, tax value changes, and differences in real estate markets.

You cannot invest directly in an index.

Past performance is not indicative of future results.

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