

Monthly Chartbook

July 2006

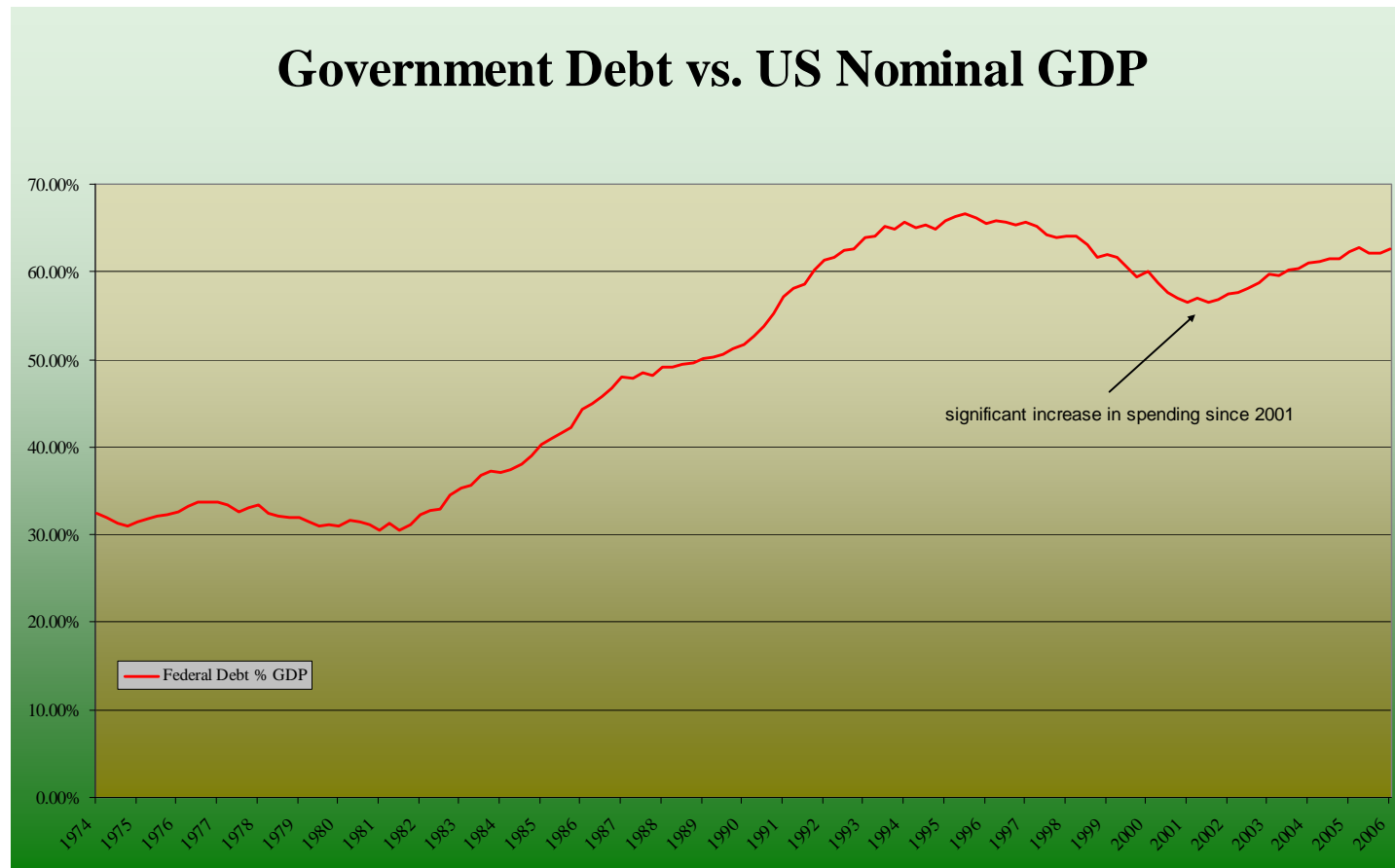
Who's afraid of the US dollar?

We are... and here's why.

Potential weakening of the dollar:

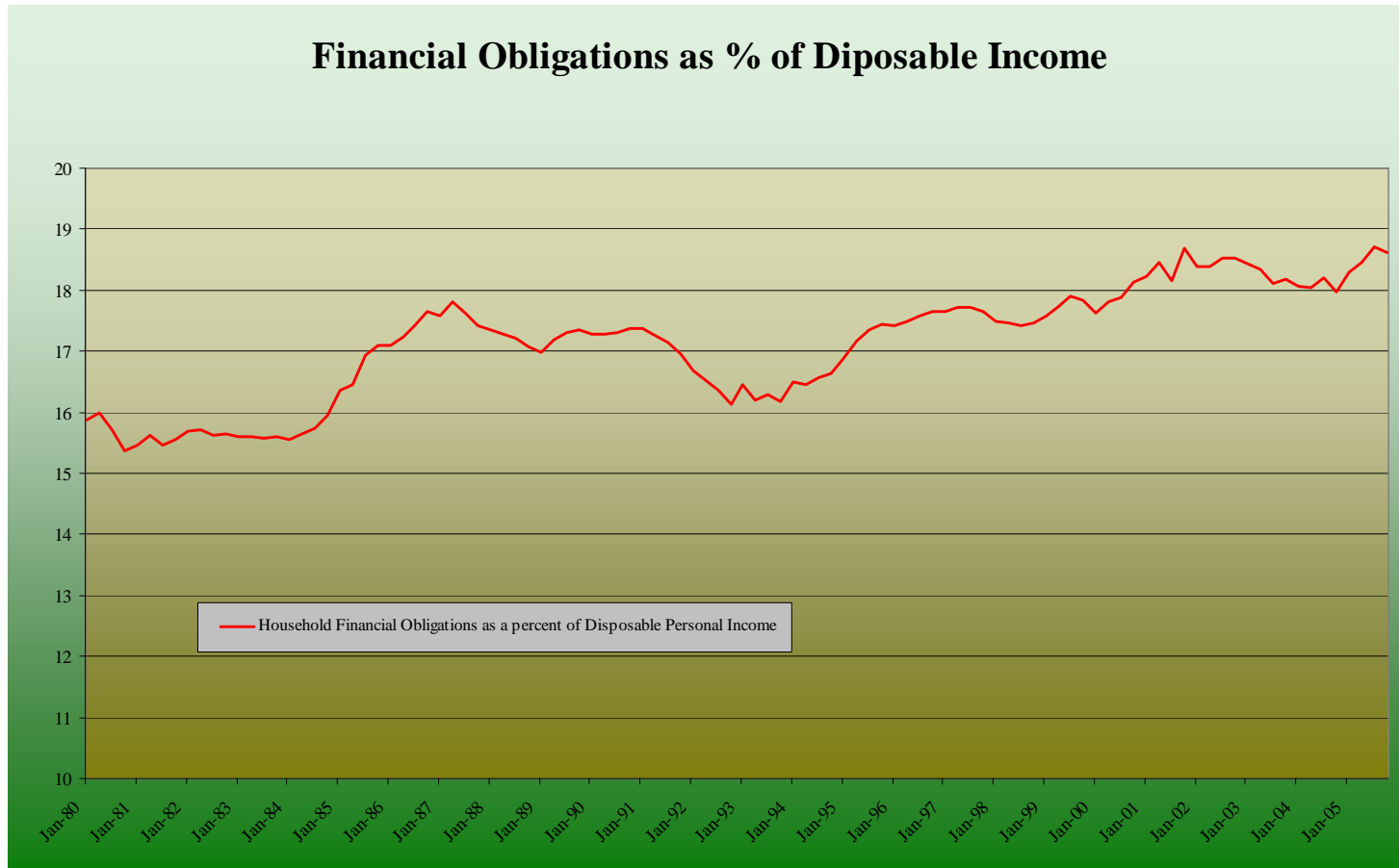
- Irresponsible deficit spending in Washington
- The increasing indebtedness of the US consumer
- Currency diversification away from the dollar
 - » Foreign currency reserves (especially Asian)
 - » Diversification of petroleum profits
 - » Growing parity among global GDP growth rates
- Inflationary pressures within the US economy

Macro-economic research



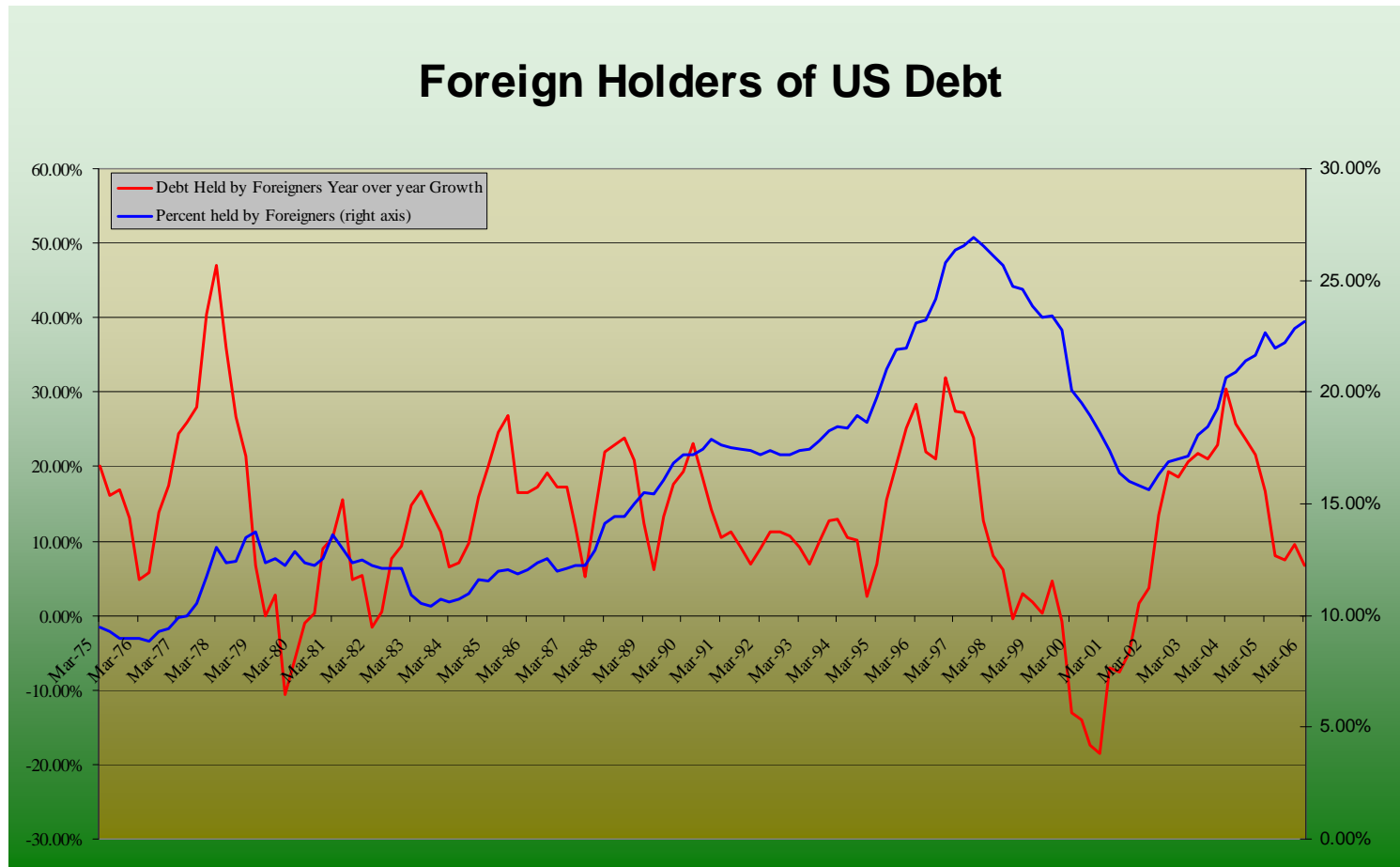
It's not Bernanke printing money that we need to worry about... it's Congress. Transportation bills, energy bills, Katrina relief – you name it, and money can be spent (often irresponsibly).

Macro-economic research



Americans are funding their lifestyles by borrowing, especially against the “value” that has been created in housing. But, with minimal wage growth over recent years and artificially low interest rates (with high monetary stimulus), it can be argued that consumers have been acting rationally.

Macro-economic research



The percent of our debt held by foreigners remains high, but the growth rates have slowed considerably. Is this due to more difficult comparisons, a gradual reduction in new foreign exposure to the dollar, or a little bit of both?

Inflation expectations

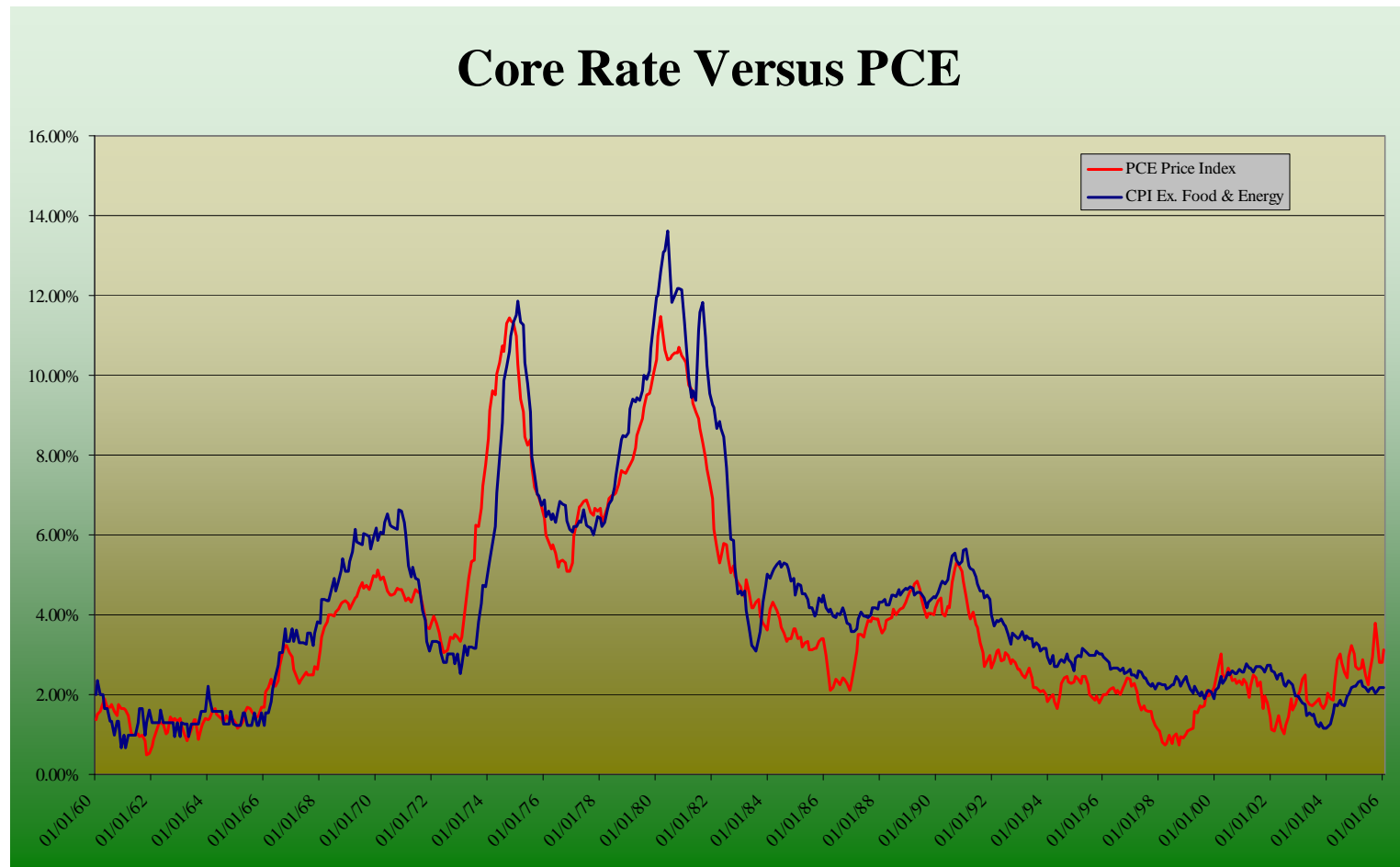
We feel that trend-line inflation will remain higher unless there is a substantial deceleration in GDP growth in the US and / or globally.

The prices for both input (materials) and labor should continue to increase, and this will impact the cost of living – even with the ability to substitute among goods.

This price movement will also affect corporate earnings as costs rise but most ways of reducing costs have been explored (and exploited) by corporations.

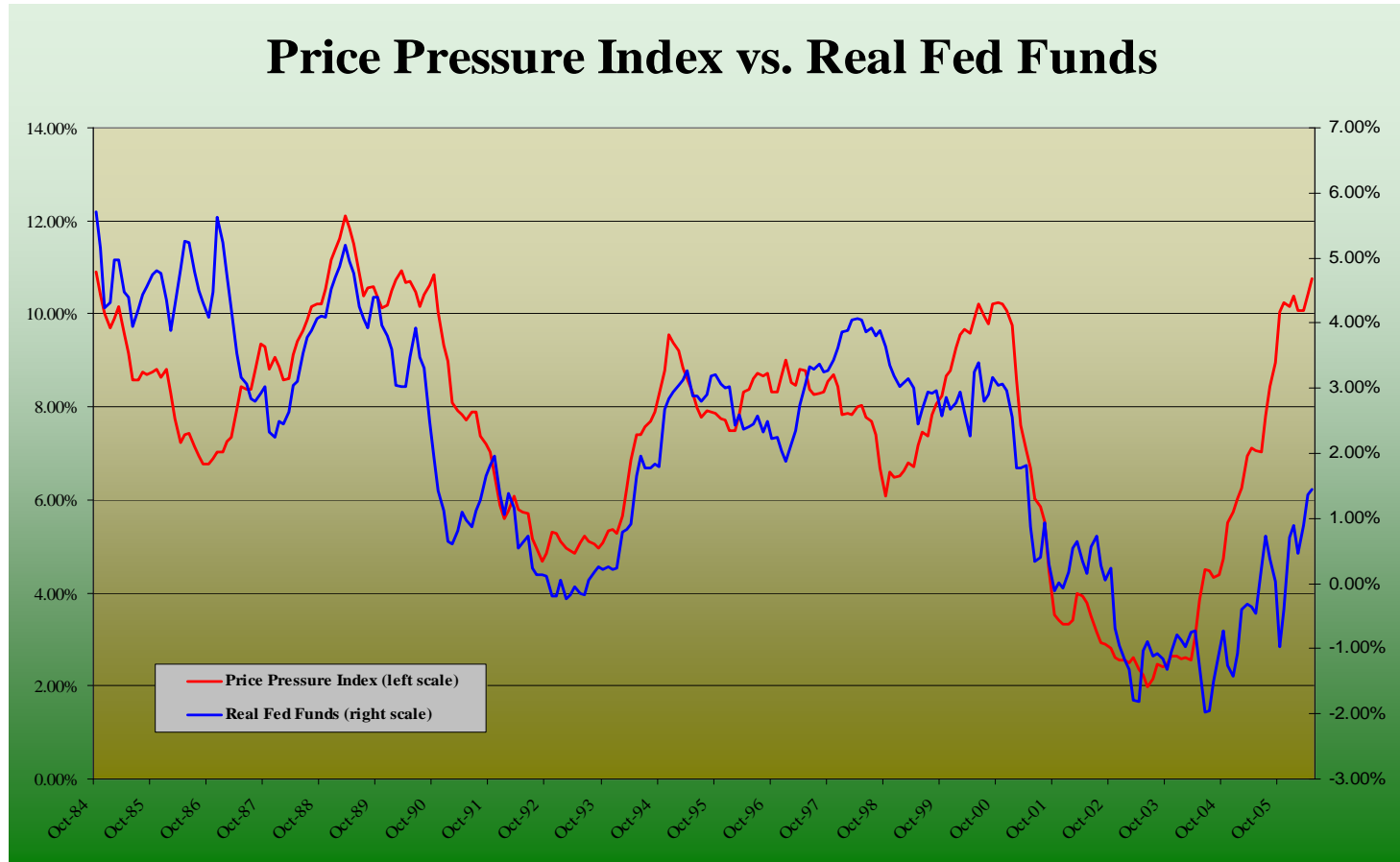
Long-run expectations in the bond market under-discount the risk of higher sustained inflation, and we feel that inflation continues to be a problem in the current environment.

Inflation expectations



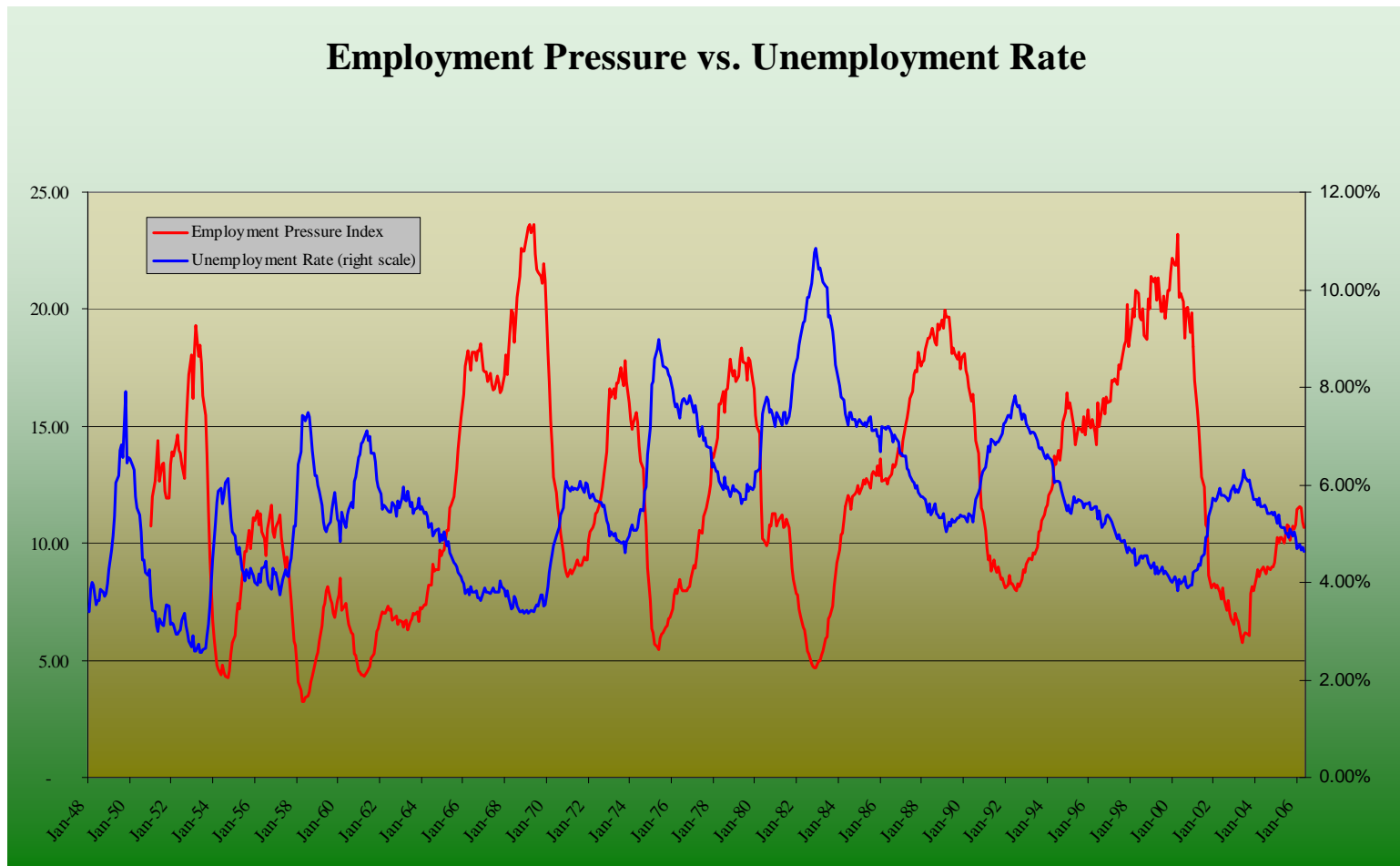
The personal consumption expenditures index (PCE) is one of the Federal Reserve's primary tools for estimating inflation because it allows for the substitution of goods (i.e., if it's too expensive to fly to a destination, I will drive). A range of 1-2% is believed to represent price stability; however, it is currently up 3.25% yr/yr and climbing.

Inflation expectations



The Fed is closing the gap between the present and the historic normalized spread by increasing short-term rates. This gap remains large and is driven by the pressure in prices from both labor and materials, neither of which is abating at the present time. Forecast based on this analysis – more rate hikes.

Inflation Expectations



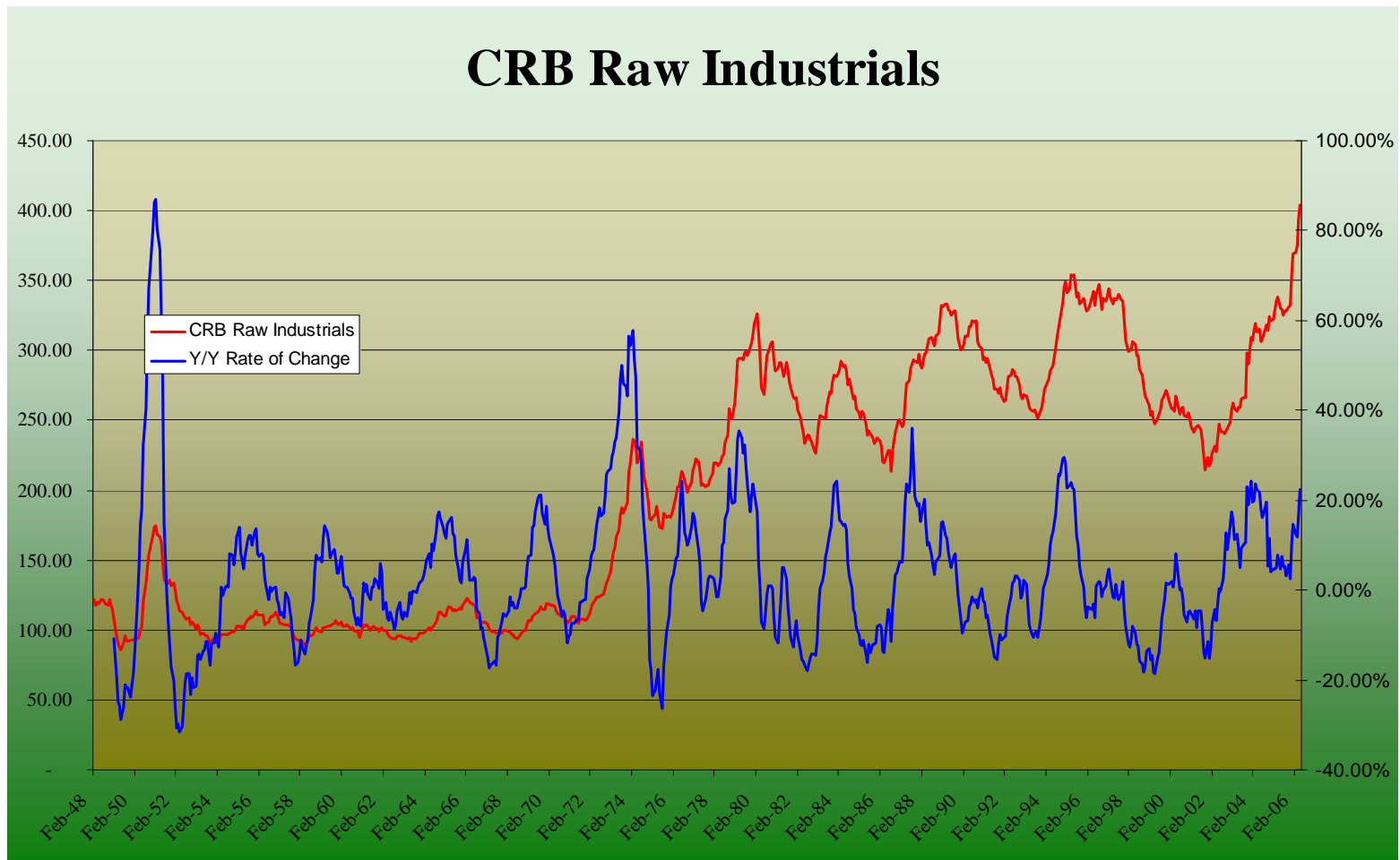
As employment pressure increases, the power shifts from those hiring to those being hired. This should result in higher wages. Thus far, many of the benefits of any recent economic strength have accrued to shareowners, so it's likely that employees will finally have their day in the sun.

Inflation Expectations



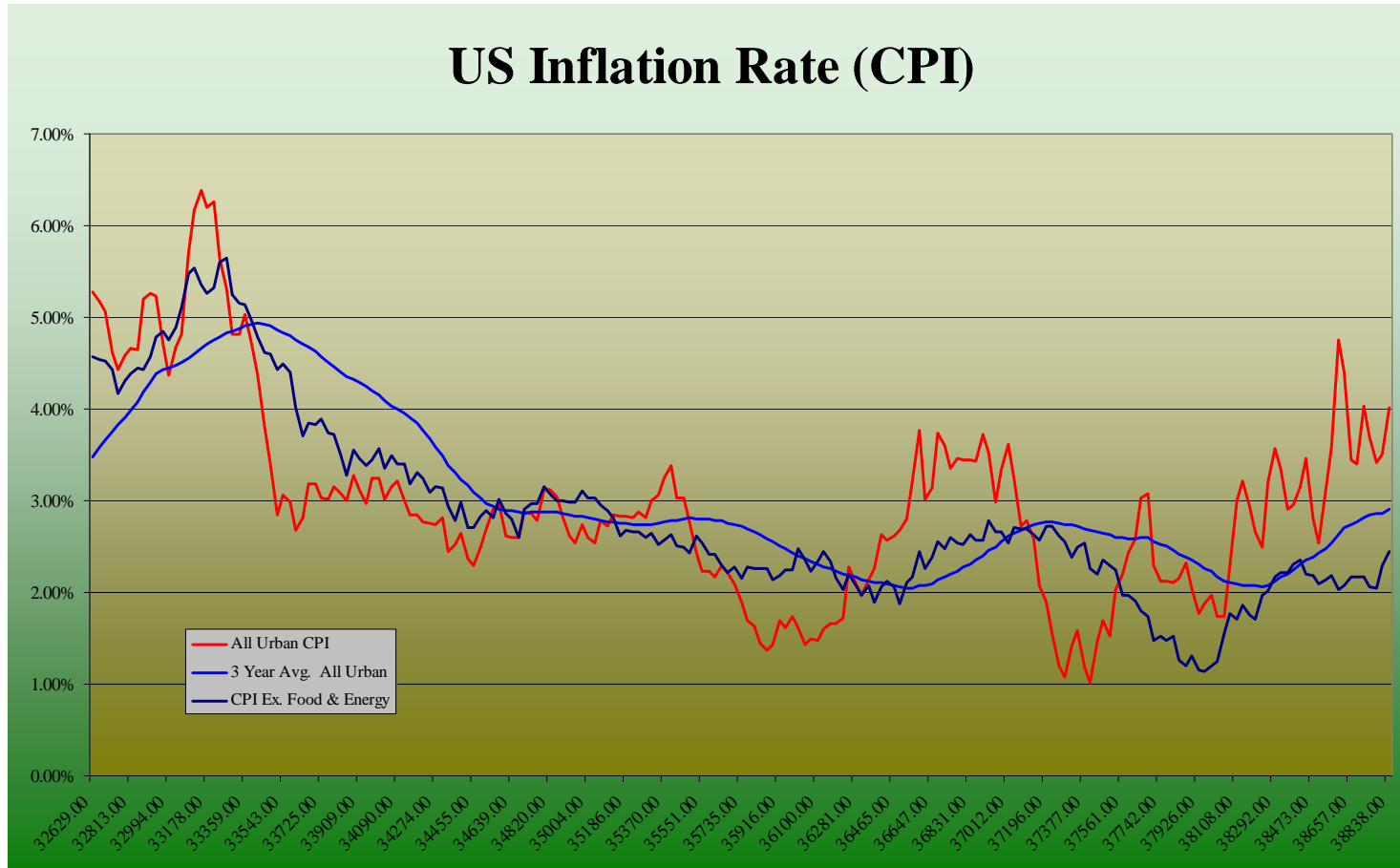
And, it's probably about time to provide higher wages, as income growth is near record lows and well below its recent average. This is part of the reason that workers have been monetizing their homes to supplement their consumption habits.

Inflation Expectations



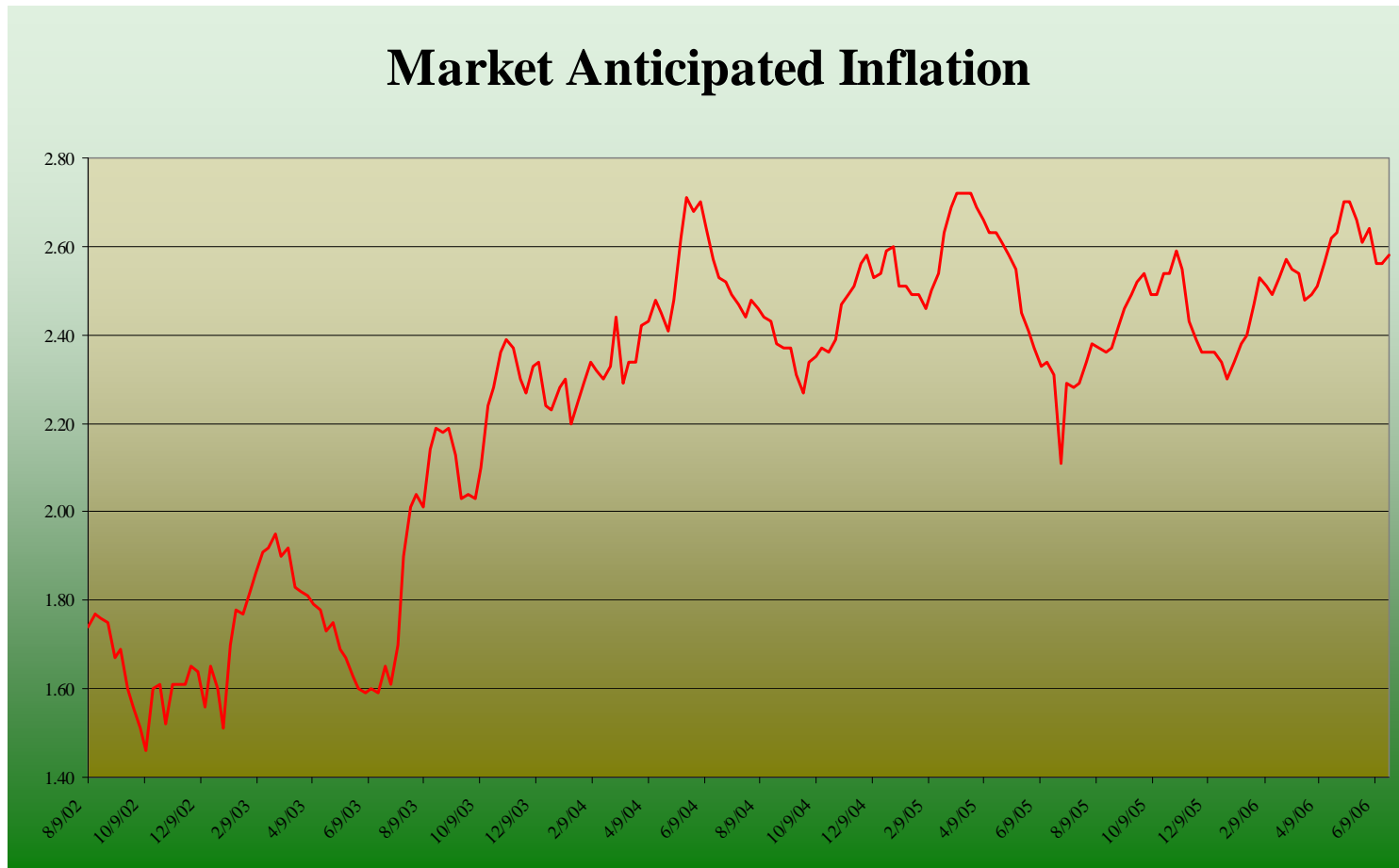
In addition to potentially increasing wages, the cost of materials does not seem to be decreasing...

Inflation Expectations



As all measures of inflation continue a march upward...

Inflation Expectations



... the markets anticipate long-term inflation of just 2.58%. We feel this is quite optimistic given current conditions.

Federal Reserve Watch

It seems that in all our recent client meetings, people have been “fussing” about our new Fed chair and requesting that he keep his mouth shut. Others contend that he is more likely than not to de-value the US \$ by printing too much money. Therefore, it is important to see what changes are slowly occurring in US monetary policy and also look behind some of the words.

What is happening (apart from rising interest rates) –
Real yield is available for savers (yield above the rate of inflation)
Money supply growth is slowing
Overall monetary conditions are not as accommodative

Behind the words – Quotes taken from an article by Justin Fox found of cnmney.com...

“... in a speech in November 2002, early in his first stint with the Fed, Bernanke approvingly mentioned a Milton Friedman parable about how a "helicopter drop" of cash could push prices upward. It was simply an attempt to reassure then-skittish markets that the Fed had ways to stave off deflation, but the image of a man willing to dump bills out of helicopters stuck. In hard-money circles, Bernanke is still known as "Helicopter Ben."

Comment – it is important to know the context of the statement

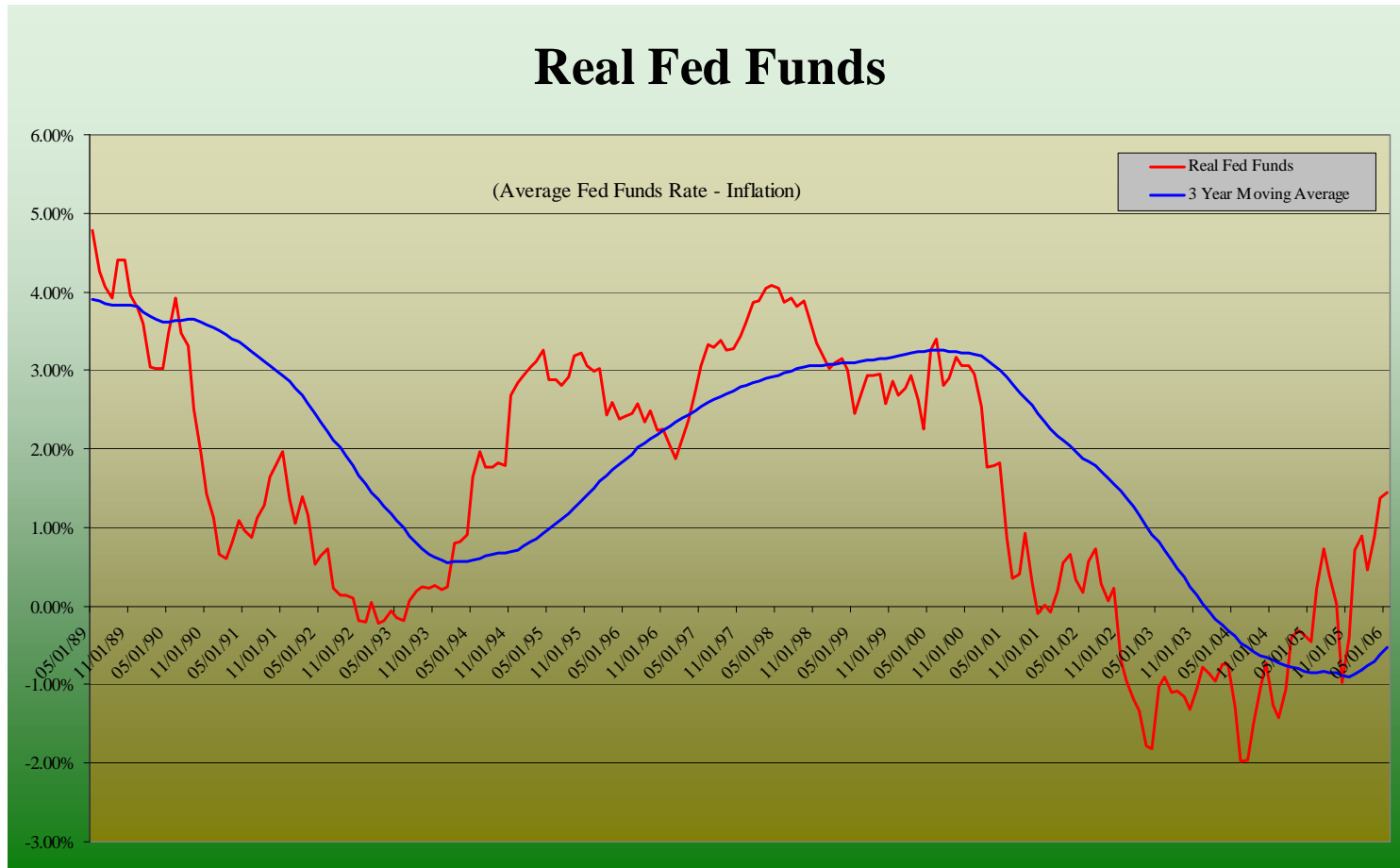
“The Bernanke Fed raised rates a quarter-point (to 4.75%) at his first meeting in charge in March. Then, in congressional testimony in April, he said the Fed might "take no action at one or more meetings, in the interest of allowing more time to receive information.”

Comment – but the market desperately wants to think rate hikes are done; this is one reason we are extremely cautious

“Ever since, Bernanke has been trying to make his inflation-fighting intentions crystal clear. The Fed raised rates another quarter point in May, and after a series of hawkish speeches by Bernanke and other Fed officials, the betting among many economists is that the hikes won't stop until rates hit at least 6%. In response, stock markets around the world have swooned.”

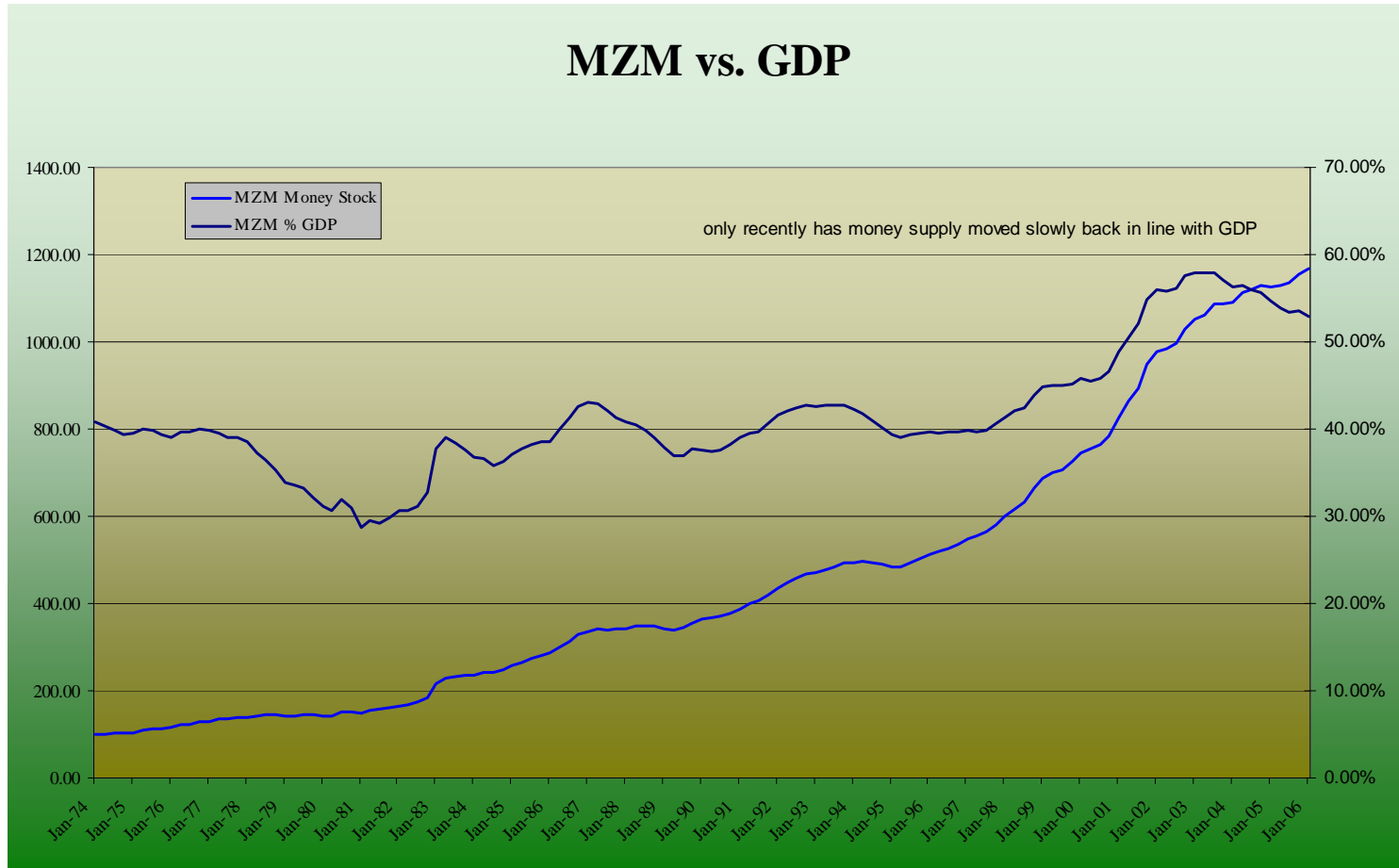
Comment – there will be other buying opportunities this summer as the market (in a thinly traded time of the year) reacts negatively to certain economic reports – employment and prices especially

Federal Reserve Watch



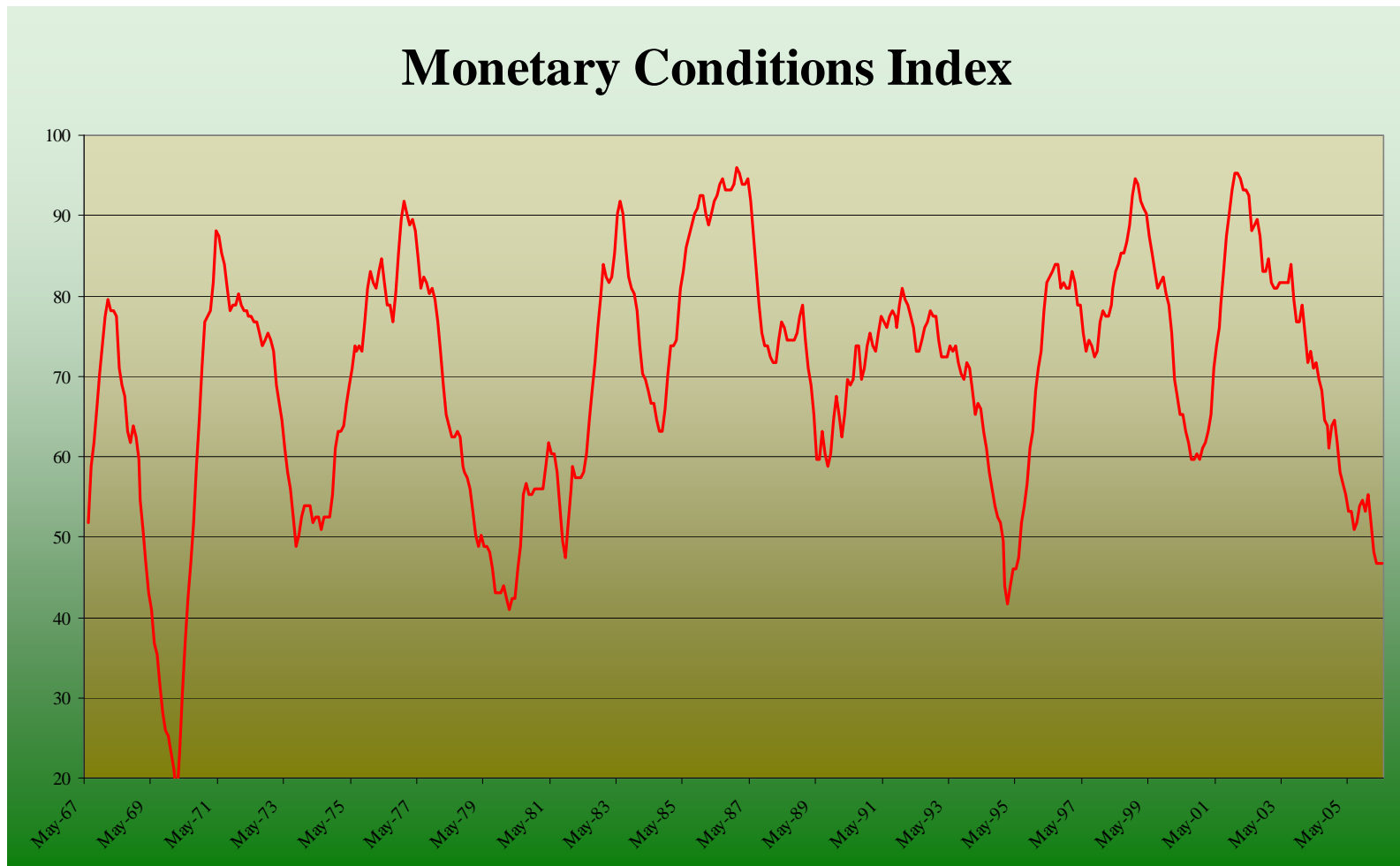
There is real yield in short-term fixed income for the first time in a while. If your money market account is not paying near 4%, it's time to shop around.

Federal Reserve Watch



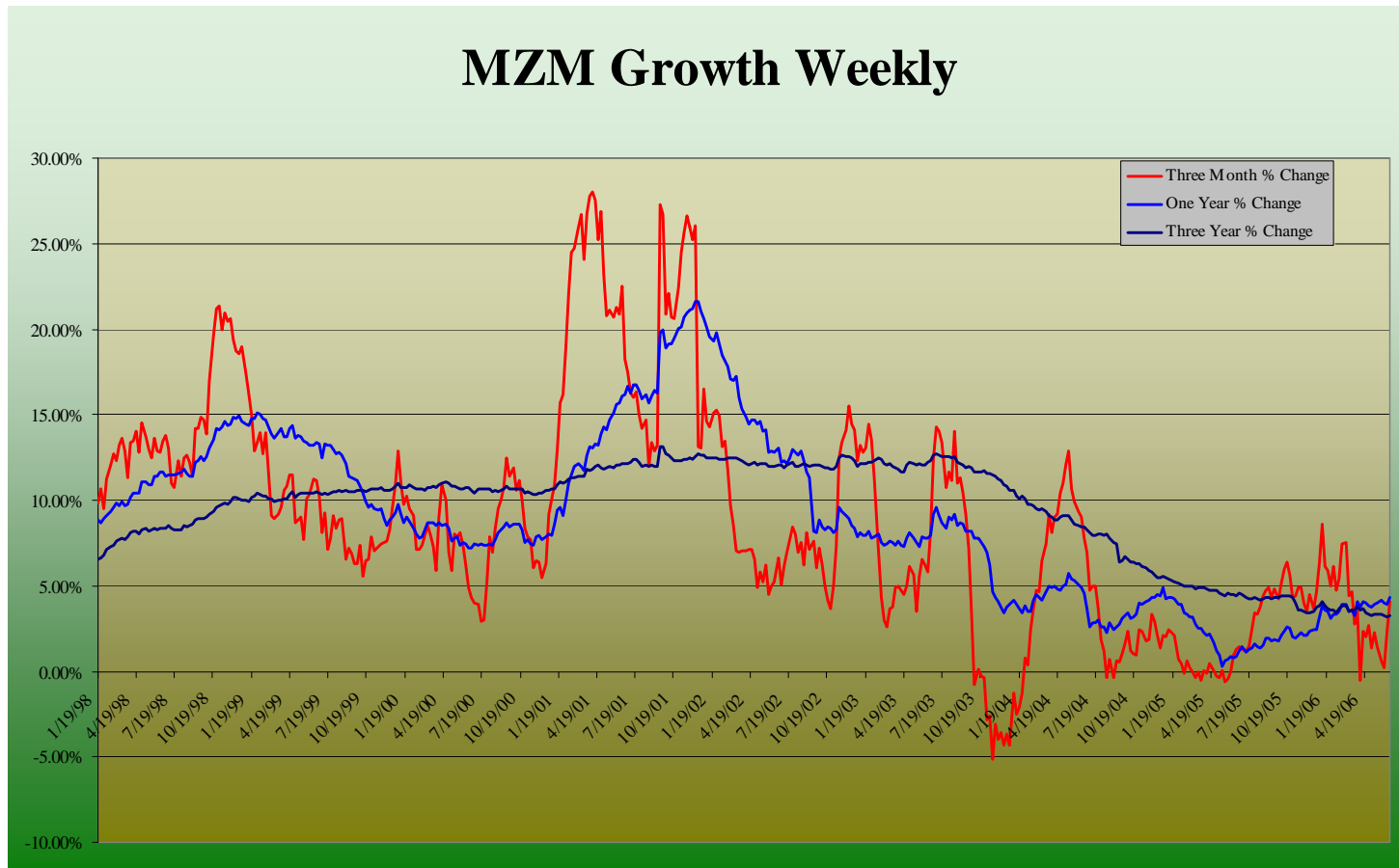
Slowing money supply growth is bringing that measure back in line with GDP; this helps reduce a “monetary overhang” due to excess money in the economy (which cheapens its value in the international marketplace).

Federal Reserve Watch



The monetary conditions index has fallen tremendously as liquidity has been removed from the economy.

Federal Reserve Watch



Near term growth in money supply doesn't outweigh the longer-term trend.

Outlook & Forecast

We anticipate annualized returns for the US markets to be between 5 – 7 % for the near term while we work out some significant structural issues.

Risk in the US continues to be under-priced and there are good investment options in other parts of the world – read this as “diversify” rather than “liquidate”.

But, there is still a lot of cash on corporate balance sheets and within investor portfolios which will be used for short-term purchases.

Outlook & Forecast

Although we feel that international diversification is important due to potential pressures on the US \$, we also have a renewed appreciation for the structural advantages of the US economy over the longer term...

- Labor market flexibility
- Dynamic and accessible capital markets
- Culture that rewards creativity and entrepreneurship

Special thanks...

Much of our research effort this month is based upon a trip to the CFA Institute conference in Zurich. We extended our time there to include research in Germany, Holland, Belgium and France based on the investment thesis about the dollar provided in the initial pages of this report.

As part of our time there, we were able to meet individually with a number of portfolio managers and economic analysts and listened to those who have years of international macro-economic experience.

As such, we would like to thank the following people for their time and insight:

Hemmo Hemmes, Portfolio Manager

Fortis Mees Pierson, Amsterdam Netherlands

Joost de Graf, CFA, Senior Portfolio Manager

Kempen Capital Management, Amsterdam Netherlands

Roland Bezemer, CFA

F. van Lanschot Bankiers, Antwerp Belgium

Dr. Marc Faber, Managing Director

Marc Faber Limited, Hong Kong