Investment Focus

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Allegiant Asset Management Company

The Discipline of Investing, a Commitment to Results

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IT'S ALL ABOUT THE FED

By Brian Stine, CFA, Investment Strategist, brian.stine@allegiantgroup.com

One thing became quite apparent this past quarter: the markets are hostage to the Fed.

The Federal Reserve Board has steadily and consistently removed policy accommodation at a "measured" pace since June 2004. Not only has the regularity of its actions been extraordinary, but so too has its transparency—the Fed's openness about both its thought process and intentions. This level of transparency, no doubt, has helped enable the Fed to increase the federal funds rate from 1% to over 5%, with relatively little disruption to the financial markets.

Well, perhaps some disruption.

Chairman Ben Bernanke suggested before Congress that the Fed might pause following the May 10th Federal Open Market Committee (FOMC) meeting. Then came a series of inflation reports that were a bit higher than expected, and a bit above the Fed's preferred range for inflation. Hawkish comments from several Fed members followed. What also followed was a market correction (some markets experienced something more akin to a collapse) as investors perceived the pause was off the table. Volatility spiked, and markets worldwide fell sharply. Even most commodity markets fell sharply, as it seemed like everyone was reducing risk.

Fed to the rescue.

While the Fed talked hawkishly, several Fed members also expressed their belief that the lag effect of the interest rate hikes would gradually slow the economy and also gradually reduce inflation pressures. The official statement following the June 29th FOMC meeting confirmed the view that the slowing economy should reduce inflation pressures. The pause was back on the table, and the markets rebounded.

Yes, it is all about the Fed. ■

Market Scoreboard *(as of June 30, 2006)*

Performance	Quarter	One Year
Oil	10.96%	30.85%
Gold	5.52%	41.41%
Dow Jones Industrial Avg	0.94%	11.09%
International Stocks	0.70%	26.56%
Large Cap Value	0.59%	12.10%
TIPS	0.49%	-1.64%
High Yield	0.25%	4.80%
Treasury	-0.06%	-1.68%
S&P 500	-1.44%	8.63%
Large Cap Growth	-3.90%	6.12%
Emerging Market Stocks	-4.34%	35.47%
Small Cap Stocks	-5.02%	14.58%
U.S. Dollar	-5.09%	-4.41%
NASDAQ	-7.01%	6.48%

● Stocks ● Bonds ● Currencies/Commodities

Source: Bloomberg

WHAT LIES AHEAD

While the U.S. domestic economy likely will moderate in the coming quarters, the global story is one of growth rather than slowdown. World gross domestic product (GDP) is on pace to grow at 4.9% for all of 2006. That is faster than in 2005. And, yes, the world is growing faster than the United States.

And that's good news for investors. As a result of increasing globalization, most U.S. corporations are really global corporations. Their earnings are not constrained by U.S. economic growth. They can participate in the economic growth of China, Japan and other vibrant economies.

The bottom line is, in spite of moderating U.S. growth, corporate earnings could continue to grow at the rate we have come to know and love. It also means investors should pay increasing attention to economic developments overseas, as it becomes less and less about the Untied States, and more and more about China, Japan and others.

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FUTURE OF THE EMERGING MARKETS

By Brian Stine, CFA, Investment Strategist, brian.stine@allegiantgroup.com and Crystal Stetzy, Strategy Analyst, crystal.stetzy@allegiantgroup.com

The emerging markets are moving rapidly toward developed market status, and that has major implications for investors.

What are the emerging markets?

The term "emerging markets" was first used in the early 1980s to identify economies with low per capita income. Today, we usually associate emerging markets with those countries that are undergoing rapid economic reform and development and are "emerging" into the global arena. Emerging-market countries typically are growing faster than developed countries and are often heavily dependent on foreign aid. Their markets usually offer greater growth opportunities, but with greater risk.

Most of the emerging markets have made monumental strides toward "developed" status over the past 20 years. As they make this transition, they will eventually shed the "emerging" label.

What has changed about the emerging markets since the 1980s?

Dramatic global changes have taken place since the 1980s, and that has been clearly evident in the emerging markets:

- The emerging markets are moving rapidly toward developed-market status. China, Taiwan and South Korea, for example, have strong, healthy economies with trade surpluses and extensive foreign currency reserves, yet they remain in the MSCI Emerging Markets Index.
- Globalization has resulted in reduced risk for emerging markets. Increased sharing of capital, technology, information, materials and labor has resulted in healthier, more vibrant and more stable economies. Today, over half of the emerging markets are rated investment-grade versus about one-tenth in the late 1990s.
- Investors enjoy unprecedented access to the emerging markets. Specialized mutual funds and exchange-traded funds (ETFs) afford both institutional and individual investors easy access to these markets. Investor flows have been very supportive of the emerging markets in recent years.

Most investors equate the emerging markets to the MSCI Emerging Markets Index which consists of just 26 countries:

Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

What lies ahead for the emerging markets?

The emerging markets should continue to be the biggest beneficiaries of globalization. In particular, the resurgence of the Japanese economy, combined with Chinese expansion, could fuel the growth of emerging-market economies for several years. The role and importance of emerging market economies as part of the global economy should only accelerate in the coming years, as they experience above-trend growth and become an increasingly larger component on their road to developed-market status.

The World's Largest Economies

	Actual GDP (US$bn) 2005	Actual World Rank	Projected GDP (US$bn) 2020	Projected World Rank
United States	12,457	1	28,830	1
Japan	4,617	2	6,862	3
Germany	2,829	3	4,980	4
China	2,225	4	10,130	2
United Kingdom	2,213	5	4,203	5
France	2,132	6	3,536	6
Italy	1,720	7	2,543	10
Canada	1,122	8	2,206	11
Spain	1,119	9	2,146	12
South Korea	804	10	2,607	9
Brazil	787	11	1,600	13
India	759	12	3,228	7
Mexico	752	13	1,450	14
Russia	749	14	2,692	8

Source: Economist Intelligence Unit

The table above illustrates how the accelerated growth of some emerging countries is expected to impact the global economy. For example, China is currently the fourth-largest economy, but its economic growth is projected to propel it past Japan within 15 years. Other emerging economies include South Korea, which already ranks among the top 10 world economies. The continued growth of both India and Russia likely will move them into the top 10 as well.

What are the investment implications of the emerging markets?

Above-trend economic growth could very easily translate into increased earnings for corporations domiciled in emerging market countries. In addition, increased globalization means that developed market corporate earnings are no longer constrained by domestic economic growth. Domestic U.S. companies are global as much as they are domestic and are, therefore, direct beneficiaries of the rapid growth of the emerging markets.

While different accounting rules and levels of transparency often make it difficult to compare earnings data, valuations of many emerging markets remain well below those of developed nations. While emerging markets still have more risk than developed nations, the evolution from emerging to developed status would suggest that the risk premiums should gradually converge.

What can be concluded about the emerging markets?

Clearly, major changes have occurred in the emerging markets over the past several years. Globalization has resulted in both stronger and more stable economies for most of the countries in the MSCI index, and the risks inherent in the emerging markets are much different from what they were in prior decades.

Nevertheless, the markets' recent volatility is a stern reminder that the emerging markets are still just that and are intrinsically riskier than the developed markets.

Longer term, however, as the emerging markets reap the rewards of globalization and move toward developed status, their valuations should continue to trend toward those of developed-nation levels. ■

INDIA'S MUDDLED PATH TO ECONOMIC SUCCESSES—AND WHY IT WON'T STOP

By Holly R. Harrison, Product Specialist, holly.harrison@allegiantgroup.com

Serendipity is defined as making a fortunate discovery by accident. There is no shortage of stories from the past where luck, skill and timing coincided to change the path of history. The story of India's rise from a failing socialist state aspirant to China's biggest challenger to dominate world growth is a random walk paved by poor government policies, lack of enforcement, misguided use of resources and, most importantly, the confluence of luck and timing that ultimately changed its course.

When India gained its independence from Britain in 1947, the country was well positioned to become one of the dominant economic powers. With over $2 billion in foreign reserves, the country controlled over 2% of global trade. However, when Mahatma Gandhi was assassinated in early 1948, the prospects for a free market economy died with him. Jawaharlal Nehru was subsequently elected India's first prime minister. Nehru implemented a rigid, state-controlled economic planning system based on Russian socialism that ultimately derailed India's economy for over 40 years.

The Industries Act of 1951 nationalized major industries throughout the 1950s, including utilities, machinery, steel, mining and water. A multilayered bureaucracy created numerous government departments, each focusing on a different aspect of the country's industrial complex. Business moves could require months, or even years, to gain governmental permission. Import tariffs to discourage international trade and protect domestic infant industries were enacted. Indian companies were prohibited from establishing foreign offices and receiving foreign investment. By the 1970s, the top corporate income tax rate was 93.5%. Throughout this period, it was barely profitable for a business to jump the multiple licensing hurdles while paying the outrageous fees associated with them. Clearly, these policies did little to raise the standard of living across India or establish the nation's presence as a global economic power.

These policies, however, planted some unexpected seeds for future success. In an effort to become an industrial juggernaut, government funds poured into the education system to train future engineers. In fact, the country over-invested in engineering; both public and private institutions were plentiful. Private schools actually focused on providing job-focused education, equipping students with the skills to compete in a global economy. As a result, India has approximately 7 million engineering graduates who have been out of school seven years or less. This is 1.5 times the number in China and two times that in the U.S. They are adding new graduates at a rate of 2.5 million a year. This ultimately created a huge pool of highly educated, English speaking labor.

In 1991, India was on the verge of a major fiscal meltdown. It faced a foreign exchange crisis and nearly defaulted on its international debt. The government rose to the challenge, enacting major fiscal and economic reforms based, surprisingly, on China. India aimed for a balanced budget; the rupee was allowed to float freely; the licensing system was dismantled. The door for foreign investment opened, inflation was brought under control, and Indian companies were permitted to both borrow from and invest abroad.

Technology was one of the first areas to benefit. The laws of the 1950s failed to recognize the (future) importance of technology, so the industry was spared much of the chokehold that stifled other areas of productivity. Although India was used since the 1980s for outsourcing in areas like data entry and medical transcription, it wasn't until the reforms of the 1990s that the country became a global technological force.

Combine economic reform with a bit of serendipity, in the form of the Y2K crisis, and India was given the opportunity to prove itself on the global stage. U.S. companies desperately needed the programming expertise of every available person as the year 2000 crept closer. India was a natural source of technological capacity. The work was a dramatic boost to the country's esteem, as well as its economy.

Success has a way of breeding success. Indian companies have moved further up the sophistication level of goods and services provided. Over 1,600 companies now export products and services from India. Interestingly, it is no longer just cheap labor costs that draw foreign companies to outsource to India. The country's strong business and scientific expertise is now the driving factor. The net cost savings, approximately 45%-55%, also is compelling.

> *"India is on track to be the world's 7th largest economy by 2020, and could become one of the two biggest economies in the world by 2035."*

India's economy is expanding at an annual growth rate of about 7%. That puts India on track to be the world's 7th largest economy by 2020. If the trend continues, it could become, along with China, one of the two biggest economies in the world by 2035. The U.S. and Japan would be relegated to third and fourth place. India still faces many challenges, the biggest of which is its population, the majority of whom live below the poverty line and put additional demands on an infrastructure already strained. As of now, the country is relying on the information technology industry to shoulder the burden of the cost to reform, but it must diversify industry positioning to manage risk.

Nonetheless, India has made dramatic strides, which could not have been predicted even a decade ago, as an emerging economic superpower. Going forward, it is not hard to envision health care and pharmaceuticals as the next industries to be tackled. In any case, India has defied the odds, as well as the shackles of its history, to abruptly turn around its economy in record time. Call it serendipity, call it luck…but it will be careful planning, combined with hard work, that will determine the next stage of its growth. ■

KEEPING CONNECTED: INTERNATIONAL EQUITY

An interview with Martin Schulz, Allegiant's Director of International Equity, martin.schulz@allegiantgroup.com

Martin C. Schulz, J.D.
Director, International Equity

Q: How do you keep abreast of international business sentiments?

A: We have sell side contacts that we talk to on a daily basis. Beyond that, it's really something you build your experiences on. It's a combination of time and being in the business and developing relationships. I have a much better feel for the markets and the factors that may affect the markets, be it sentiment or direction.

Q: You're fluent in both German and French. How much does this help with "keeping in touch" with the international business community?

A: I also lived in Germany as a child and returned to Munich for some of my graduate studies. But to your point—speaking different languages definitely helps with rapport when you're abroad. The rest of the world often looks at the U.S. as provincial—a country that doesn't know any other language or history. So it's always a good ice-breaker or credibility enhancer. Generally, however, most of Europe and parts of Asia are fairly fluent in English. About the only place we continue to use translators is in Japan. Communication often goes beyond language. I was a prosecutor about 15 years ago, and I believe understanding the culture as well as the human nature of the personalities you're talking to can help. There's some art and science to talking with people. When we meet with companies, it helps to at least gauge the reaction to specific questions that might be a source of concern on our part or an issue that may affect the company on a growth perspective.

Q: How much thought goes into unforeseeable events when making your investment decisions?

A: Whether it's wars or depressions or famine, if you listed on the board all of the crazy things that have happened and will continue to happen, you'll see the market keeps going up. The issue is more about systemic risk versus portfolio specific risk. Yes, if there is some geopolitical 9/11 event that happens again, it's going to affect all asset classes across the board. The only thing going up in such a situation, possibly, is gold.

Q: Are there events that can happen abroad that have more impact than others, for example, an embassy bombing?

A: Those events aren't as relevant. The events that are relevant are monetary and fiscal changes over longer term periods of time. I believe you can make the argument that the Fed has been raising rates and really hasn't had a lot of effect on liquidity. Perhaps the Fed isn't the main organization affecting liquidity. There are so many other factors going into it. Today, it's also the Bank of China and the Bank of Japan exerting influence. What I find interesting too is that a lot of domestic managers started using a lot of international names to spruce up their portfolios. I think that indicates that not only is the world becoming more global, but sometimes you have to either borrow dollar weakness or find stronger companies based outside the U.S. for that kind of diversity.

Q: What trends are you currently watching?

A: I think there's a structural shift going on in the developing markets like in India or China or Brazil. I think they will have done the right things in the past 10 years to put their economic houses in order. Economically, they are starting to support a middle class that heretofore didn't exist. So there's demand there. We're also in the midst of a commodity bubble. Exactly where we are in that cycle is the bigger question. Basically, we're positioned as a component player, so to speak. We are invested heavily in engineering companies involved in geological work, seismic ventures, anything that would assist the oil companies— commodity producers that are going to come under increasing pressure on margins because they're going to have to increase their productivity, growth and production.

Q: How do you get the less sophisticated investor excited about international investing?

A: As the old saying goes: "familiarity breeds confidence." Originally in the late '90s, when we started to introduce international, there was a lot of, "Well, I don't know what's really going on in Sri Lanka… and the bombings there…" But when you start to look at the products that people use on an everyday basis, whether it's a Nokia phone or Toyota car… Dove soap… you name it, the world is so global now that it's absolutely irrelevant as to the provincial view that some people may take on local versus international stock investing. I think we've already passed that point. People understand that the world is much closer than it used to be. ■