November 10, 2006

Third Quarter Commentary

" 'Its a poor sort of memory that only works backwards' the Queen remarked."

- **Charles Ludwidge Dodgson, 1832-1898, AKA Lewis Carroll**
- **English author, photographer, mathematician, logician, and Anglican clergyman**
- **Through a Looking-Glass, 1872**

We confess to having the same memory flaws as the Queen in Lewis Carroll's extraordinary work. And imperfect our memory is as we have only history upon which to anchor. "History"; water under the bridge, as they say. Investment memories are still fresh with remembrance of excesses in 1999 and 2000, and observable behavior supports the idea that avoidance of a repeat is high upon the psychic agenda. So when the venerable Dow Jones Industrial Average broke out to new all-time highs this past quarter, pundits of all flavors were eager to offer up reasons as to why this event was really "no big deal". After all, were not the S&P 500 and NASDAQ still languishing well below previous ceilings?

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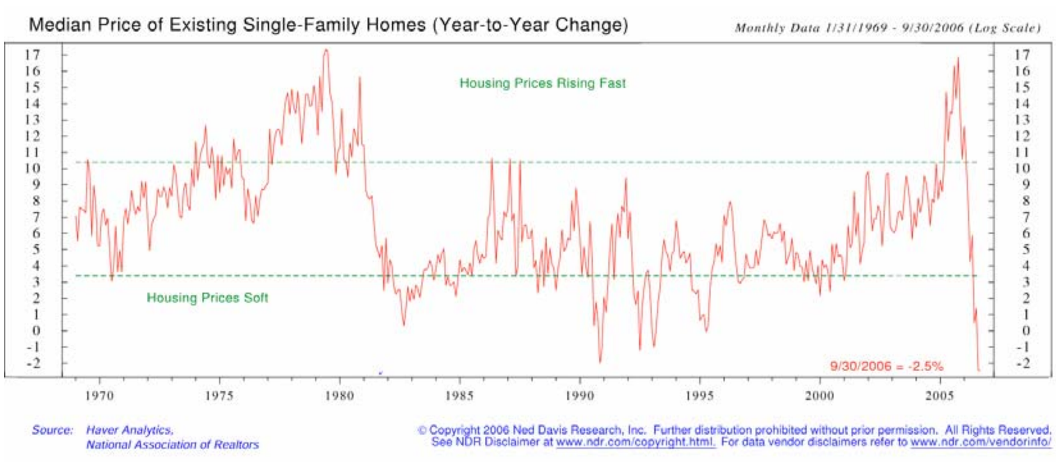
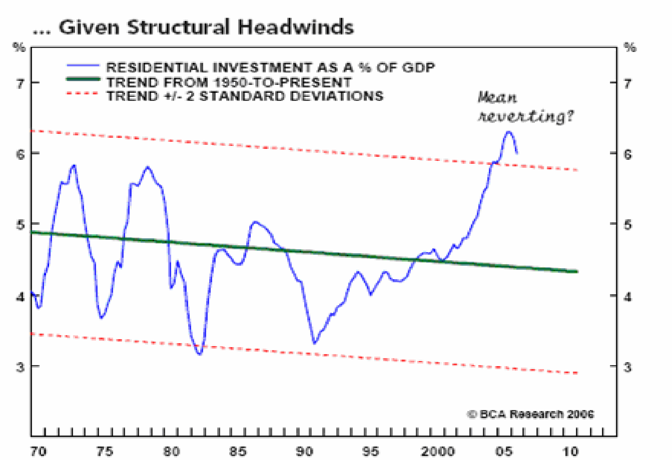
Moreover, this Dow 12,000 stuff was proving downright inconvenient, as it flew in the face of the notion that the internet-bubble highs would not be seen again for God only knows how many eons into the future.

The economic slowdown has arrived at last. Or has it? Third quarter real GDP was reported up only 1.6%, supposedly 1.1% lower than it would have been had not residential investment dropped 17% so far this year.



As for price drops in housing, the latest nationwide statistic has prices off 2.5% in the trailing twelve months. Certainly the boom in residential investment, as seen here, was begging correction.



We could not help but notice in recent travels through a couple of the more heated real estate markets that prices have already

dropped by some fair amounts in the boomer-havens of Arizona and Florida, Gannett News Service, 10-22-06:

> **"Asking prices in the Phoenix area have dropped about 25% this year, says David Khalaj, an agent at Realty Executives."**

Advertisements for new homes by developers Ryland Homes and WCI in Lee County, Florida (Fort Myers, Port Charlotte, Naples), Fort Myers News-Press, 10-22-06:

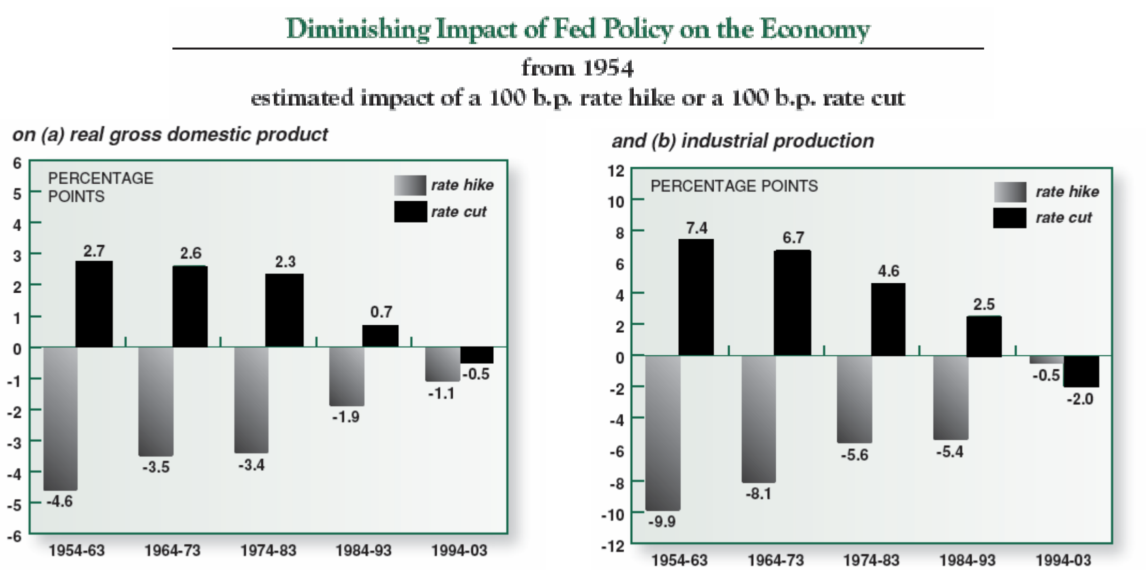
New Homes	Was	Now	Drop
The Siesta	299,991	225,000	-25%
The Madiera	332,909	235,000	-29%
The Barcelona	324,625	305,000	-6%
The Ponte Verde	384,515	350,000	-9%
The Marseilles	519,270	420,000	-19%
The Monaco	505,857	450,000	-11%
The Venice	509,870	475,000	-7%
The Capri	520,875	500,000	-4%
The Costa Verde	613,859	506,000	-18%
The San Marco	605,287	540,000	-11%
The Sicily	594,494	560,000	-6%
Charleston at Hampton Park	742,425	589,990	-21%
Madrid at Pelican Reserve	711,056	591,056	-17%
Milan at Pelican Reserve	423,850	378,850	-11%
Monet at Pelican Reserve	404,786	339,786	-16%
Lerida at Pelican Reserve (condominiums)	403,868	250,000	-38%
		Average	-16%

Housing permits are now down eight months consecutively through September, such a string of declines last seen in 1961! Could it be that most of the damage has been done already? We profess no expertise in real estate, but observe that all the talk is negative. Last we checked, that was the definition of a "market bottom". If, in fact, the majority of the damage has been done already, can recovery be far behind? And if recovery is in the offing in 2007 or so, then maybe the Fed will not be reducing interest rates any time soon, or if reducing rates, not by much. Since commodity prices are up 87% over the past four years, we know that the flow-thru to finished product has yet to be completed since this process takes over a decade to

complete. Therefore, we are concerned that higher rates of inflation have yet to embed themselves in the price structure overall, irrespective of Fed actions. Since the commodities markets are not directly controlled by the Fed, crushing consumer demand via higher interest rates is the only tool available. Even so, this response relies upon the U.S. being the 800 pound economic gorilla...otherwise commodity demand from elsewhere in the world will only serve to thwart Fed action.

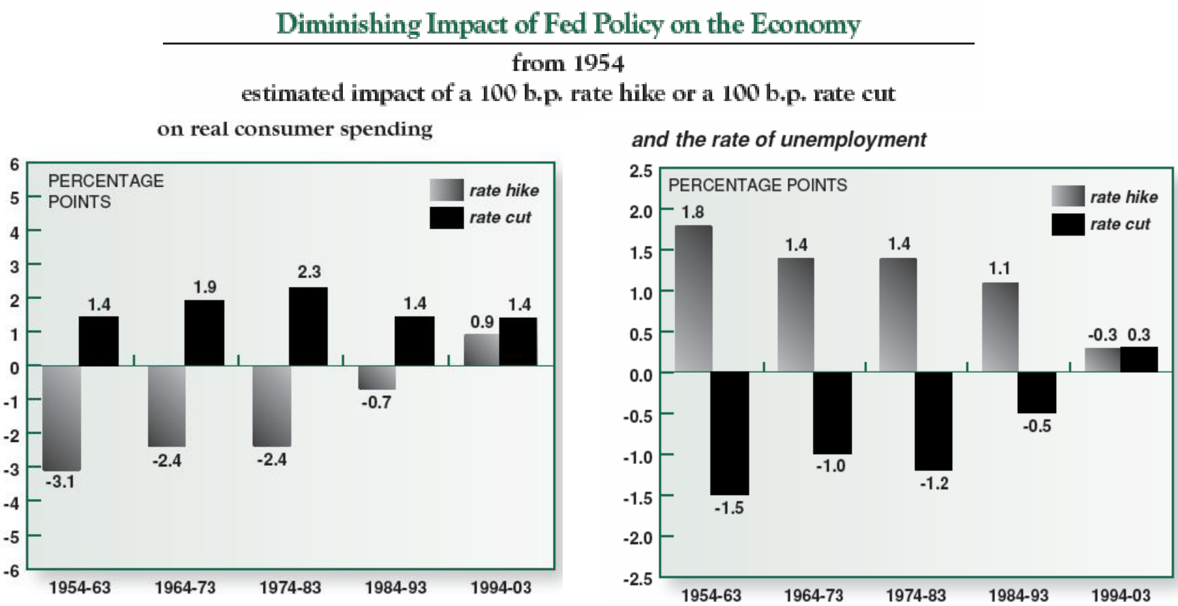
In past years we thought asynchronous economic growth was a good thing. If Japan was in recession, then economic growth in Europe and the U.S. would help pull them out. Synchronous growth is what we have seen in recent years. Now we have had the U.S., Japan, Europe and China all raising interest rates simultaneously which has the potential to create a major worldwide slowdown...followed by overstimulus to get the economic engines humming again, accentuating the cycle.

In an age of globalization, it is difficult to rein in inflation through restrictive monetary policy in one country if other major economies of the world are pursuing expansionary policies. This becomes more acute as the U.S. share of world GDP shrinks as it has in the past decade. The Fed is having a progressively harder time affecting real GDP and industrial production with interest rate policies alone, as seen below.



Data: H.C. Wainwright & Co. Economics Inc. Calendar-year totals of real GDP (Bureau of Economic Analysis), monthly industrial production indices and daily yields on three-month Treasury bills (Federal Reserve Board).

Where a 1% change in the Fed funds rate used to produce a large response in GDP and industrial production in the 1950's and 1960's, a 1% change today produces only minor shifts in real GDP and industrial production. The reasons for this are manifold: the demise of Regulation Q which used to cause disintermediation in the credit markets, the creation of the junk bond market, direct purchases of commercial paper by money market funds, repos and reverse repos, creation of adjustable rate mortgages, the evolution from a manufacturing economy to a service economy, globalization, etc. Not only is the Fed's diminished potency applicable to industrial production, but also to consumer spending and the rate of unemployment as seen here.



Data: H.C. Wainwright & Co. Economics Inc. Calendar-year totals for personal consumption expenditures deflated by the overall GDP implicit price deflator (Bureau of Economic Analysis), together with calendar-year averages of monthly numbers of unemployed (Bureau of Labor Statistics).

The implications of this are that it would take perhaps significantly higher interest rates to pull inflation down to 1.5% to 2.0%, the Fed's stated goal. And the corollary is that we should not be so surprised little economic results can been seen after seventeen consecutive increases in the Fed funds rate totaling 400 basis points(4%).

Nevertheless, this raises the question of whether the Fed will pull out the stops in an effort to kill rising inflation. Taking cues from the bond market, the conclusion would be not to worry. Recent comments by Fed Chairman

Bernanke show the Fed is worried about collateral damage should they pursue higher rates. Home ownership was expanded to 68% of households from 63%, much of it coming from a relaxation of credit standards and the creation of mortgage instruments heretofore unheard of. These households are particularly vulnerable to further rate increases, and the Fed probably does not want to be accused of destroying what the Legislative Branch created to further the American dream. Therefore, it may be that the Fed leaves interest rates where they are, but lingering for a longer period of time than we suspect at the moment. Certainly with October junk-bond defaults reported at an all-time low, and with corporate cash still near all-time highs, and with employment strong, the Fed has only inflation and asset bubbles to worry about as the corporate sector is in robust condition.

We ran across some fascinating data recently which speaks to the issue of the probability of price/earnings ratios contracting. P/E's on the S&P 500 have shrunk three years in a row with 2006 being the third year. Simply put, earnings have grown faster than stock prices. Year 2007 would make for a fourth year in a row which has only happened twice in the past 100 years as seen below, 1934-37 and 1976-79.

P/E Rarely Contracts Four Years In A Row

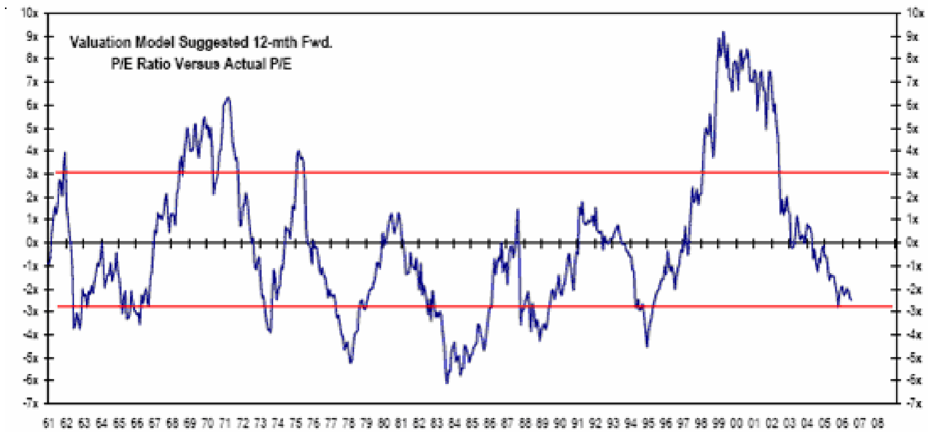
Consecutive Periods of Multiple Contraction

Year 1	Year 2	Year 3	Year 4		Year 1	Year 2	Year 3	Year 4
1905	1906	1907	1908		-15%	-9%	-23%	56%
1915	1916	1917	1918		-24%	-41%	-17%	50%
1934	1935	1936	1937		-16%	-9%	-5%	**-45%**
1939	1940	1941	1942		-33%	-27%	-26%	27%
1946	1947	1948	1949		-20%	-34%	-30%	9%
1964	1965	1966	1967		-0.2%	-4%	-19%	25%
1976	1977	1978	1979		-4%	-20%	-11%	**-6%**
1992	1993	1994	1995		-3%	-17%	-17%	13%
2004	2005	2006td			-10%	-9%	-4%	???
				Average	-14.0%	-19.0%	-18.3%	16.1%
				Median	-15.4%	-16.9%	-17.9%	19.0%

td = as of 9/30/06. Source: Robert Schiller, Thomson Financial, S&P, Haver, Morgan Stanley Research

P/E's have shrunk about one point in 2006 to date. Our bet is that P/E's will not shrink again in 2007, but go up as the market climbs the proverbial "wall of worry". In fact, as seen below in the chart from Bear, Stearns & Co., Inc., a case can be made that the current market P/E is at least two points below where it should be (forward P/E currently

estimated to be 14 times 2007 earnings, and might be 16 or 17 times 2007 earnings).



The market has made a pretty fair advance since June quarter's end, and could be in need of a breathing spell. Nevertheless, we think 2007 has a fair shot at being a good year overall for stock market investors.

The Wall Street Journal recently published an article which was a telling insight into investor behavior. To wit: Over the past ten years, owners of diversified U.S. stock funds collected 7.3% per year, 1.5% less than their funds' 8.8% published return. The reason for this sad state of affairs has to do with investor behavior. By trying to avoid losses in ugly markets and seeking exposure to only rising markets, investor trading of these funds causes them to experience dollar-weighted returns that are 1.5% less than time-weighted returns. We are pleased to say that we see very little of this behavior among our clients.

Like Lewis Carroll's Queen, we would prefer a memory that worked backwards *and forwards*...but only forwards for us. We're not holding our breath on that one, so we plow ahead dodging the slings and arrows of outrageous fortune.
We thank each of you for your patience and understanding.

Alan T. Beimfohr John G. Prichard, CFA