Investment Watch

2nd Quarter, 2005

TSUNAMI

Last Christmas night, the 4th largest earthquake since 1900, registering 9.0 on the Richter scale, created a **tsunami** which raced outward at *450 miles/hour* from the epicenter in the Indian Ocean. The earthquake caused no significant damage; however, within only ten minutes, the resulting **tsunami** struck 11 nations leaving a trail of destruction, killing more than 280,000 people - the highest death toll of any **tsunami**.

Seismologists study the build up of pressure between the continental tectonic plates, the red areas on the map. These rigid tectonic plates float above the earth's soft mantle in opposite directions constantly grinding against each other. This tectonic friction can create *unsustainable imbalances*.

Five years ago the bubble in the stock market proved *unsustainable*. Just like an earthquake releases the pressure built up by the movement of tectonic plates deep within the earth, so too did the pricking of the tech bubble release the pressure of over-inflated stock prices. The market collapse was the 3rd most violent in our history!

To temper the economic fallout, the Federal Reserve slashed short-term interest rates to 45-year lows. Now five years after the peak, many pundits blame Greenspan's greased monetary policies for allowing our economic "plates" to slip too freely creating numerous other *imbalances* - **housing bubble**, **near zero personal savings** and a runaway **current account deficit**. Will the aftershocks of the market crash be equally devastating or will snail-like, quiet micro-quakes return us to balance?

As Willy Wonka might say, *"So much time. So few imbalances! Check that. Reverse it."* First, let's discuss the **housing bubble** -

Low interest rates have added to the "froth" in housing prices, but the Fed can only set short-term rates. Global economic integration is pushing down long-term rates thus tricking Greenspan. These low interest rates not only bamboozled the Fed Chairman but allowed us to buy even bigger houses especially using the *no-money-down*, ARM loans.

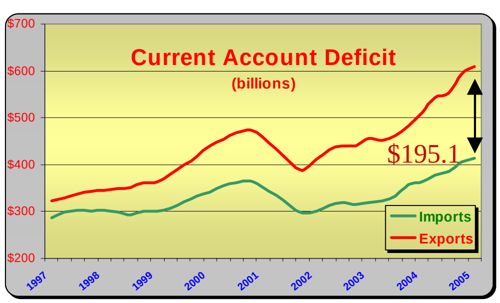
Is Greenspan's coffin sealed? Is he now a befuddled old man who blew it on interest rates and created a housing bubble which will crumble with the next economic quake? Maybe not! Let's look at some startling facts. **Worldwide residential property values have doubled** in the last five years. This boom equals 100% of the developed countries combined GDP (for comparison our stock market bubble was 80% of our GDP).

Britain, South Africa, Ireland and Spain have led the way with property tripling in price in the past 8 years. This is truly a global bubble. Here in the US, the boom has only been 73% with most of this increase isolated to the Northeast and California. It is a bubble in those areas as demonstrated by ownership costs 1-½ times higher than rent. An *unsustainable imbalance*! Will it unwind in an orderly manner or will our increased wealth be swept away by a tidal wave? Many economists believe that this "froth" in local markets is more likely to pop randomly like many micro-quakes.

Can't fault Greenspan for the global *imbalance* in housing prices. But what about **personal savings**? Okay, this is an easy one. Let's blame someone else for our spending habits! Historically, our savings rate has been about 8-10%. Throughout the '90s it steadily declined to 2%. After the easy money policy started in 2001, savings actually blipped up a little; but then steadily declined to less than 1%, the lowest in history.

And we continue to borrow. Our personal debt is skyrocketing even as home values swell. More personal debt, but more personal wealth. No tectonic friction here! But, unlike the earth's elastic crust cushioning seismic jolts, we've spent our new found wealth and have no reserves to protect against higher interest rates.

This spending expands our trade *imbalance* to what many economists view as *unsustainable*. The Bureau of Economic Analysis (BEA), who reports on such things, said the first quarter's **Current Account Deficit**, the broadest gauge of our foreign financial *imbalance*, hit another record at $195.1 billion, or 6.4% of GDP. If a developing country had such an *imbalance*, no one would loan them money and sometimes their currency collapsed. We continue to borrow



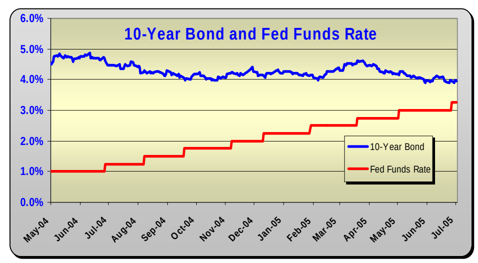
from our Asian neighbors in order to fund our excess. Today, we're not only reliant on the Middle East for $60 oil, but Asia for money.

Economists all agree this global *imbalance* is *unsustainable*. The debate is, "*how will it end*?"

Volker, the ex-Fed Chairman, thinks a major economic quake is inevitable. Greenspan, on the other hand thinks that *imbalances* always exist and seldom result in crisis - "…an invisible hand is readdressing market *imbalances* to reach equilibrium."

This "invisible hand" is globalization and is clearly at work in holding down long-term interest rates to the surprise of all. The economic tectonic plates of the earth are moving closer together. The integration of the world economies' disinflationary effects of low cost goods and labor is capping our interest rates. Greenspan has little control. He has no choice but to continue to try to push up the long-term rates, so that his benign micro-quake scenario materializes.

We are clearly in uncharted waters. The old axioms, like "every $10 increase in oil will reduce our GDP growth by ½%.", are invalid. Our GDP increased by 3.8% and corporate profits by 15.4% in the 1st quarter, both with $60 oil. Our economy is on solid footing. Inflation is under control. Foreign countries are loaning us more money than ever before at a low 10-year Treasury note rate of 3.9%.



Instead of looking straight ahead, let's try to peer around the corner. One year ago today the Fed started their **"measured pace"** tightening and true to their word at today's FOMC meeting increased the interest rates for the 9th straight time. The corner will occur when they stop. But with this "No Surprises" Fed, they'll tell us in advance.

See how close the 10-Year Treasury Bond is to the Fed rate today. Alan Greenspan's conundrum was exacerbated by the 10-Year Bond **dropping** from 4.5% to 3.9% this quarter! You'll see this reflected in good bond returns on your report recouping the losses of last quarter. Your stocks have been going nowhere all year.

When the Fed signals the end to monetary tightening, will the stock market react? The next two Federal Open Market Committee meetings are scheduled for August 9 and Sept. 20—let's see if we feel the earth move under our feet!

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