H.M. Payson & Co.

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Perspectives

The Tide Has Turned

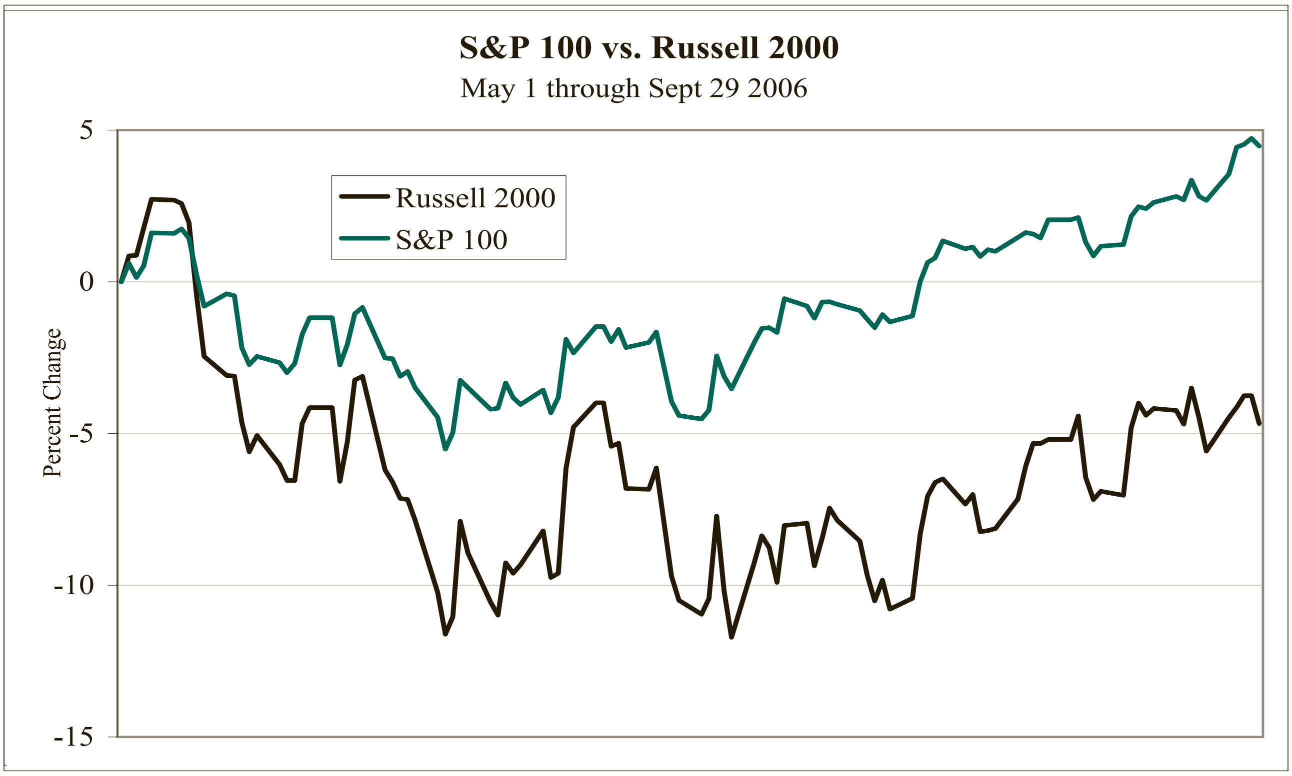
Change is in the air, and we're not talking about frost on the pumpkin. Behind the recent flurry of excitement in the media about record highs for the Dow, an important investment story may be unfolding. For the first time in seven years, large capitalization stocks appear to be gaining ground relative to their smaller brethren. A curious overlay to this apparent shift is the contradictory economic scenarios implied by simultaneously surging stock and bond markets. Our sense is that the stock market is rationally rewarding the healthy cash generation capacity, strong financial position, and compelling valuations of the largest U.S. companies, despite the possibility of slower economic growth.

The third quarter of 2006 was surprisingly good to both stock and bond investors, thanks to a steep slide in oil prices and a rapidly cooling housing market. With new economic predictions ranging from slow growth to recession for 2007, and the inflation outlook thus suddenly improving, bond yields turned down sharply. From late June to late September, the yield on the ten year U.S. Treasury Note fell from 5.25% to 4.54%, causing the inverted yield curve to become more pronounced. Stocks generally do well during periods of low inflation, and fresh hope that declining gasoline prices would provide some relief to the U.S. consumer allowed consumer discretionary stocks to recoup losses from earlier in the year. Technology stocks, increasingly tied to consumer spending, recovered sharply from their 52-week lows. Through October 5th, the S&P 500 Index produced a total return (including dividends) of 9.9%, providing hope for double-digit returns for the year. [1]

Contrary to its simplistic portrayal in the popular media, the stock market is not a homogenous entity, but a collection of subsets loosely grouped by industry or market capitalization. Rarely are all sectors moving in the same direction; rather, one or several may be leading the trend in one direction, while others may behave quite differently in the short run. Market leadership changes as cycles or popular themes play themselves out, most commonly due to divergences in valuations between different groups. Driven by crowd behavior, expectations tend to become either too optimistic or too pessimistic at the extremes. Inevitably, valuations converge over time, and market leadership shifts from yesterday's winners to yesterday's laggards.

Since 2002, small capitalization stocks have been the place to be. Valuations for this group

1 *Source: Thomson Baseline, Inc.*



became compelling during the previous decade, as they were shunned in favor of large, index-leading companies. In addition, smaller companies are highly sensitive to economic cycles, and many experienced above average earnings growth as the economy recovered from the brief recession which ended in mid-2001. As a result, for the past five years, the small-cap Russell 2000 Index has advanced by a whopping 74%, versus the S&P 500's 26%. [2]

On several occasions in recent issues of *Perspectives*, we have commented on the attractiveness of large capitalization stocks relative to most other asset classes. As these high-quality industry leaders came back to earth following the Bubble, their valuations appeared reasonable against the backdrop of a robust economy and low interest rates. In particular, stocks that were once characterized as "growth" stocks, such as Home Depot, WalMart, Johnson & Johnson and Oracle have at times been trading at *discounts* to the market multiple. Although we may have been early in our shift toward the blue chips, their valuations are now at the most attractive levels in ten years. Happily, recent market action suggests the tide may finally be turning for these under-appreciated icons.

This spring, the Federal Reserve and central banks around the world signaled their intention to aggressively fight escalating inflation with continuing rate increases. The prospect of higher interest rates, combined with ongoing instability in the middle east and elsewhere, triggered a "flight to quality" in the financial markets that continues today. During May and June, the Russell 2000 lost more than 13% of its value, compared to a 6.5% decline for the S&P 100 (a subset of the largest stocks in the S&P 500). As concerns about

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2 *Source: Thomson Baseline; Data as of 10/09/06*

a potentially slowing economy mounted, the strong relative performance of the large caps has continued, as shown in the accompanying graph. Because small caps had advanced nicely through the first quarter, the two indices are now about even for the year; but the signs of a change in leadership seem clear.

While the large stock indices like the S&P 500 and the Dow Jones Industrial Average have been surging on the prospect of moderating inflation, bond yields have been falling sharply. Ordinarily, such a rapid surge in bond prices might reflect growing fears of recession – particularly when the yield curve is already inverted.

Blue Chip Special

	Return On Equity*	Dividend Growth*	P/E	Price To Cash Flow
Citigroup	18%	29%	12	11
Home Depot	21%	26%	13	10
IBM	29%	11%	15	9
Pfizer	25%	15%	13	10
Wal Mart	21%	22%	18	12
Average	**23%**	**21%**	**14**	**10**
S&P 500	17%	10%	17	11
Russell 2000	11%	4%	27	15

* Five year average Data as of 10/13/06
Source: Thomson Baseline, Inc.

Indeed, such fears have been raised recently with increasing evidence of a severe slump in the housing market. This begs the question of which market is right - a strong bond market signaling a possible economic slowdown, or the resilient stock market suggesting the possibility of further steady economic gains?

It seems certain that a slowing housing market will have some economic impact. Yet, many indicators (employment, retail sales, business investment, corporate earnings) remain strong. These factors taken together might indicate a slowing economy, but not necessarily a recession.

Historically, large capitalization stocks have done well under such conditions. Their balance sheets are generally very strong, giving them good financial flexibility; and although earnings growth may slow, these companies generate mountains of cash. They can use this cash to benefit shareholders through stock buybacks and dividend increases. Finally, as we have mentioned, the other factor favoring this group is very attractive current valuations.

Although we have been ringing the bell for large cap stocks for some time now, clients and regular readers of Perspectives will remember that this has not always been the case. In our Spring 2000 issue we wrote "…the capitulation to large-capitalization growth stocks has been so pervasive and unanimous that by most measures mid- and small-capitalization stocks generally, and "value" stocks in particular, have never been more attractively priced…" What a difference six years makes! While we will always maintain a value orientation, the most important tool in our arsenal is the flexibility to go where we see the best opportunities. Because large capitalization stocks have languished for the past several years, it is sometimes easy to forget they dominated the market in the late '60s and early '70s, and again in the late '90s. As Mark Twain said, "the past does not repeat itself, but it rhymes."

Acquisition

We are pleased to introduce Daniel M. Lay, Esq., as the newest member of our portfolio management team. Dan brings twenty years of experience in portfolio management and fiduciary services to the firm. He most recently served as Managing Principal and Senior Trust Officer with The First, N. A., in Damariscotta and Bar Harbor. Earlier, he practiced law with Eaton Peabody in Bangor and worked in the legal division of State Street Bank and Trust in Boston. Dan lives in Brunswick with his wife and two children.