

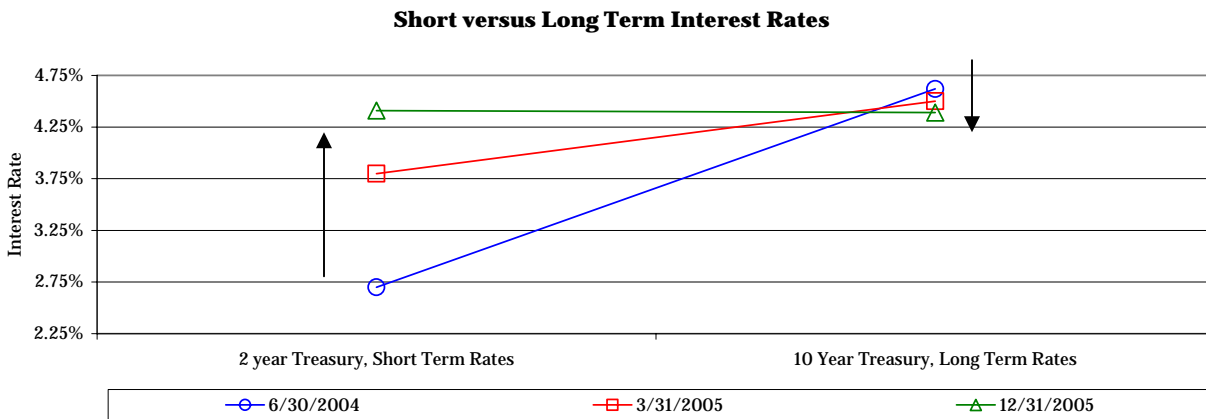
Athena Capital Management Corp.

January 18, 2006

Interest Rates

The Federal Reserve has raised short term interest rates 13 times over the last 18 months. At the same time, long term interest rates have been flat or decreased (the fed has a lot of control over short term rates, but the marketplace sets long term rates).

The chart below is a graphical depiction of this situation. The diamonds represent a snapshot of 2 year (short term) and 10 year (long term) interest rates on 6/30/2004 (18 months ago), the squares represent 2 and 10 year interest rates on 3/31/2005 (9 months ago), and the triangles represent 2 and 10 year rates on 12/31/2005.



What is causing long term rates to fall even though short term rates are rising? Some analysts believe long term bond investors are forecasting low inflation and slower economic growth, which is leading them to buy long term bonds and drive down long term interest rates. Other analysts believe that China & Japan are buying long term bonds with surplus dollars they are getting from US consumer spending. I think it's a little of both. If long term bond investors or Japan & China reduce their buying of long bonds, expect long term rates to rise.

How do interest rates impact us? Long term interest rates are used as an input to value stocks. When rates go lower, stock prices tend to rise. Similarly, when rates rise, stocks tend to decline. Because of this interest rate/stocks connection, a *further* decrease in long term interest rates will probably lead to higher stock prices. The decline of long term rates over the last few years is one of the reasons why the stock market seems over-valued to me. If long term rates rise because of higher inflation, higher economic growth, or Japan & China finding other places to invest their trade surplus, expect stocks to decline.

Interest rates also impact mortgage rates. Lower long term interest rates mean lower house payments for those who lock in 30 year mortgages. Further, short term interest rates determine adjustable rate mortgages, which have become popular over the last 5 years. All things being equal, higher interest rates tend to slow the housing market and reduce economic growth, whether short or long term rates are rising.

One of the most reliable predictors (meaning somewhat better than a random guess) of future economic growth is the *difference* between short and long term interest rates. When short term interest rates are much lower than long term rates, the economy tends to grow strongly. When short term interest rates are close to long term rates, *like at present*, the economy tends to grow a bit slower. If short term rates rise above long term rates and stay there for a few months, the economy tends to slow and could even decline (a recession).

Athena Capital Management Corp.

Forecasting or reacting to interest rates is difficult, and I'm not trying to make a forecast or suggest action. **We should, however, pay attention to interest rates in the future because they are likely to indicate changes in the economy and stock market.** Stay tuned for future updates.

The Housing Market

Is the housing market a bubble about to pop? I am not an expert in this field, but I am fairly certain the housing market will never tank like the NASDAQ did from 2000 to 2002 (down 78%). However, home prices could decline, remain flat for a while, or simply grow more slowly.

There are good reasons to think that recent rapid home price increases will end. If you look at housing statistics, you will find:

- The average person owns less equity in their home than ever before (historically 65-80%, currently 55%)
- The expense of owning a home is high relative to people's income (incomes have risen much more slowly than house prices)
- Rental income on homes is very low relative to corresponding mortgage payments, housing expenses, and home prices

In other words, this is as stretched as the housing market has been for quite some time.

Is it true that housing prices have never gone down? No. Since the 1970's, aggregate housing prices have never gone down for the nation as a whole. But, anecdotal information suggests that national housing prices almost certainly went down during the Great Depression in the early 1930's. Further, Japanese housing prices went down for 14 straight years (until this year) after their housing market peaked in the early '90's. Finally, consider the housing price peaks in southern California and Texas in the '80's, where housing prices *adjusted for inflation* still haven't regained prior peaks.

Housing markets are much more *locally* based than stock or bond markets. Even if the prices for condominiums declined steeply in San Diego, that doesn't mean that housing prices in Minot, ND will go down as well. If you own your home for the long haul and don't think of your home as a short term investment, you are unlikely to be affected by slower growth or even a decline in housing prices. The only people that may get hurt are those speculating on housing prices over the short term, and those who have taken on too much debt to buy a house they really couldn't afford.

The Economy

The economy performed very well in 2005 despite record trade deficits, high government budget deficits, hurricane Katrina and Rita, record high gas and oil prices, and a host of other worries. Although I would love to see this outstanding performance continue, there are reasons to expect the economy to slow.

- Rising short or long term interest rates could crimp both consumer and company spending. Higher interest rates increase expenses for both individuals and companies because it raises the amount of interest they both have to pay.
- If the housing market slows, it would impact jobs and people's perceived wealth.
 - Many of the new jobs created since the 2001 recession have been in home building and housing finance. A slowdown (not even necessarily a decline) in the housing market could lead to layoffs and reduced incomes.
 - Housing has a big impact on people's perceived wealth. When people's home price grows quickly, they can use a home equity loan to cash out the equity value of their home to spend on goodies. And, people don't feel they have to save as much because their growing home price has become their savings. If you remove these benefits, spending will decline as people stop cashing out their home equity and start saving their money.

Athena Capital Management Corp.

Predicting economic growth is not my specialty, nor does anyone else seem very good at it. But, I do know that economic growth tends to fluctuate above and below a consistent average. And, because growth in the economy over the last 2½ years has been above average, **it would not surprise me to see growth return to average and maybe even below average.**

If you are curious about how the economy will do going forward, pay attention to short versus long term interest rates and to the housing market. If long term interest rates decline below short term interest rates, this indicates the economy is slowing and, if the difference is large enough, could signal a recession. Further, if the housing market slows or goes into decline, the economy will slow as well.

Fortunately, predicting the economy is not necessary for long term investing success. If the economy keeps chugging along, client portfolios will benefit from its growth. If, on the other hand, the economy does start to slow or decline, it will be an excellent opportunity to buy great companies at bargain prices. **Regardless of what the economy does, I will continue to position client portfolios to achieve good long term returns.**

Michael Rivers, CFA
Portfolio Manager, Athena Capital Management Corp.
mike@athenacapital.biz
www.athenacapital.biz