NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Oil, Inflation and Interest Rates

Oil

Based on normal cycles, we had expected a reprieve in the upward march of energy prices. While we thought oil prices had a long way to rise over the next ten years, we believed that, near-term, prices would retreat in the face of mounting inventories. Then came booming 10% plus growth from China, Iran nuclear tension and rebels in Nigeria; as a result, oil hit new highs, over $75 a barrel. We do not see tension with Iran ameliorating any time soon and with worldwide growth expected to be higher this year, demand for oil will remain robust. So, oil could well average $70 per barrel this year and gasoline prices will remain high.

Inflation

Inflation is not going away, Fed best efforts aside. The Fed has been counting on core inflation (prices excluding food and energy) staying below a 2% annual rate. Unfortunately, in March, the core inflation rate rose 0.3%, a 3.6% annual rate. This is the largest increase since October 2005, pushing 2006 growth to 2%.[1] Upward pressures on inflation persist, including a three year surge in energy costs, record metals prices and rising wages. Housing is not included in the above pressures because the price of buying and maintaining a home *is not included* in the core CPI calculation! Instead rental prices (about

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20% of the index) are measured. Up to a year ago, rental prices had been *declining* for about three years as people purchased homes instead of renting, so this component lowered the inflation rate artificially, in our opinion. Now that interest rates have risen and some house buyers have been pushed out of the housing market, they are renting instead and rental rates are finally going up. In Santa Clara County, rents plunged 35% from a March 2001 peak to December 2004. Since then, rents have been increasing. From a year ago March 31, San Jose rents have increased 5.8%, San Francisco 5.0% and Los Angeles/Orange Counties 6.7%.[2]

Interest Rates

For the first time in four years, the yield on the 10-year Treasury crossed 5%. And it is going higher. The equity markets have focused near-term on Fed chairman Bernanke's comments that the Fed might be ready to pause in the rate-tightening cycle that began in June 2004. What the markets chose to ignore was his statement “of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings”. He also said: “future policy actions will be increasingly dependent on the evolution of the economic outlook, as reflected in incoming data”.[3] In other words - it depends on what happens and our read is that the data will in fact support further increases over time. After his remarks, other Fed spokesmen ventured forth to assure the bond and currency markets that taming inflation is the focus of the Fed. Fed Governor Donald Kohn said “at this juncture, given the strength in demand and the narrowing margin of unused resources, I am focused on making sure that inflation expectations remain well anchored”.[4] *What happened?* Both the dollar and the 30-year Treasury bond fell more than 4% after Bernanke's remarks and some market reassurance was necessary. The problem is interest rates are rising around the globe and our interest rates need to stay competitive to attract funds needed to support our huge borrowing appetite. 30-year Treasury bond rates recently hit 5.3%, up from 4.6% only four months ago. This has been partially a response to increasing inflation concerns but the real culprit is rising overseas interest rates that are siphoning money away from the U.S. For example, Japan, who is our biggest lender, has seen their 10-year note go from 0.5% three years ago to 2% today.[5] China, Australia, and Canada recently raised rates and the European Central Bank (ECB) has hiked rates twice in recent months to 2.5%. Jean-Claude Trichet, the president of the ECB, called for “strong vigilance in the face of a heightened risk of accelerating inflation”.[6] In central banking parlance, his statement suggests the bank would lift rates as soon as its June meeting, and that several more rate increases might be in the offing. The good news is that the world is enjoying unprecedented growth - the bad news is that easy money and low interest rates may be an anomaly of the last four years.

Current Economy

United States Economy

The American economy grew at its fastest pace in more than two years in the first quarter of 2006. Gross Domestic Product (GDP) increased at an annual rate of 4.8% in the first quarter, more than twice the 1.75% rate in the fourth quarter. However, this performance was boosted by increased government spending on reconstruction in the Gulf Coast. Federal government spending rocketed up at a 10.8% rate, in sharp contrast to the 2.6% rate of *decline* in the fourth quarter. Once this government shot in the arm recedes and rising interest rates begin to bite, most economists expect the economy to cool to a 3% rate by the end of the year.[7]

Interest rates are finally having a significant impact on housing. The average rate on a 30-year mortgage is now 6.59%, a 4 year high.[8] Sales of existing houses are expected to fall by 6% this year, while new home sales are expected to drop by 10%, according to the National Association of Realtors.[9] One clear sign the market is taking a breather is the number of for-sale signs on front lawns. In the Bay Area, over the last year, the time it takes to sell a house doubled from 1.8 months to 3.6 months, the highest level in over four years. Foreclosure activity across the Bay Area and California ticked up to its highest level in two years as the pace of home price gains slackened.[10] Fewer homeowners in the first three months of the year could count on the higher profit from a home sale or refinance to help bail them out of late mortgage payments. However, the real estate market so far is in an orderly retreat and should stay that way unless interest rates were to go significantly higher from current levels.

World Economy

The world's economy is on a tear; we have not seen this kind of growth for over thirty years. For 2006, Gross World Product (GWP) may finish the year at a 4.7% growth rate versus 4.5% in 2005.[11] With the Japanese economic recovery broadening to the consumer sector, Euro-Zone growth doubling from its recession lows and Asia production continuing to ramp up, the world economic engine is firing on all cylinders. China and India, accounting for one-third of the world's population, are big drivers in this above-trend growth since they are expanding output at twice the global average. This economic expansion is the most broad-based in history, with virtually every region (except the Euro-Zone) forecast to grow by over 3%.[12] We do not think that negative factors such as high energy prices and geopolitical uncertainties from international terrorism are likely to derail this secular global economic expansion.

Investment Outlook - United States Equities

Strong economic growth, solid earnings gains and hints that the Fed may be ready for a pause in raising interest rates, helped the U.S. market to solid first quarter results. The S&P Index advanced 4.3% while the NASDAQ was up 6.1%. Focusing on the right sectors again proved rewarding. Commodity related, natural resource and high technology sectors did quite well, while utilities, health care and consumer staples under performed. For example, diversified metals and mining stocks returned 29.9%, gold stocks 20.5%, energy funds 8.3% and computer/electronics stocks 26.6%. Utilities lost 2.1%, health care 1.9% and consumer staples 0.1%.[13]

The market continues to be resilient as it battles between positive earnings growth and rising interest rates and energy prices. Stocks look cheap with a high earnings yield (earnings/prices) relative to bond yields and historically wide profit margins. However, uncertainty as to the length of the Fed tightening cycle, the lagging effects of still-high energy prices and potentially higher interest rates worldwide leave us cautious. After a great first quarter, the earnings outlook remains mixed due to elevated wage pressures, increasing capacity constraints and mounting margin pressures. Based on our October 2002 piece: Why a Rally Now?, which argued that the stock market bottoms roughly every four years, we expect the next major low in the market this fall. Accordingly we remain underweight U.S. equities, waiting for the opportunity to load the boat later this year.

Asset Allocation

U.S. Stock and Bonds

Our near-term asset allocation favors selective equity themes and short-term bonds. We favor big cap issues. We think it is possible that this could be the year that big cap issues start outperforming small cap issues. One plus for big caps is they tend to do better in a weak dollar environment versus small caps and we expect the dollar to be quite weak over the next couple of years. We like industrials, high technology, including communication stocks and selective health care. We've begun adding to bank stocks for their relatively high yield, reasonable valuation and their tendency to perform well when the yield curve steepens. We continue to recommend treasuries, corporate bonds or bond funds with maturities less than five years for fixed income portfolios.

International

Over weighting international equities has greatly enhanced results for our portfolios. For the first quarter, the European, Australian and Far East Index (EAFE) returned 9.5%, handily beating the S&P 500 return of 4.3%. We continue to like the Far East, Japan and Emerging Markets. We also have added to China, as we believe its stock market has finally started to reflect its underlying fundamentals by reversing the bear market it has been in for the last six years. In the first three months of this year, China's economic growth raced ahead by 10.2%, even faster than the blistering 9.9% pace registered for all of 2005. Recently, it raised its benchmark lending rate to 5.85% from 5.58%. The Chinese central bank said it was acting to strengthen economic controls to "sustain fast-paced, balanced and healthy developments of the economy."[14] We expect China's economic growth to slow to 8.5% this year and then settle around 7.5% annually over the next decade.[15] In our opinion, the Chinese stock market is starting a new secular bull market similar to Japan's and will be one of our most important secular themes.

In addition to equities we are now recommending positions be taken in international bond mutual funds for their currency exposure. In addition to receiving interest income, these funds will appreciate in value as the dollar weakens over the next couple of years. If the U.S. Dollar Index, which is currently at 85.9, were to breach the 70 level, this would equate to a potential currency gain of around 20%, depending on the holdings of the particular fund. In terms of the Euro, this would equate to a rate near $1.50 up from the current value of $1.27.

Natural Resources and Energy

All commodity and commodity related issues are continuing to outperform the general market indices as the worldwide economic boom rolls on. Since we expect global growth to continue for some time, barring short-term setbacks, this area should attract capital over the next five to ten years. Accordingly, we expect to over weight this area for many years to come.

Real Estate

Amid further signs of improving fundamentals in the real estate sector, U.S. REIT's chalked up an impressive quarter with a return of 14.7%. We think it will be difficult for REIT's to outperform the broader market going forward. The current dividend yield of 4.1% is the lowest yield, relative to the 10-year treasury, now 5.2%, since 1997, the last time REITS had a serious decline.[16] One area we continue to favor is Hotels, where earnings are likely to remain strong and valuations are reasonable. Overall, we recommend under weighting this asset class for better opportunities in the future.

Summary

The U.S. stock market is in a tug-of-war between rising interest rates and, so far, strong earnings growth. We think that at some point this year rising rates will dampen U.S. equities and create a better buying opportunity. We are emphasizing big cap issues over small cap issues. For the other asset classes we are over weighting our natural resource and international themes while under weighting cash, short-term bonds and REIT's.

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