Monthly Chartbook

February 2006

CORNERSTONE
Investment Management and Consulting

2/28/2006

One and done?

Two and through?

Don't bet your life on it!

Something wicked this way comes…

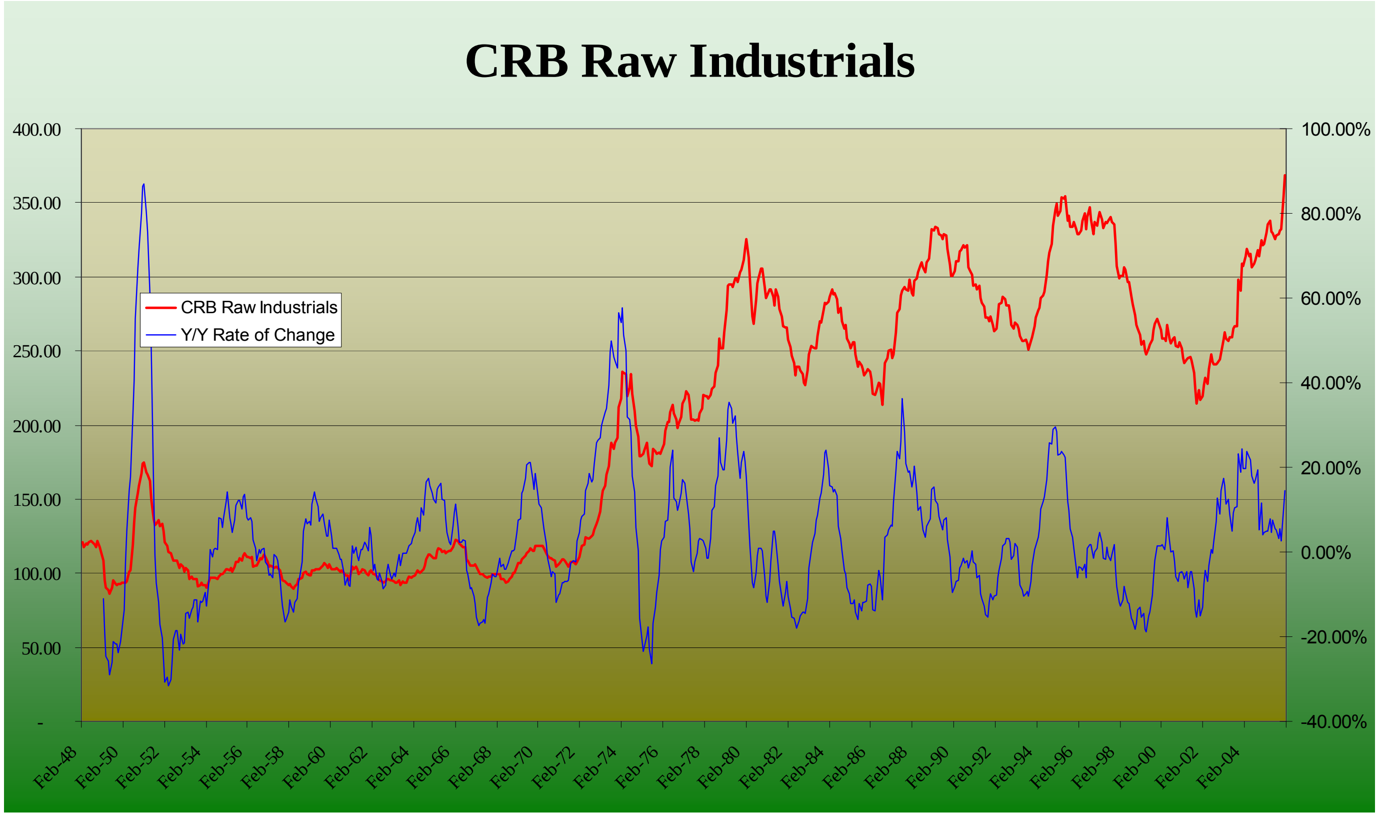
After Hurricane Katrina most economic indicators signaled brief but deep dips. We are well past the immediate impact of last year's hurricane season and, with it, we are past signs of economic weakness.

While the economy is not screaming, pressures are ***slowly and surely*** building -- building to a point that the Fed may have to do more than anyone now expects.

Looking ahead…

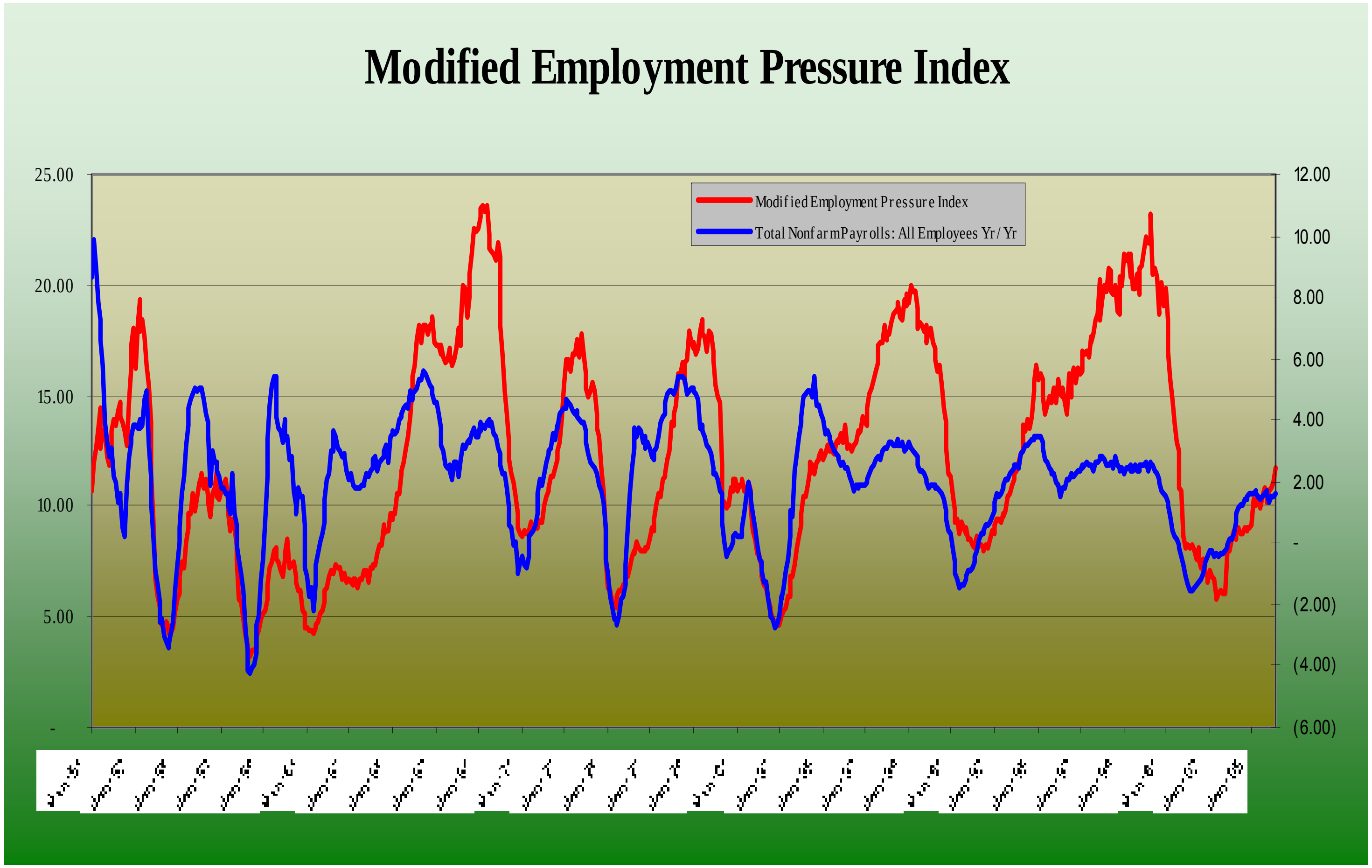
The Fed wanted to reflate the economy and, boy, they got it. You name it, and it is up in price (ha! not value) in the last five years -- homes, classic cars, gold, condos, land, oil. Everything except perhaps large cap growth companies, or the good ole US $.

The bottom line… materials costs have been on the march and now labor has firmed to a point where wages may begin to join the inflationary party.



Raw industrials continue to move higher, input costs are bleeding into core inflation.

Macro-economic Research



The dip in jobless claims comes at a time when labor utilization is much improved.

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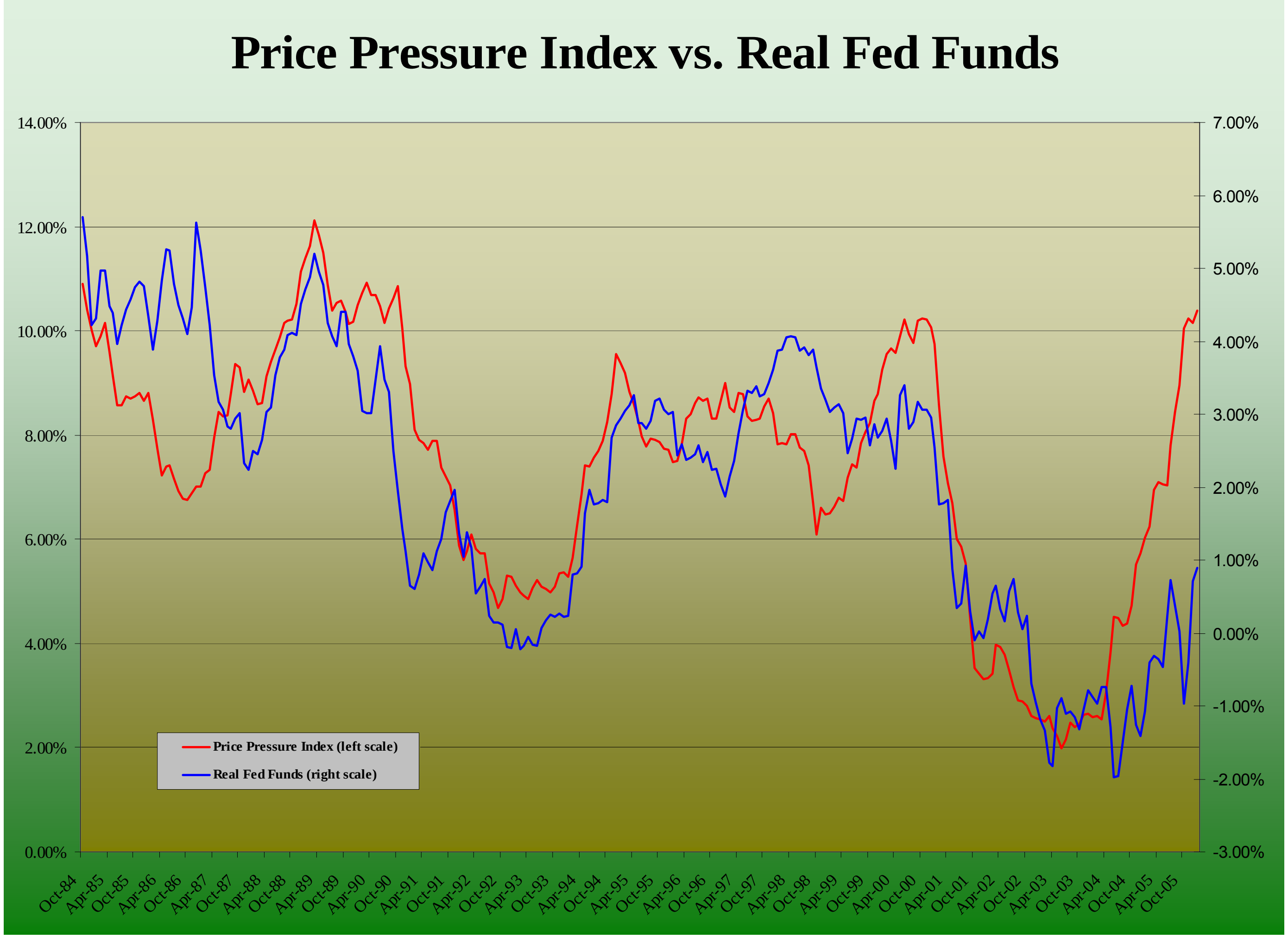

You cannot ignore the large gap between the two series that we currently observe.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	**1280.66**	**Trading range**	↔	**1120-1275**	**Next 6 months**
Ten Year Treasury	**4.54%**	**4.62%**	↓	**4.25 - 5.00%**	**6 months**
Inflation (all Urban)	**4.03%**	**3.22%**	↑	**3.00 – 4.00%**	**6 months**
Fed Funds	**4.50%**	**4.75%**	↑	**4.5 – 5.00%**	**3 months**
S&P 500 Earnings	**$70.92**	**$73.57**	↑	**$71 - $74**	**1Q 2006**
	Legend:	↑ Higher	↓ Lower	↔ Indifferent	

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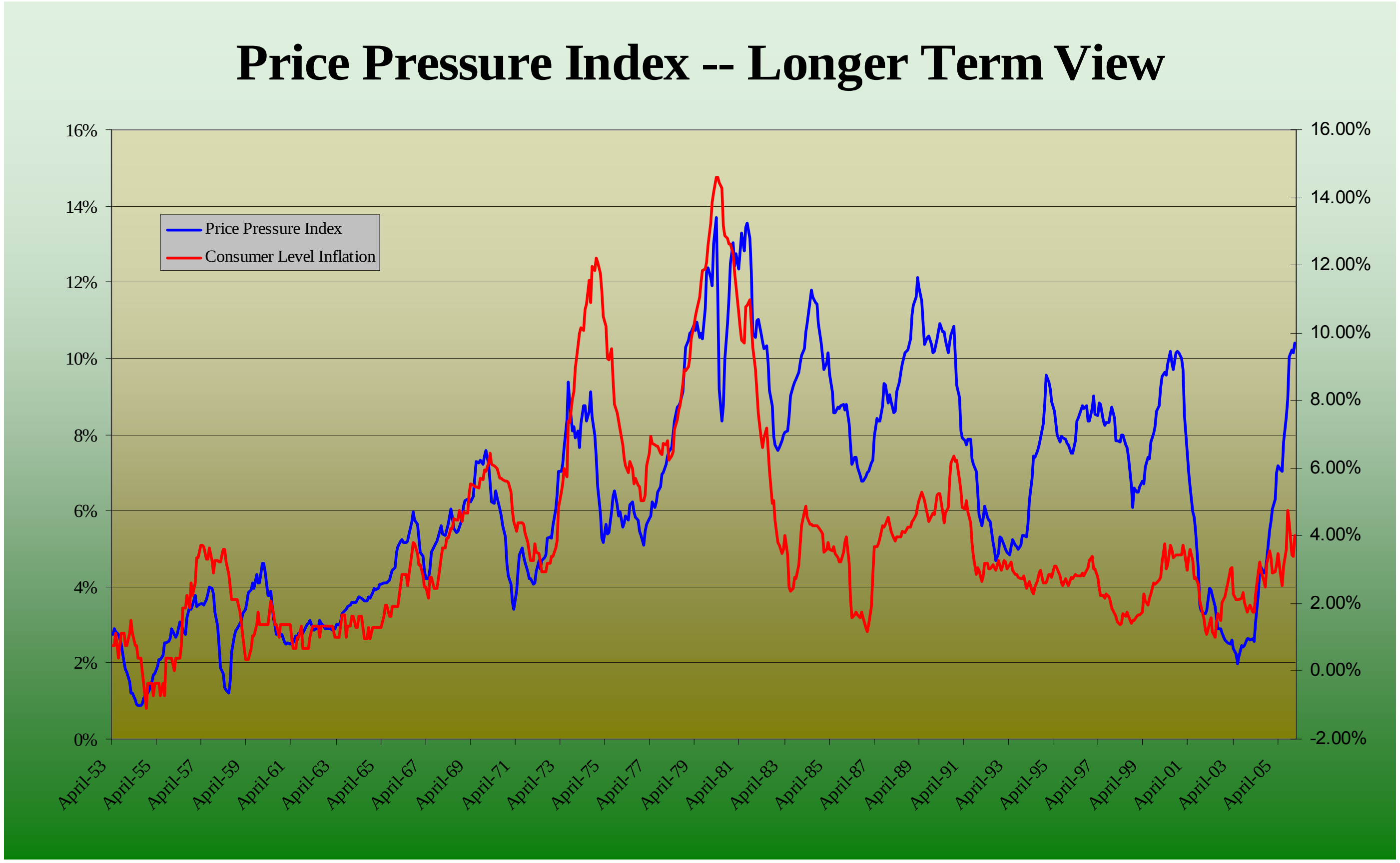
Inflation expectations

Unless the US economy and/or the global economy slows significantly in 2006, trendline inflation will remain higher.

At this point, long-run inflation expectations in the bond market under-discount the risk of higher sustained inflation.

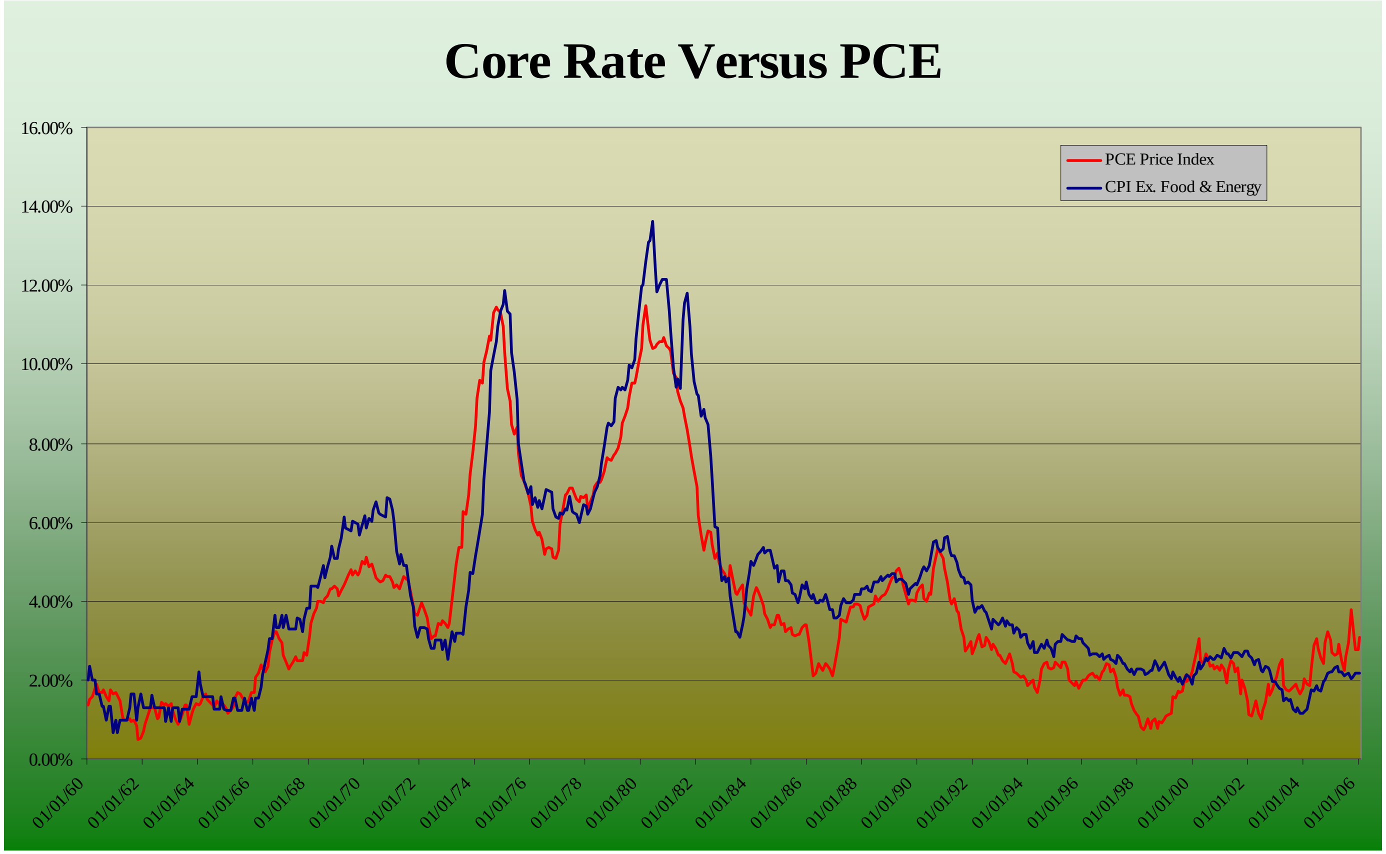
In sum, Mr. Market has it wrong -- inflation is a problem in the current environment.

Inflation Expectations



Look at that damn thing go!

Inflation Expectations



The core rate and the PCE rate are both well above 2.00% and beginning to trend higher.

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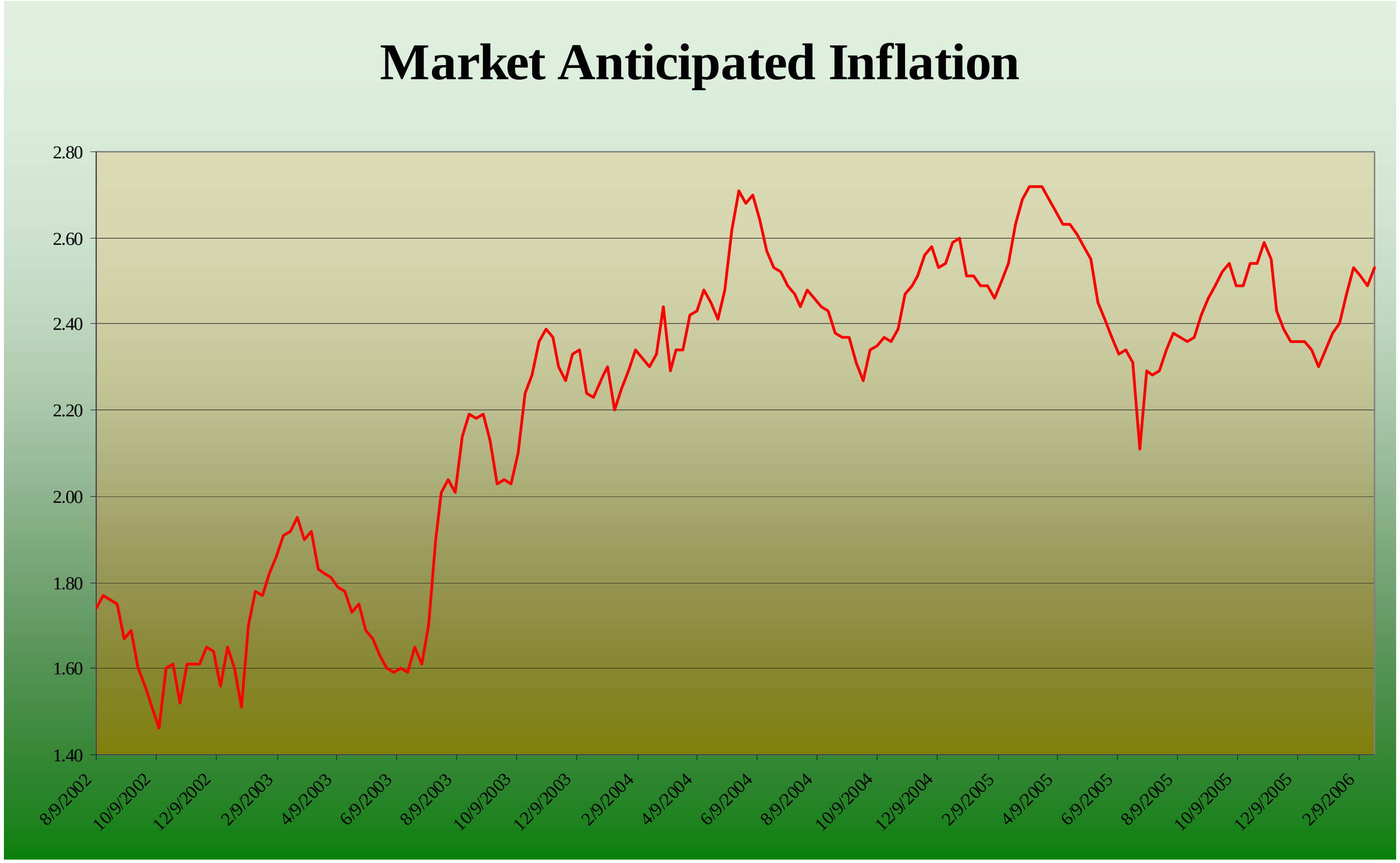
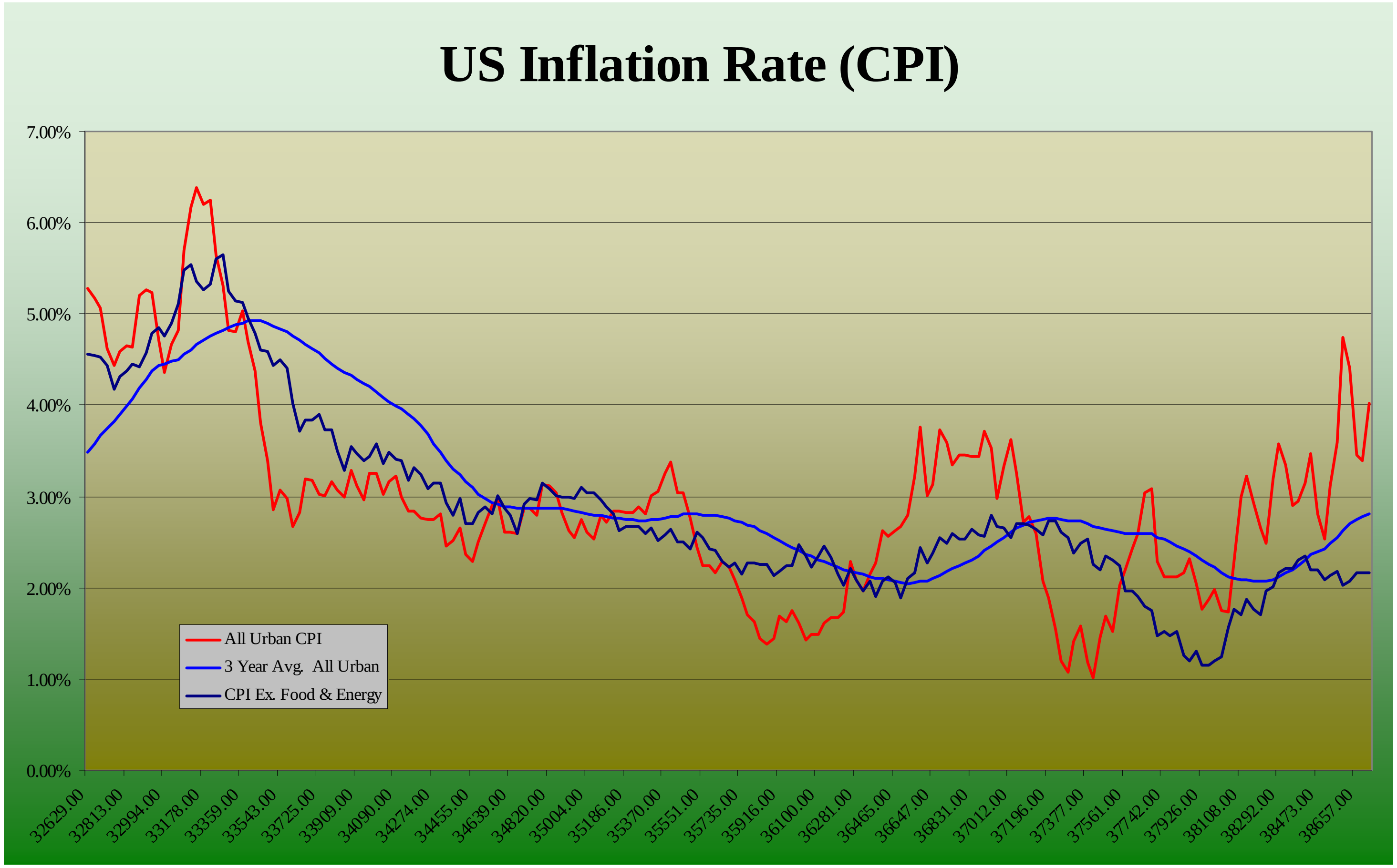
Inflation Expectations



Decomposing the TIPS spread to get an implied inflation rate, the markets anticipate long term inflation of just 2.53%, quite sanguine versus current conditions. Where the &^%! are the bond vigilantes?

Inflation Expectations



Core rate still above the 2.00% internal Fed target. Beware!

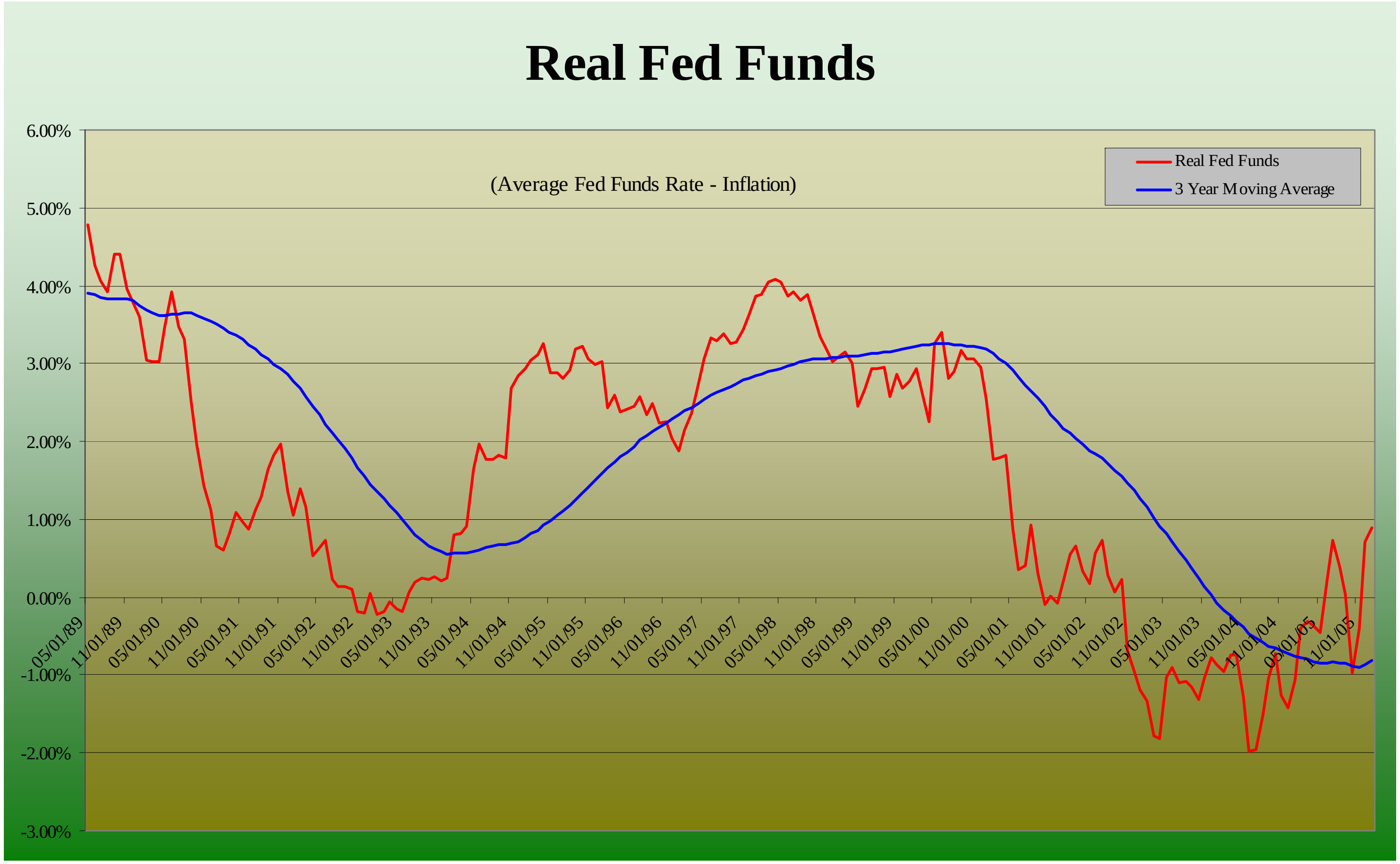
Federal Reserve Watch

Consensus replaces the cult of Greenspan. We hope no crisis hits soon, because getting 7 people to agree on anything is difficult.

Dr. Ben's TV premier was a love fest, save for the inane questions and political grandstanding. He is easy to love right now, he hasn't done anything wrong!

It's up to Dr. Ben to get this expansion balanced without steering us into a ditch; let's hope he can do it!

Federal Reserve Watch



We are a long way away from a level that we called "normal" just a few scant years ago. Read: short term rates could go much, much higher.

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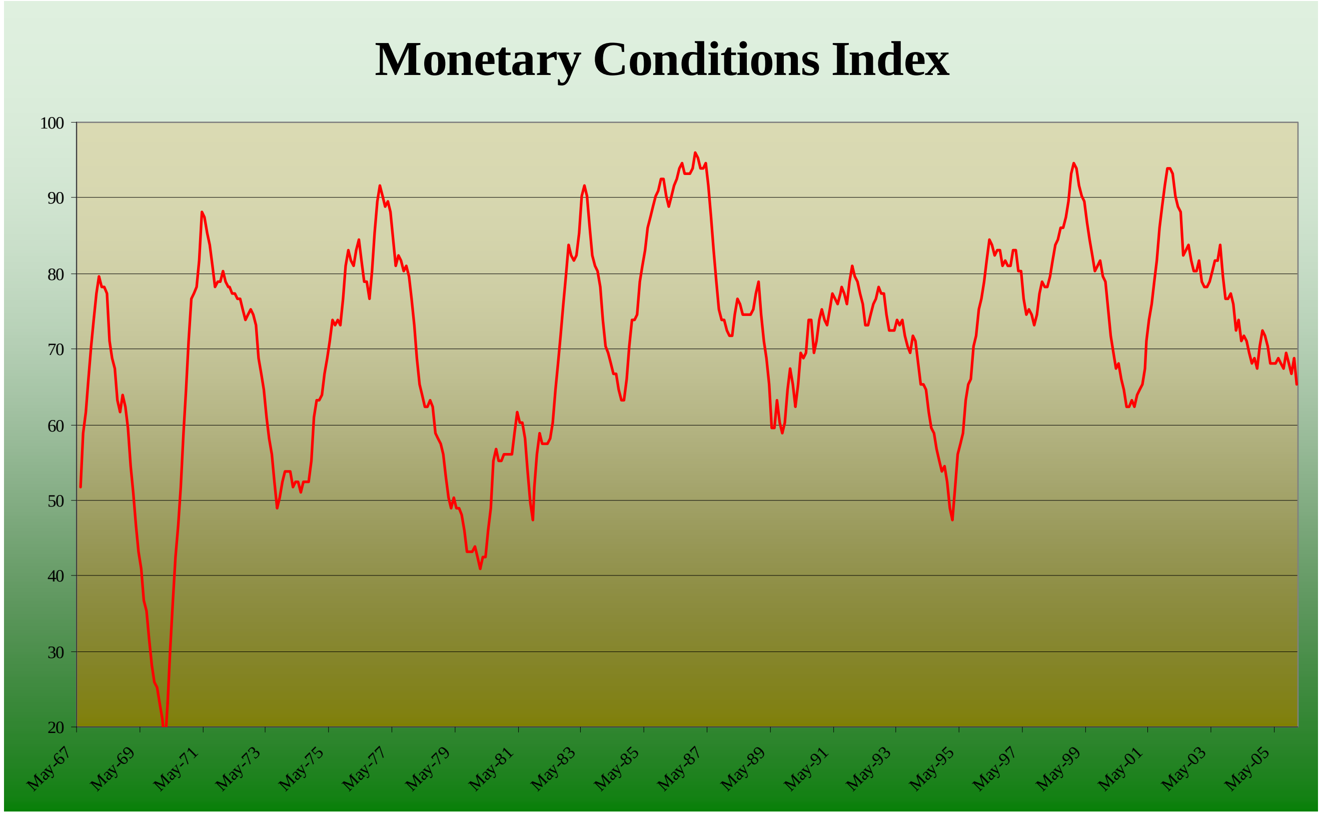
Federal Reserve Watch



Above 60 = accommodative policy, but the trend in the series is negative.

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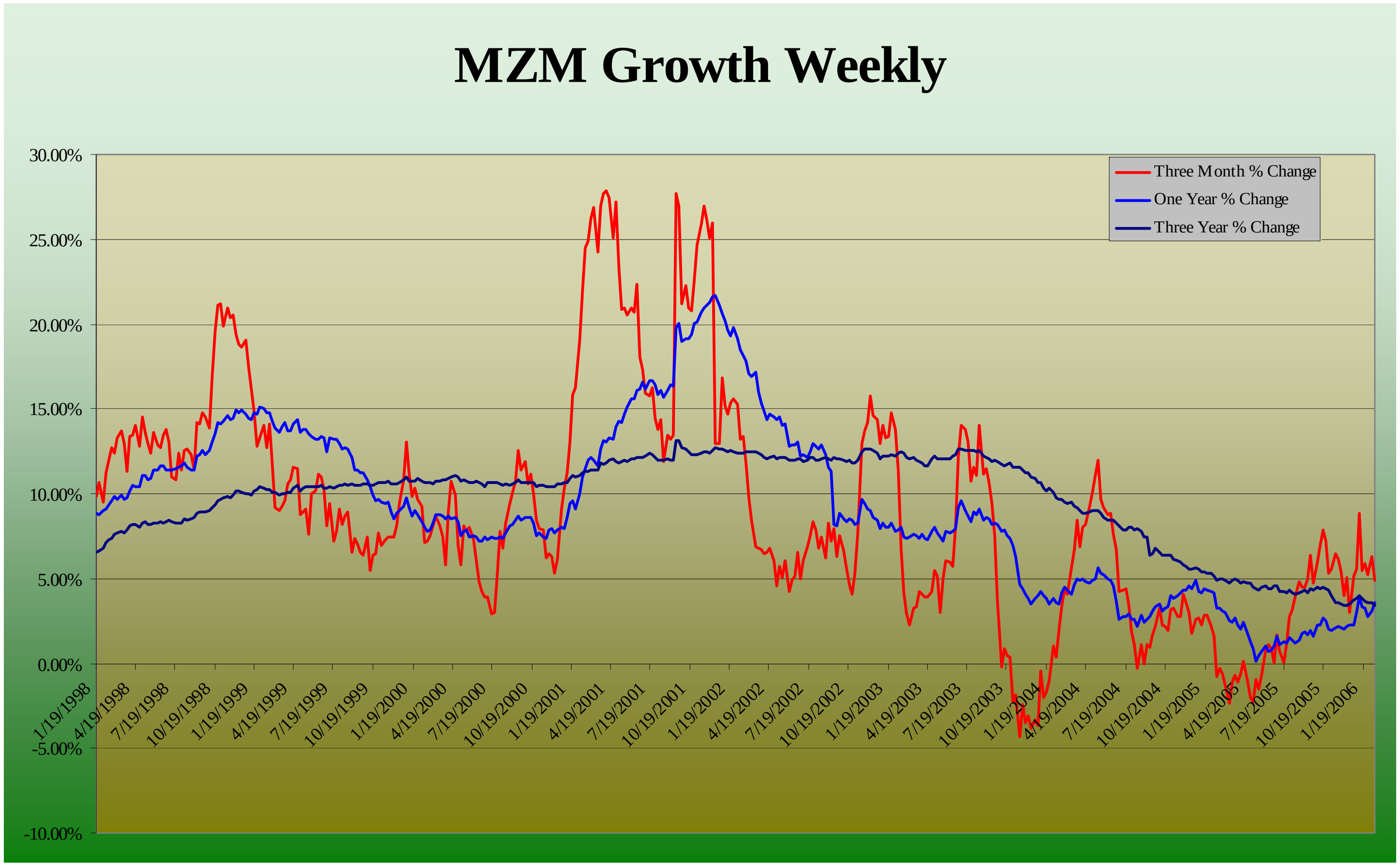
Federal Reserve Watch

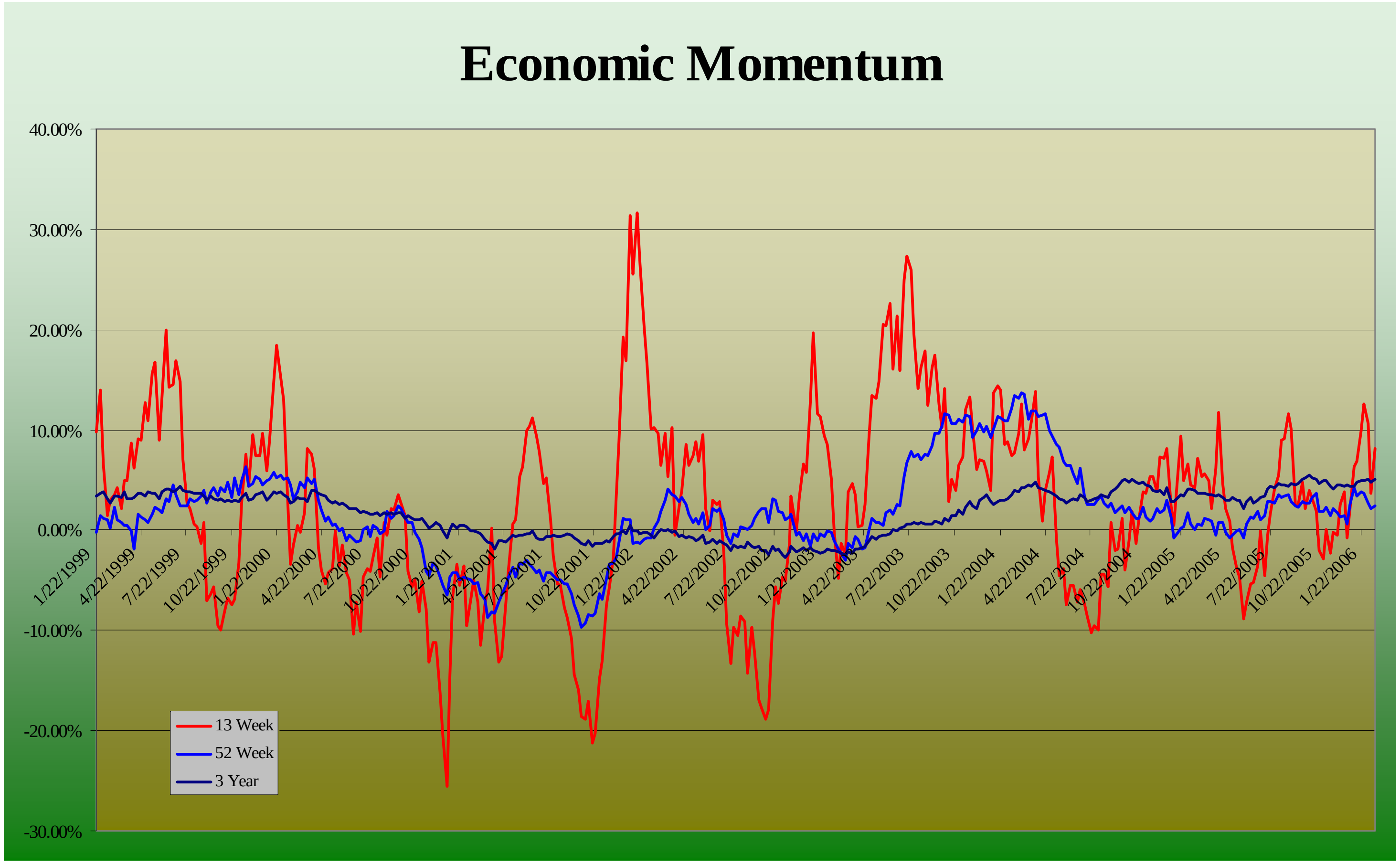


Liquidity has been pegged out for so long that if things every really got tight (like Volker tight), the world as we know it would end.

Outlook

Nervous bull thesis continues: keep umbrella and rain coats handy. Getting this expansion balanced without tipping into recession is going to be tricky.

Outlook



Yield curve not withstanding, forecast growth continues…

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