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Funds Flow

2005. It was a year of solid GDP growth. Consumer spending was strong, but residential housing cooled. Oil prices soared then eased. Short-term interest rates climbed; long-term rates did not. Most U.S. stocks gained modestly; foreign equities more so. The dollar appreciated. Profits gushed; cash piled. Some cash went into M&A; more of it went into dividends and share buybacks, with capital expenditures beginning to pick up.

The nation's GDP—the broadest measure of economic output—increased at an annual rate of 4.1% in the third quarter of 2005, according to the Bureau of Economic Analysis. In the second quarter, GDP increased 3.3%. In the past two-and-a-half years, GDP averaged 4.1%, and it's expected to decline in 2006. The consensus forecast of 56 economists surveyed by *The Wall Street Journal* is that GDP will grow at an annual rate of 3.5% in the first half of 2006 and 3.1% in the second half.

Business spending is expected to be the primary driver of GDP growth, offset by a cooling housing market and persistently high oil prices. Surging residential real estate prices of the past five years are slowing and could decline. There are a record number of homes up for sale, and they are likely to spend more time sitting on the market. The number of unsold homes is at a nine-year high, and the number of unsold newly built homes has jumped 20% in the past year to 503,000 as of November, according to a Merrill Lynch & Co. report.

Consumer borrowing against real-estate wealth has fueled consumer spending in the past five years. In fact, consumers spent more than they earned last year—$39 billion more, according to the Bureau of Economic Analysis. The last time that occurred was 1933. But a slower growth in housing prices may put a damper on consumer spending and, in turn, cause economic growth to slow.

Oil prices are another concern. Economists expect high prices to continue into 2006, with the price of oil between $50 and $60 a barrel. The last four years have all ended with spot oil prices seeming high. If the oil futures market is any guide, there's no evidence of prices easing. The oil futures contract expiring in February 2006 is at $63.95 per barrel. That's down from its peak of more than $70 reached in August, when Hurricane Katrina raised fears of oil shortages, but it is well above what anyone expected a year ago. Moreover, the futures contract for the end of 2008 sells for about $63.90.

Too much additional tightening of interest rates is another risk to the economy. The Federal Reserve's 19-month campaign of raising interest rates may come to a close soon—

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after one or two more quarter-percentage-point rate increases to keep inflation in check in the first quarter of 2006. At the December meeting of the Federal Reserve's Open Market Federal Committee, the Fed increased short-term rates to 4.25%, the 13th consecutive quarter-percentage-point increase since June 2004, when it stood at a 46-year low of 1%. But higher energy prices and business spending could hike inflation and prompt the Fed to raise rates higher than 4.75% later in the year.

U.S. stock prices showed tepid growth in 2005, perhaps portending a bigger-than-expected slowdown in GDP in 2006. The Dow Jones Industrial Average of 30 blue-chip and broadly traded stocks ended 2005 flat, declining a mere 0.61%, the smallest annual change in 79 years. Only 14 of the 30 Dow industrials showed gains.

The broader S&P 500 index eked out an overall gain of only 3%, while the Nasdaq Composite rose just 1.4%. Eight of 10 industry sectors in the S&P 500 were up, led by energy with a gain of 29.1%. The losing sectors were telecommunications, which is facing more competition from cable companies, and consumer discretionary, a sector that includes both auto companies and newspaper publishers. The latter saw the Internet erode newspaper profitability at a faster pace than expected.

Despite the small gain for the S&P 500 stock index, gains were widespread. Of the 499 stocks in the S&P 500 that were trading a year ago, 288 stocks showed gains for the year. It was the third consecutive year that more stocks rose than fell and a sharp contrast to 1999, the last year of the bull market before it faltered, when the index gained 19.5% but only 241 stocks in the index were up. Of the stocks in the S&P 100, which are generally the largest in the 500, just 51 showed gains last year.

Foreign stock markets posted impressive gains in a broad rally, beating their U.S. counterparts for a third straight year and attracting record sums of U.S. capital. The Nikkei Stock Average of 225 companies rose 40.2%. Britain's FTSE 100 index rose 16.7%. Germany's DAX Index did even better, rising 27.1%, while the Paris CAC 40 Index rose 23.4%. South Korea's KOPSI jumped 54%, and Brazil's Bovespa index was up 27.7%.

Global conditions last year were nearly ideal for stocks. Low interest rates worldwide prompted widespread borrowing and investment. European and Japanese companies continued to restructure, producing larger profits and boosting their share prices. Emerging markets in Asia benefited from strong economic growth, while Latin American commodity producers capitalized on rising prices for natural resources.

Expressed in dollars, however, some of those overseas gains were partly offset by currency weaknesses against the dollar. Despite prognostications last year that the dollar would continue its three-year decline against the euro, it climbed. For example, the dollar ended 2005 up 14.6% against the euro and up 15.2% against the yen. The U.S. Dollar Index, which trades on the New York Board of Trade and tracks the U.S. currency's movements against a basket of six currencies, rose 12.6%, its biggest annual gain since a 13.1% jump in 1997.

The growing strength of the dollar was due to several factors, analysts say. U.S. interest rates, higher than their Japanese and European counterparts, attracted foreign capital. At the same time, the repatriation of billions of dollars in profits by U.S. multinational companies because of last year's tax break added support to the currency. Also, the European Union's political infighting pushed traders out of euros, while China's modest revaluation of the yuan didn't spark a rally in Asian currencies.

Meanwhile, most U.S.-domiciled companies continued to be highly profitable yet resorted to giving more profits back to shareowners in dividends and share buybacks than investing in internal growth. But executives are beginning to find worthwhile projects to invest in.

Capital expenditures of the companies in the S&P 500 posted a year-over-year change of 12.7%, the first double-digit annual rise in expenditures since the 17.2% gain in the year 2000, according to Standard & Poor's. In the third quarter, capital expenditures for the companies of the S&P 500 increased 21.7% over that of the third quarter 2004.

But S&P 500 companies paid out more than $500 billion in dividends and share buybacks, 30% more than 2004's record. To put that number in perspective, $500 billion is $183 billion more than the federal budget deficit for the government's fiscal year that ended on September 30. It also equals $1,702 for every person in the U.S.

Among the 7,000 companies whose dividends Standard & Poor's tracks, there were a total of 1,949 dividend increases in 2005, 11.7% more than in 2004. And 544 companies declared extra dividends last year, up 4% from 2004. Extra dividends are a way for companies to reward investors without committing to a sustained increase in quarterly dividends. ■