

Monthly Chartbook

March 2007

The Pause that Refreshes...

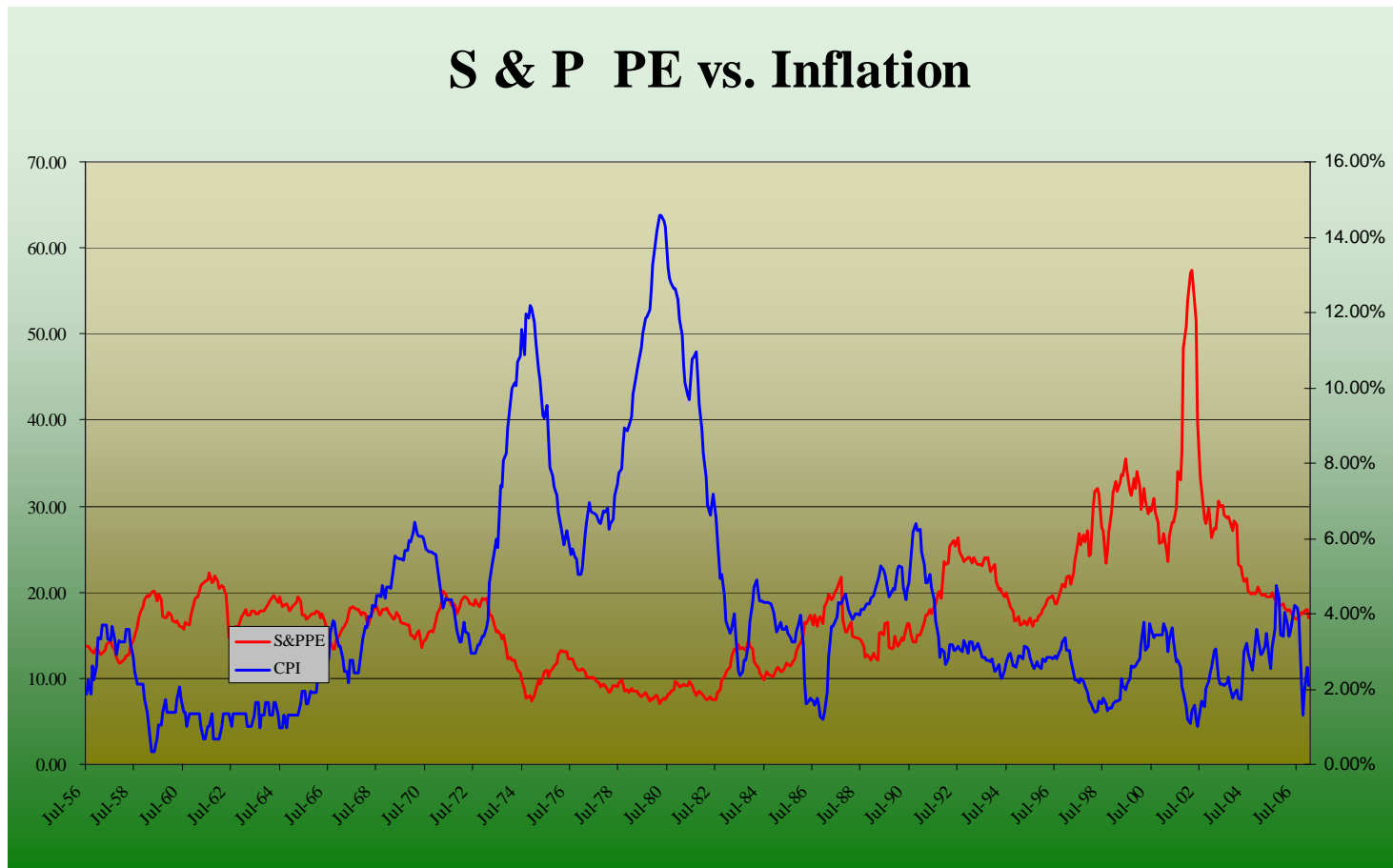
Or something else?

Macro-economic research

For some time, we have been wary of market valuations...

- risk has been under-priced
 - prior to the end of February, there hadn't been a recent significant daily decline in the market, and volatility among daily returns was very low
- the potential for increased labor costs has not been adequately factored into inflation estimates
- the US \$ as the world's reserve currency (which has benefited us immensely) may be coming to an end

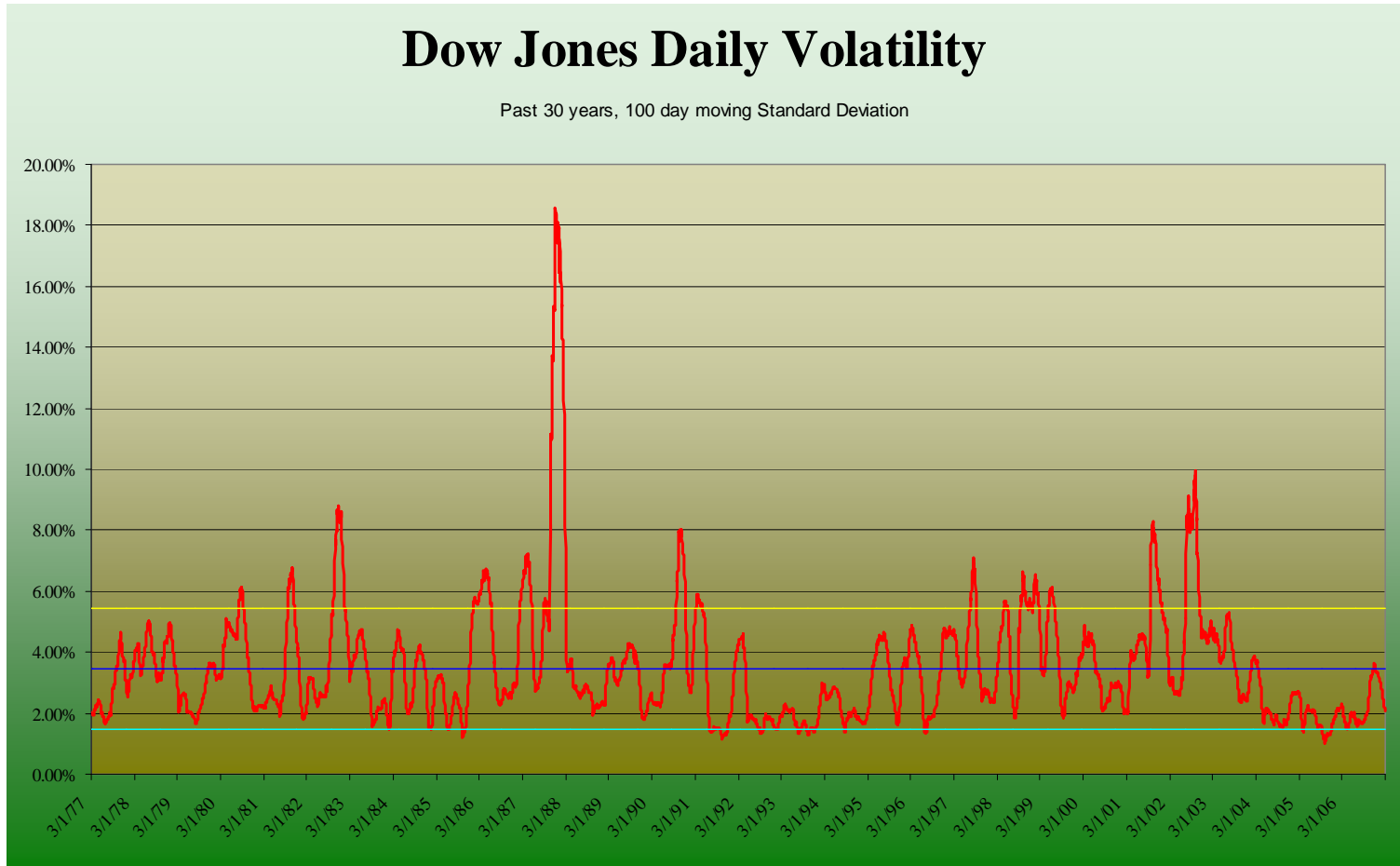
Macro-economic research



The S & P trades at higher valuations when inflation is low, but is our present measure a fair assessment? Also, corporate earnings remain strong, but for how much longer will that continue?

If inflation is truly higher than the market anticipates and corporate earnings decline from their peak, the market may not be just taking that “pause.”

Macro-economic research



For the past three years, market volatility (here measured by the Dow) has been well below its median for the last 30 years.

Inflation expectations

Do our current metrics truly gauge inflation?

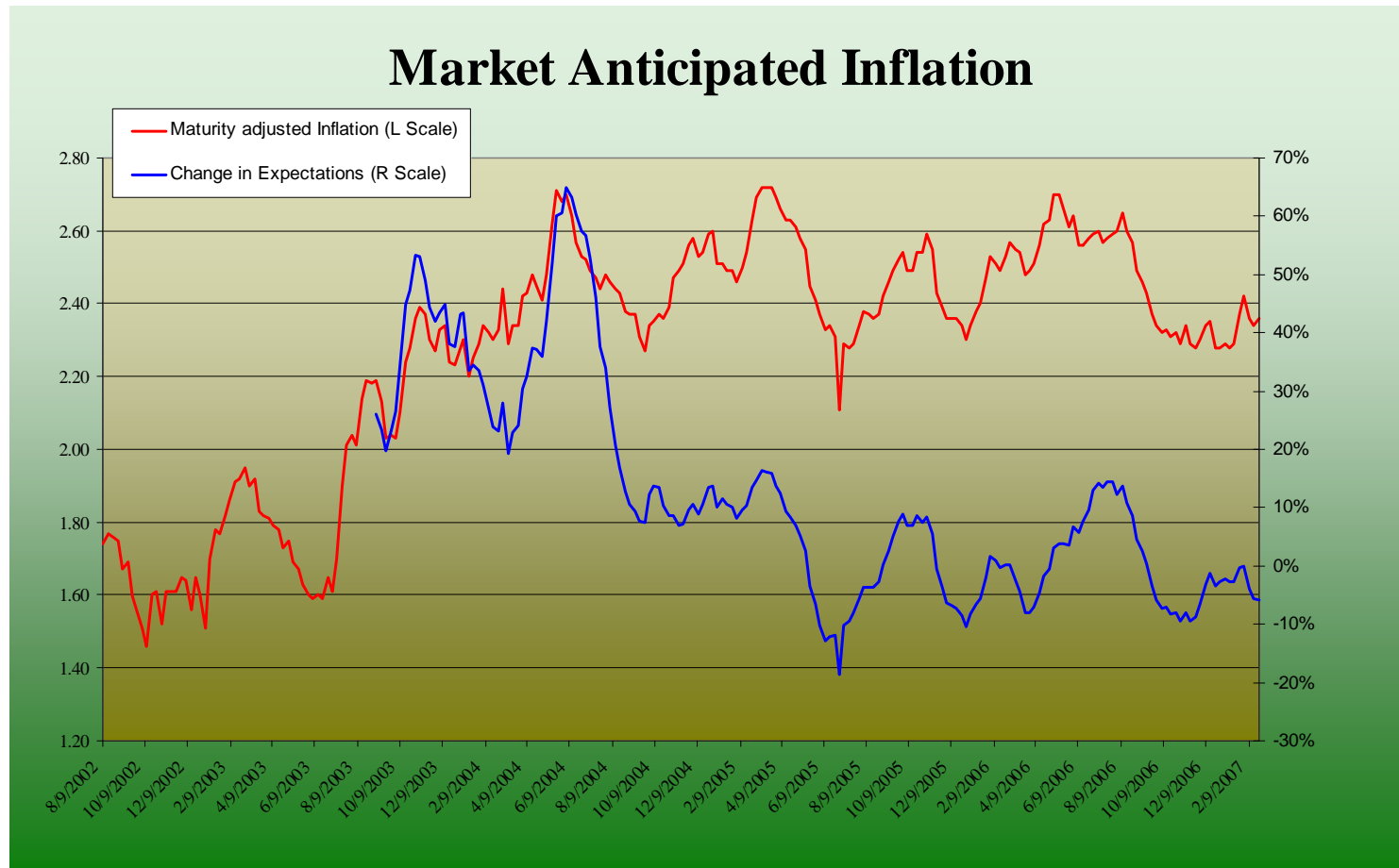
Maybe, maybe not...

- ours is a service economy, and not a manufacturing one
 - therefore, cost of goods sold is not as dependent upon materials and energy
- in our economy, labor is more expensive than capital
 - consider a “capacity utilization” measure for labor to partly measure inflation

Who benefits if CPI is not the most accurate measure of US inflation because it focuses disproportionately on the cost of goods rather than of services?

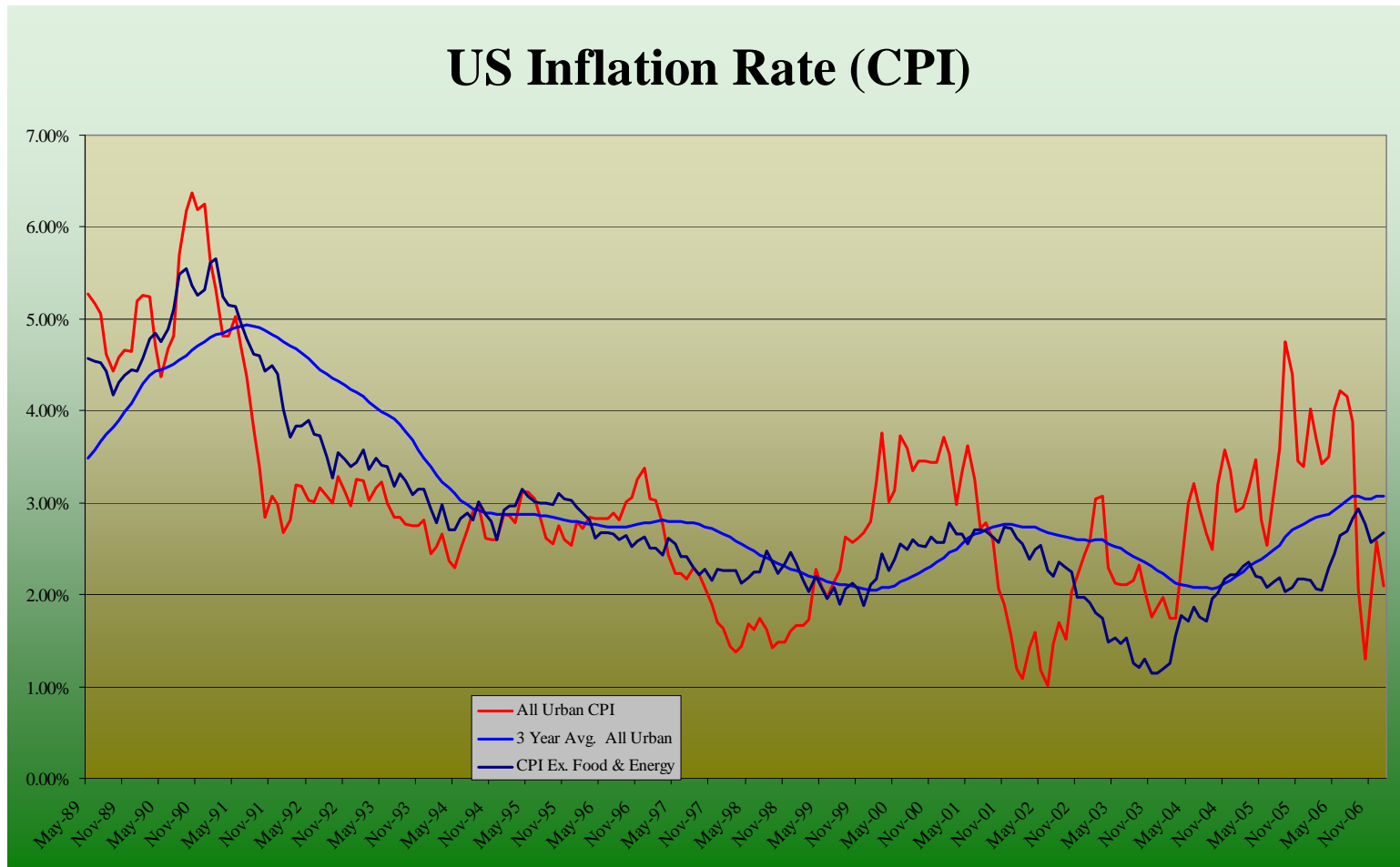
Who is hurt by this? (hint, it's those whose benefits are indexed to inflation.)

Inflation expectations



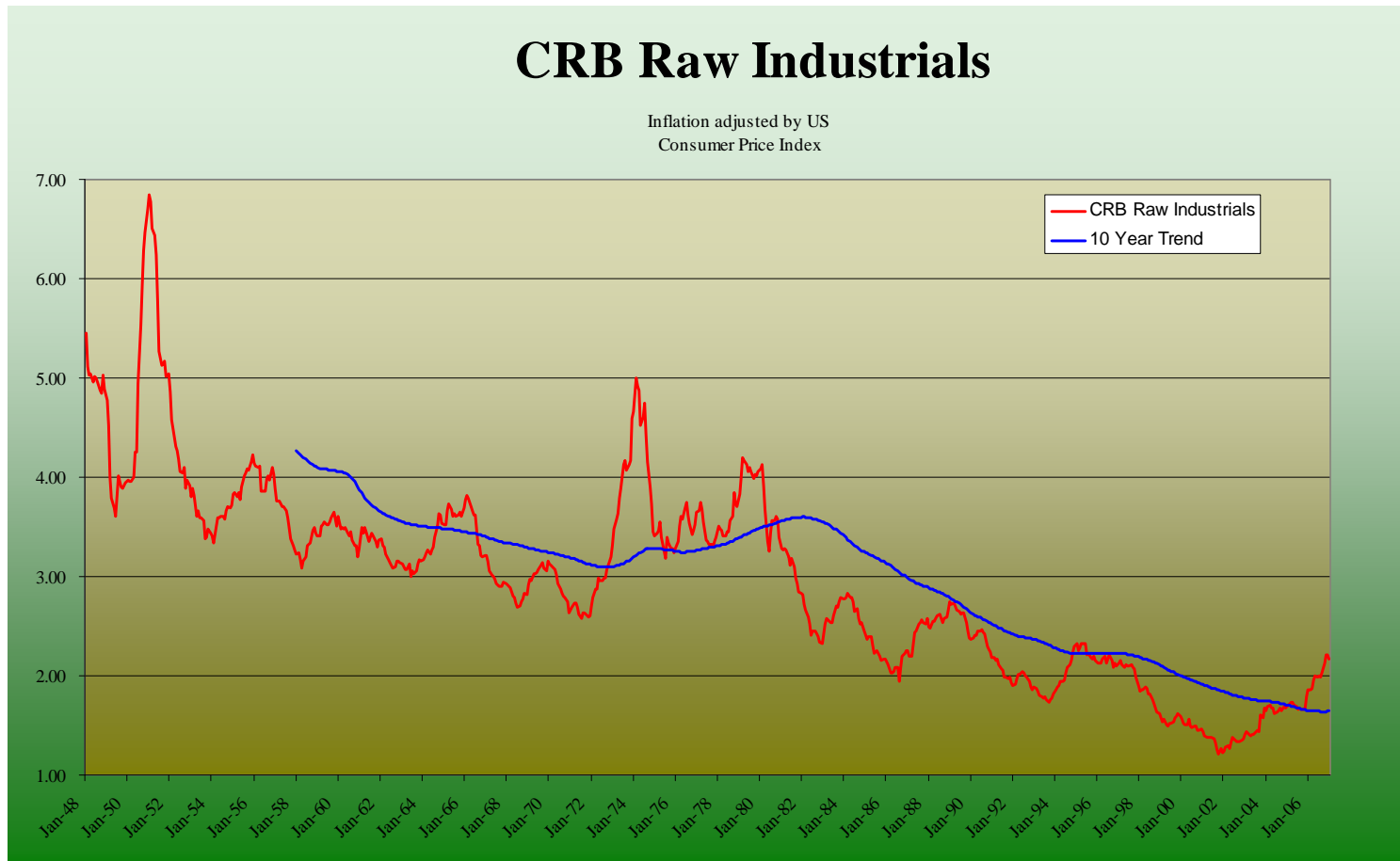
The modest inflation expectations of the bond market (using the 10 year TIPS) have assisted in keeping the equity markets stable.

Inflation expectations



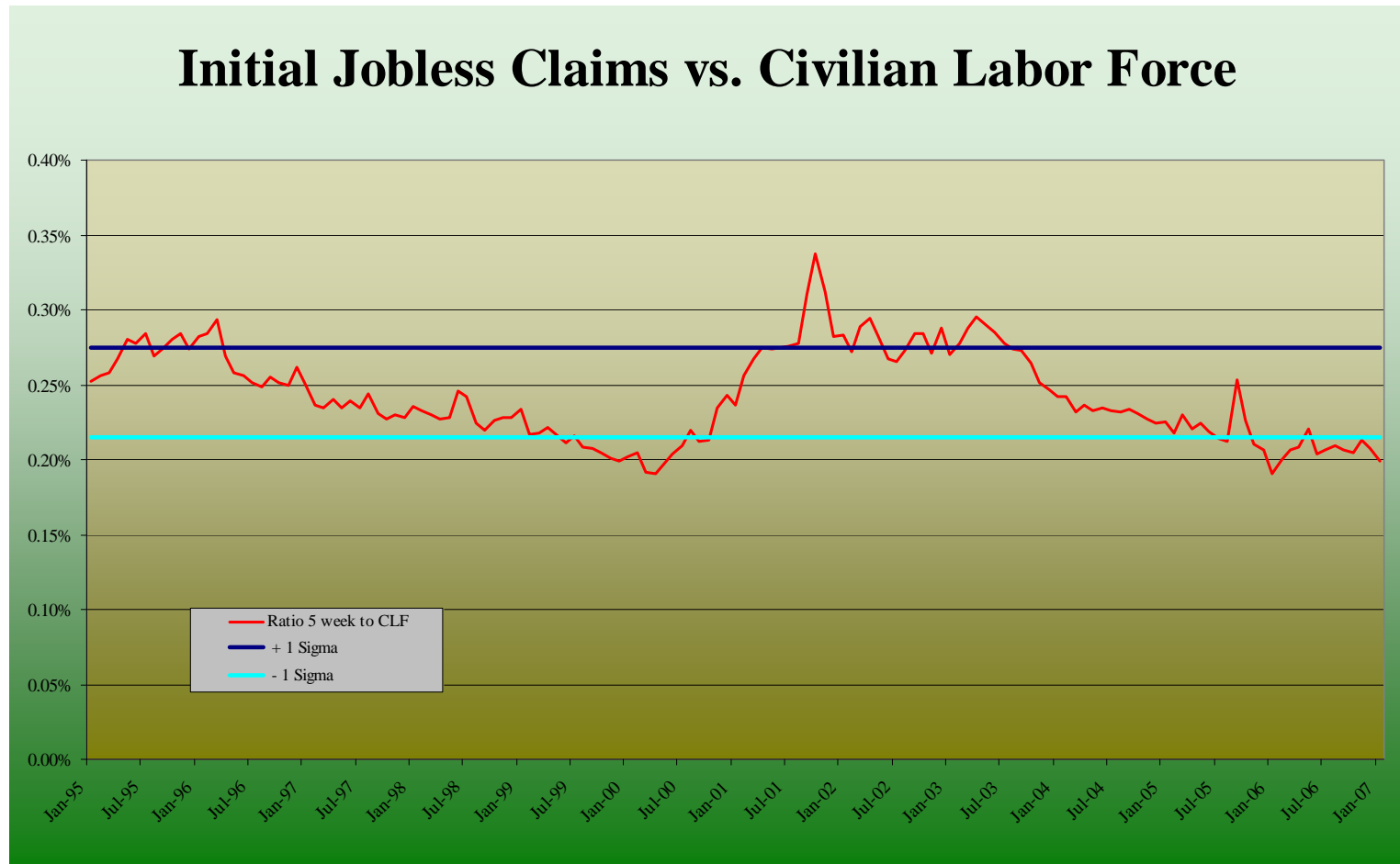
Inflation measures have risen somewhat since 2003, but they remain low relative to past measures. Overall, recent year-over-year growth in commodity prices (especially oil) has kept this growth from becoming out of control.

Inflation expectations



However, commodity prices (as adjusted for inflation) have broken through their recent ten year trend, emphasizing that we are in the beginnings of a commodity “super cycle” as China (and its workers) joins the industrial world.

Inflation expectations



Jobless claims have risen over the past month, but they still remain very low relative to the overall civilian labor force. This could potentially be a “capacity utilization” ratio for labor.

Federal Reserve Watch

There are really no major changes from our thoughts on monetary policy from last month...

- We view the Fed as “on hold”, but further rate increases are unlikely as the official data indicates benign inflation.

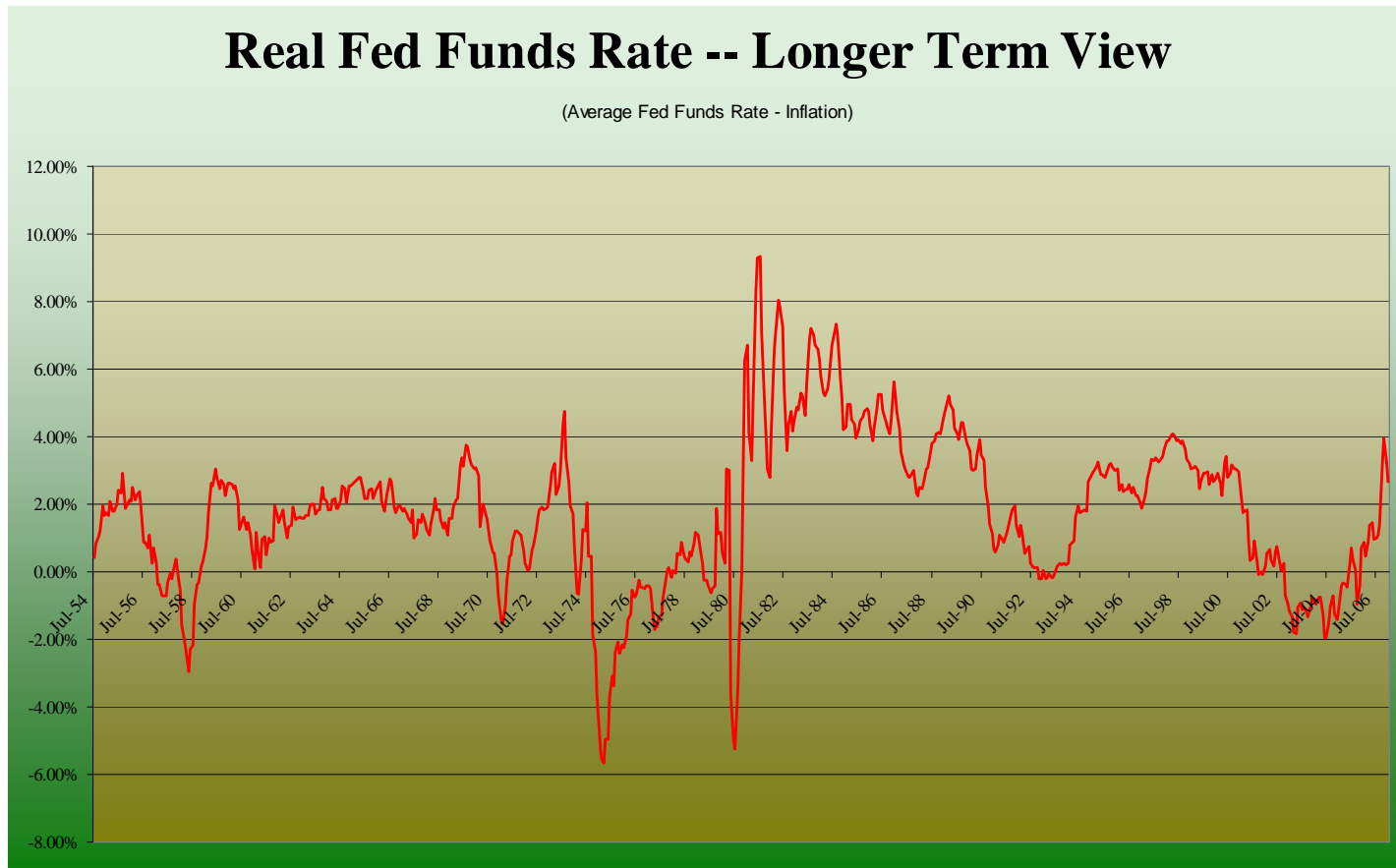
- However, we are not willing to bet on a rate cut until signs of broad weakness are detected in the economy; right now, none of those are evident.

- Foreign demand for intermediate-term US government securities has dampened the potential impact of short-term rate increases (the 10 year US Treasury bond is out of the Fed’s control and its rates have not increased commensurately with short-term rates).

- As such, the weakness in the US\$ has the Fed painted into a corner.

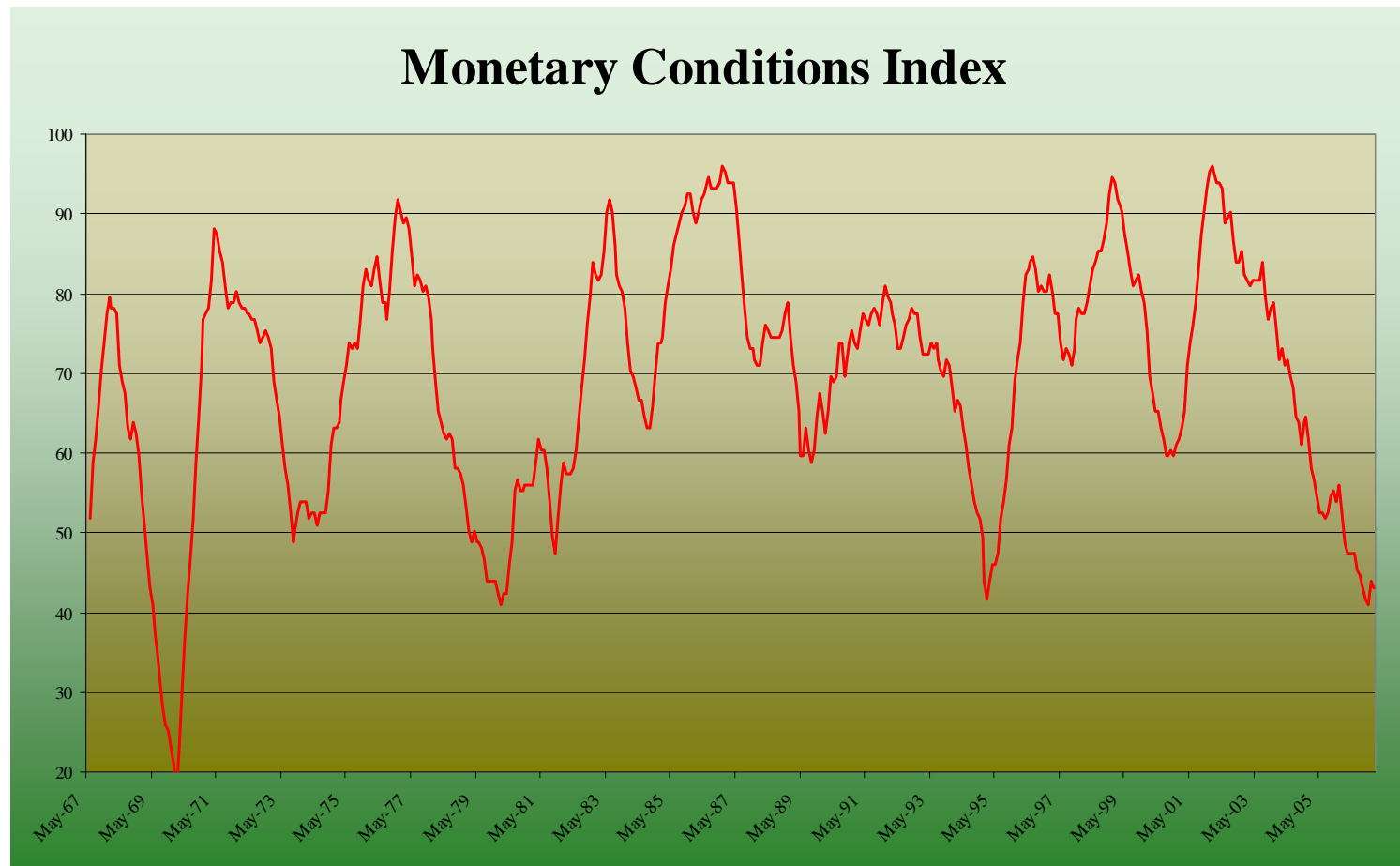
- Finally, the Fed is attempting to work through the excess liquidity of past years rather than creating its own excess liquidity.

Federal Reserve Watch



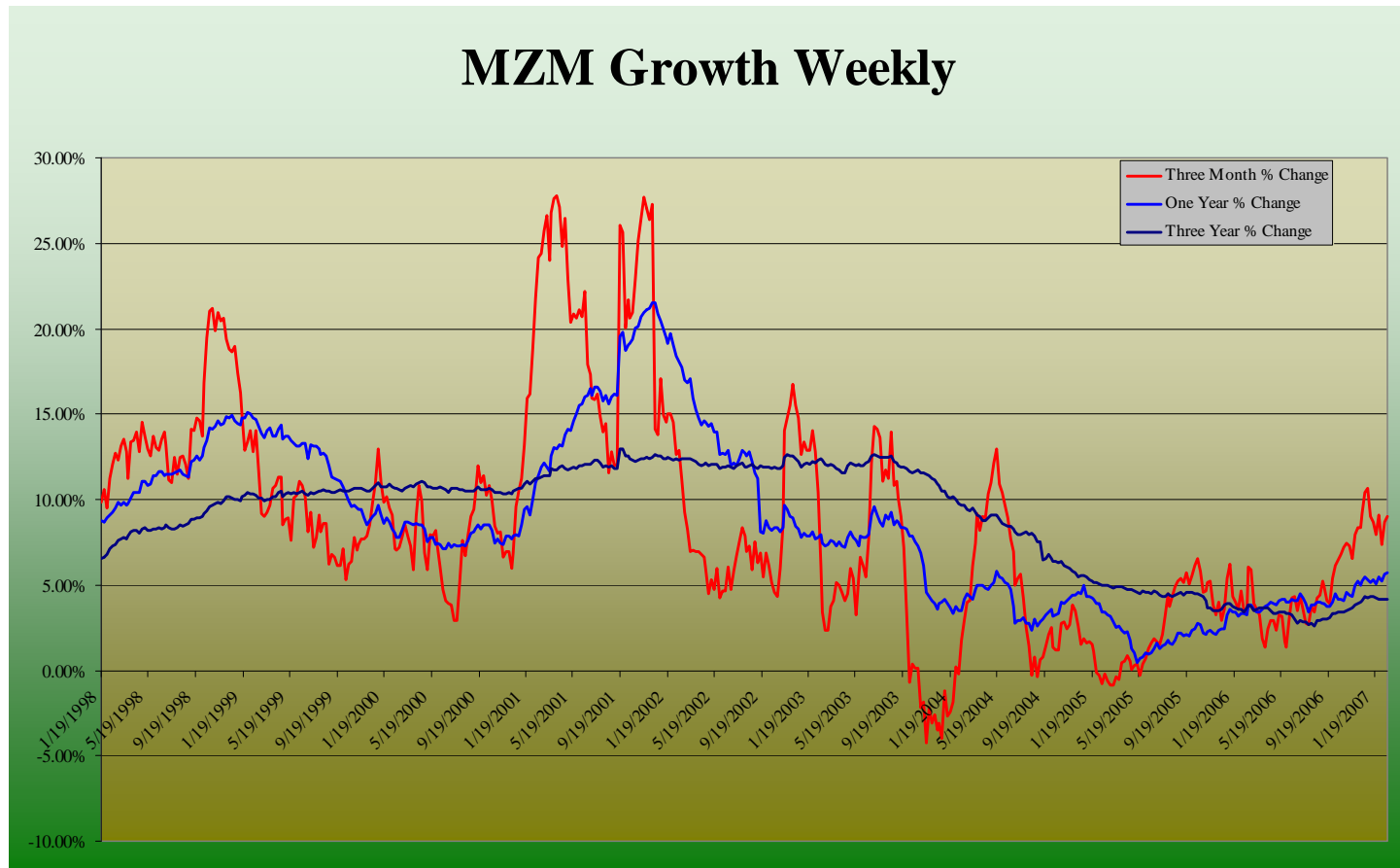
Real Fed funds has been positive for quite some time. The recent spike is a result of favorable year-over-year comparisons for oil (that made the inflation figures appear more favorable) rather than excess yield.

Federal Reserve Watch



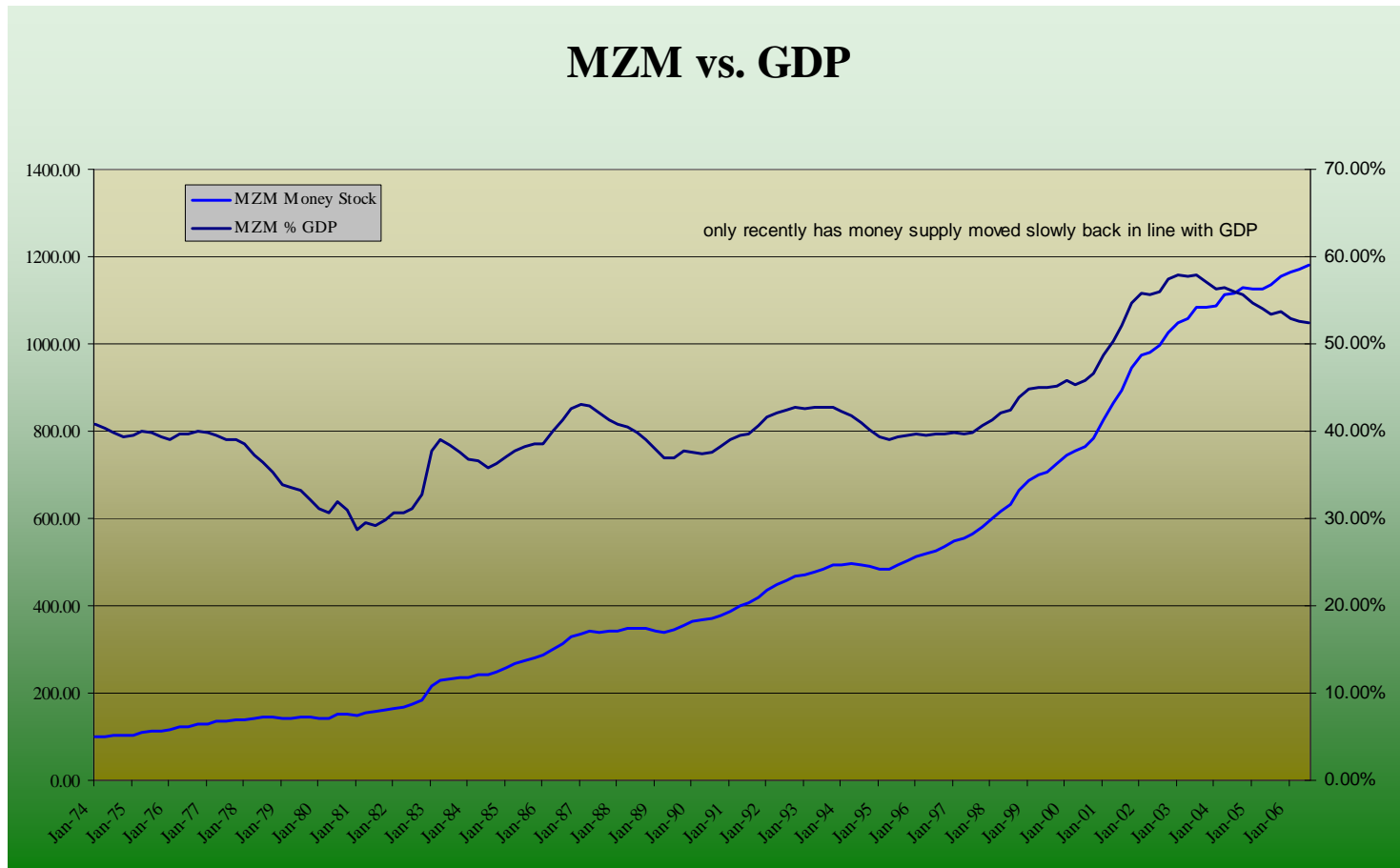
Monetary conditions appeared to have bottomed out recently, but again pointed downwards this month. This measure is a summary of a number of monetary policy decisions and will likely affect overall economic growth in coming years. Again, notice the Fed reducing money supply (and certainly not printing currency).

Federal Reserve Watch



Since the middle of last year, monetary growth has started to improve. But, that is likely due to more easy comparables rather than outright growth.

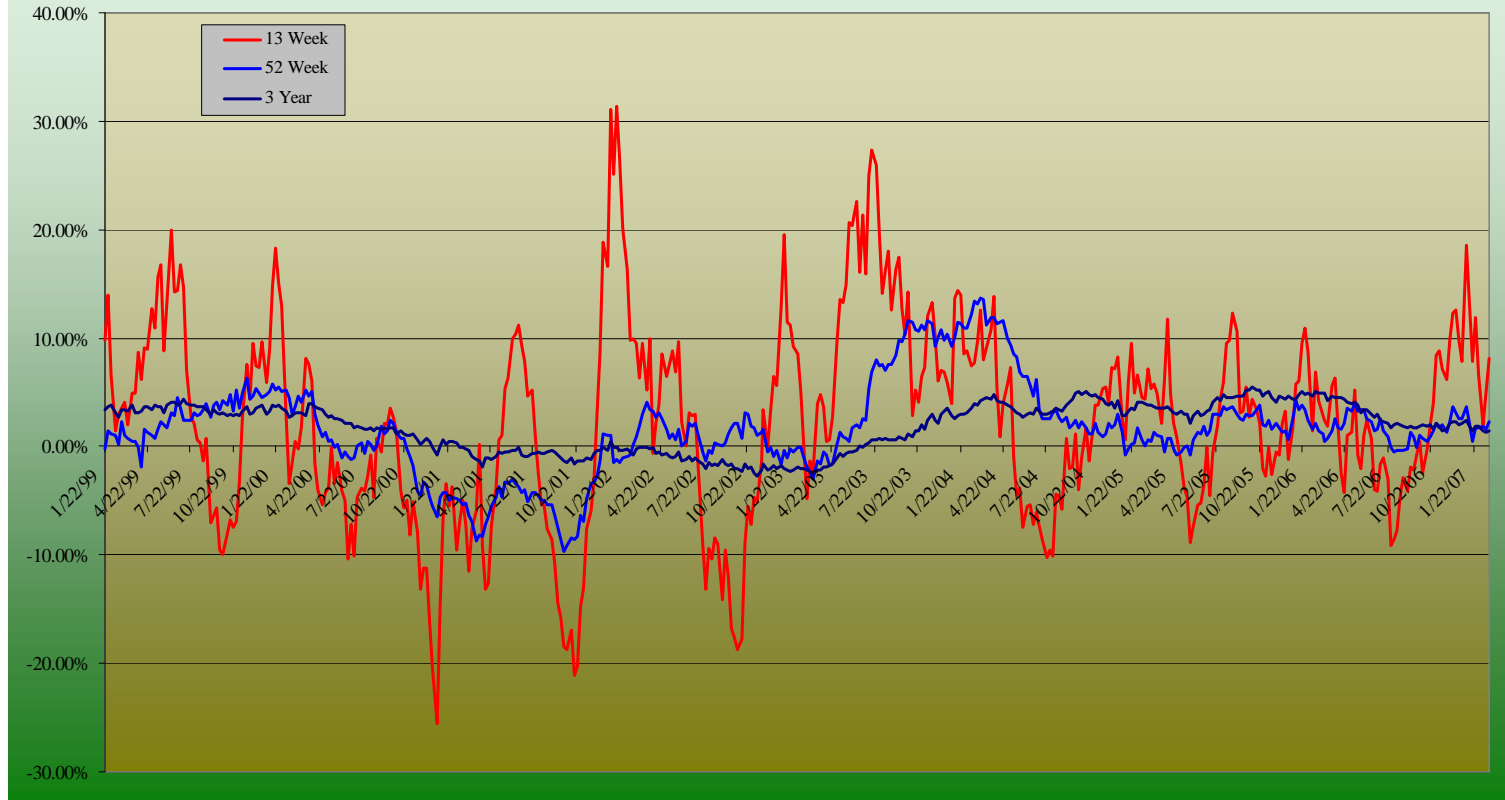
Federal Reserve Watch



Again, we see that money supply is coming more in line with GDP growth. Even though slower money supply growth typically means slower economic growth, this is a good thing as excess from the post 9/11 period is being gradually removed from the system.

Outlook

Economic Momentum



Our outlook is for tightening money supply, slightly higher inflation than anticipated and corporate earnings declining from their current peak. The overall effect should be slower economic growth that results in lower than average yearly increases in the stock markets.

Expect 5 – 7% returns in the S & P 500 for the next three to five years.