

TAX AND INVESTMENT PLANS
THE LIBERTIES
33 BEDFORD STREET, SUITE 11
LEXINGTON, MASSACHUSETTS 02420-4488
Fax: (781) 861-9916
Telephone: (781) 861-9720

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Goldilocks and the Three Bears

General Comments:

As I write this quarter-end letter we witness the Dow Jones Industrials breaking new highs, highs that have not previously been occasioned since January 14, 2000. Leading financial press headlines suggest we may be in for a “soft landing”. They state recent economic data suggests a U.S “goldilocks economy” may be in sight, one considered a perfect growth conduit, not too hot, not too cold. Costs at the gas pumps have been reduced significantly over the past couple of weeks and interest rates continue to be near historic lows. Both factors bode well for continued consumer spending domestically. Consumer spending has, to the surprise of many, continued to provide the necessary supports for our resilient U.S. economy.

Some headlines suggest this “goldilocks” scenario is the result of our well executed domestic monetary policy combined with the increased economic opportunities available through globalization. Are we entering a time of prosperity where growth oriented equity investments will rally?

Though possible, given the right set of constraints, many well respected Wall Street professionals find their crystal ball is far cloudier than the headlines suggest. Examples can be found with Charles De Vaulx of First Eagle who during his Bloomberg interview last week indicated significant concern over the cooling housing market. He now holds 35% cash in his US value investment. Warren Buffet of Berkshire Hathaway finds many US equities positions “overvalued” and has sought refuge in non correlating asset classes, investment overseas and increased cash positions. Bond King Bill Gross of PIMCO continues to be concerned with deflation and considers the bond rally of past two months in its “infancy” in his October issue of *Investment Outlook*.

Why do we find a call for caution when looking to the opinions of such well respected market strategists, technicians, portfolio managers and economists? Increasing real estate housing inventories, consumer spending concerns, and widening current account deficits continue to drive the focus of many answers. The following paragraphs look to explore these answers in greater detail.

Real Estate:

The expansion of credit created via Federal Reserve rates cuts between 2001 -2003 led to unprecedented US demand in housing as rates on mortgages fell to historic lows. The significant gains in real estate over the past several years straddled the two coasts and led to overvaluations in many other geographic areas. These property valuation increases not only helped mitigate net worth reductions occasioned from the tech meltdown of 2000, but also provided a new source of credit available to non stock market participating consumers through home equity loans and lines of credit. Cash out refinances (many in excess of 100% value of the home) helped fuel consumer spending and keep the U.S economy strong. Though this credit expansion helped fuel our economy, this liquidity infusion was realized through debt burdens requiring payback over decades. Even today Freddie Mac reports that in the first quarter of 2006, data showed 88% of refinancing was cash out refinancing, the highest it has ever been. More concerning was the fact that 50% of the equity take out refinancing was issued at higher interest rates than the prior mortgage obligation. As W. Scott Simon of PIMCO suggested “people continue to literally use their houses as an ATM machines.

As existing home inventories now balloon and new construction projects reduce prices to increase competition for the waning demand, a fear of significant home valuation declines emerge. Such an occasion, if hard and fast could have significant impact on consumer spending, bank foreclosures, and the future of the U.S economy.

The U.S Dollar & the Current Account Deficit:

“Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost.”

--- Fed Governor Ben Bernanke, 2002

Though taken slightly out of context in this example, the above quote by now Federal Reserve Chair Ben Bernanke illustrates a point worthy of review. The international currency value of the US dollar is only worth what world nations are willing to pay for it. If a publicly traded company, such as Exxon, announces that it's earnings will remain static yet it will issue additional stock, they have diluted the value of the stock to the existing shareholders. Can the U.S government continue to print an unlimited supply of dollars, increasing their role as a debtor nation without cost? Many think not.

To date, many nations purchase U.S dollars through direct investment into our Treasury bonds to build the reserve assets found in their capital and financial accounts. Export driven economies such as China continue to be the largest purchasers of our treasury debt. Such transactions help “balance” the “balance of payment accounts” by increasing the capital and financial account to offset trade imbalances found in their current account. The terminology here is not as important as the fundamental fact that this accounting mechanism reflects massive trade imbalances, mostly accumulated over the past twenty

five years. The overinvestment back into U.S assets through reserve acquisition has helped fuel asset bubbles in the U.S while reducing the currency of many exporting nations, thus allowing for goods to be purchased by Americans “cheaper” than otherwise would be occasioned.

At what point, and at what cost, do these countries start to unwind these investments in America due to the currency devaluation occurring from a U.S debtor nation with an ever growing accumulation of debt printed from its printing press?

Some professionals, such as former International Monetary Fund consultant Richard Duncan, suggest these trade imbalances are the result of self correcting trade imbalance mechanisms previously found in our prior Gold and Bretton Woods monetary systems, however not present in our current floating currency dollar standard. Will gold reserves increase on balance sheets of foreign nations in place of U.S dollars?

An Economist magazine sub-story from September 16th subtitled, *How long will emerging economies continue to finance America’s spendthrift habits?*, suggests “the world’s present external imbalances are neither desirable nor sustainable. When global imbalances are eventually unwound, the process will hurt even more. Unless America reduces its deficits before emerging economies lose interest in accumulating reserves, the dollar, treasury bonds and the whole American economy are likely to suffer a hard landing.”

Summary:

Consumer spending has in large part buoyed the American economy for the past several years, an economy many consider to be the driver for the world economy. The need for investment and economic professionals to carefully monitor the impact of falling home prices on consumer spending domestically is critical to world markets. The data that has been provided to date in this area tends to be lagging and subject to significant revisions to statistic error. The impact expansion or contraction in demand will have on our nation, and those export driven nations that have large positions of U.S treasury debt in their financial reserves, should continue to receive world focus.

As these issues underscore the caution employed by some Wall Street elite during this transition period, prudent investors will look to identify investment opportunities presented through such globalization. Economic cycles take years to develop, and years longer to be appropriately labeled.

Our current market highs may prove opportune times for sector rotation strategies, continued profit taking from boom or bust industries such as energy, and investment in areas of intrinsic value. While the world seeks clarity relative to American economic reverberations, congressional and presidential election ramifications, and continued geopolitical pressures, volatility should remain constant.

For these reasons we continue to seek investments with strong fundamentals, products that reduce risk through various hedging strategies, and companies that should experience demand regardless of market climate. Possibly to the surprise of some, technology names are once again reemerging within our value conversations. We believe some of these companies may deserve consideration for inclusion in your portfolios.

Please call our office for appointment as we stand prepared to provide specific recommendations and will look to review your portfolio asset allocations for recommended balance between equity and debt, diversification relative to market sectors, geographic exposure and stock capitalization during these volatile times.

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