TUG OF WAR

The past three months have shaken investors, as volatility has returned with a vengeance. Many have begun singing Marvin Gaye's mega-hit from the early 70's and are wondering "What's Going On?". Here's our primary takeaway from the second quarter:

Page One of the *Wall Street Journal* says investors are becoming more worried about inflation and slowing growth. That's only part of the story. Almost unnoticed by the mainstream press was the unprecedented contraction in the Japanese monetary base in May and June, whereby over $175 billion was removed from the global financial system by the Bank of Japan. Intelligent investors looked askance as startled hedge funds, or "hedgies", rushed to sell anything and everything, sensing that their source of cheap funds (borrowing in yen at near 0%) was about to dry up. More on this later.

Meanwhile, stocks continued to print record earnings and cash flow, while prices went south, thus lowering their PE ratios and continuing their return to fair value. In like vein, bond prices retreated as yields rose across the maturity spectrum, continuing their return to fair value by providing a modicum of "positive real yield" (nominal yield less inflation), which for so many years has been flat to negative. In all, we're pleased to observe this **continuing trend towards a return to normalcy**.

First here's a quick rundown of market returns:

ANNUALIZED
RETURNS AT JUNE 30, 2006

	Year To Date	Last 12 Months	Three Years	Five Years	Ten Years
S&P 500	2.71%	8.62%	11.21%	2.49%	8.32%
Value Line Composite	1.82%	7.70%	12.46%	1.25%	1.84%
Citigroup 5 Year T-Note	-1.36%	-2.50%	-.02%	4.04%	5.31%
Lehman Five Year Muni	.12%	.32%	1.64%	3.85%	4.74%
Citigroup 3 Month T-Bill	2.19%	3.95%	2.31%	2.16%	3.68%
CPI	3.20%	4.31%	3.50%	2.81%	2.80%

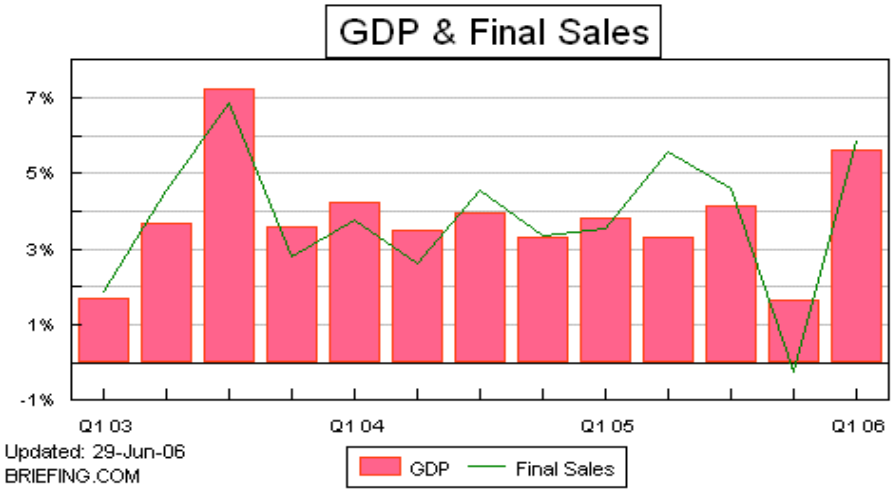
Stocks are still outperforming bonds, and we maintain that this will be the case at year end also. However, **investors should note the significant underperformance of bonds over the last three years.** We believe that the low yields reached in June of 2003 will hold and mark a major (multi-decade) turning point in bond yields. As such, we still think that bonds will trend higher in yield, and are holding cash where we can instead of fixed rate instruments. As we will explain in greater detail later, our general notion is that economies globally are more robust than they are getting credit for, and inflation (especially in natural resources, labor, and materials) is becoming more of an issue. Central banks around the world are increasingly behind the curve and will have to raise interest rates. Most of them

have not yet really begun the process. This is just not a good scenario for a rally in bond prices.

However, stocks have provided very good returns over the last several years. However, being in the right sectors and industries will matter---a lot. And the New Era we spoke about in our year end letter continues unabated—investing globally across currencies, sectors, and industries is where the world is heading. To borrow a phrase from Tom Freidman, the world is truly flat.

Macroeconomic Outlook

The U.S economy continued at an above-trend growth rate in the first half of 2006. First quarter finalized GDP came in at 5.6%, with final sales registering a 5.9% advance. (To some extent this sharp uptick is payback for last year's fourth quarter "Katrina" slowdown.) Year over year GDP is now running at 3.7%, with inflation (GDP price index) at 3.0%:



The Fed is in a tightening mode and seems bound and determined to slow what is still a firm economy. The latest GDP report confirms what we have been postulating for some time, which is that the consumer is going to be impacted the most. Sure enough, enterprise, or business, spending surprised to the upside at 14%, while personal consumption rose just 5%. The most notable feature of the release was the corporate profits picture: at 12.7% of GDP, it stands at a 55 year high! **Businesses are far better prepared than consumers to weather any slowdown.** Investors take note.

However, **we are not among those who anticipate a recession**. The housing market, especially, is not imploding, and remains relatively firm. Our current view is that GDP will slow to a modest 2.5-3.0%% or so by year end, and corporate profits will continue to trend along a 6-8% plane. This should be supportive for stocks, especially as the Fed reaches the end of its tightening campaign.

The key risk domestically is how inflation behaves over the next quarter or two. The Fed, with a rookie chairman, will continue raising rates until inflation falls to an acceptable range (less than 3%). A reasonable investor might question whether the Fed is sacrificing the

health of the economy to restore its inflation fighting credentials, if growth slows while inflation continues to rise (the spectre of "stagflation".) This is a key reason that the stock market has had a case of indigestion these past few months. We will be monitoring this relationship closely as **it is the #1 risk for U.S. investors.**

The Global Economy

Even more important than the Fed's actions though, are the policy changes occurring in Japan. It can be argued that the real source of the recent market decline was not an overcautious Fed but an unprecedented withdrawal of liquidity by the Bank of Japan (BoJ), which in two short months (March & April) drained $175 billion from its banking system.

As most investors know, Japan has maintained a near zero short term interest rate for many years, to combat a relentlessly deflating economy. This "free" money proved irresistible to the hedge fund speculators, who enthusiastically borrowed in yen at 0%, leveraged their asset base by a factor of 2 to 10, and invested in risk-free Treasuries at roughly 4.50%, producing "extraordinary" returns of 10-30%, after hedging away the currency risk.

Along the way, the global monetary base of yen grew to exceed that of U.S. dollars, for an economy one third the size of the U.S. In March, Japanese authorities announced that the country had finally turned the corner, and its economy was now growing at the best pace in years. That prompted the BoJ to announce an end to "zero interest rates", touching off a stampede to the exits for the leverage-addicted hedgies, who sold off anything they could to reduce this heretofore beneficial borrowing posture.

In May alone, the BoJ removed 15% of its entire monetary base. If the US Fed had done the same thing in such a short period, we are quite certain that a severe financial shock would have occurred.

When pundits and investors consider "how an asset bubble can be deflated", they should consider carefully what just took place in Japan. It is the opening salvo in what is sure to be an ongoing series of adjustments to restore financial sanity to global speculators who have gorged themselves on cheap money, amplified by derivatives and other financial engineering, designed to magnify returns at the expense of risk management. If there is a financial "accident" to come, it is most likely to emanate from the activities of these very large, unregulated, leveraged hedge funds. More than anything else, we think **these central bank actions are far and away the most prominent GLOBAL risk** for investors, and the recent worldwide sell-off drives home how interconnected the global financial system has become.

The good news is that the developed markets (G8) survived in relatively unscathed fashion. **This is an exceedingly good sign**, and, in a very real sense, the BoJ has helped the US Fed accomplish part of its ongoing tightening.

Like Japan, Germany is emerging from what has been a Rip van Winkle like decade long slump. They are in the early stages of economic growth, magnified by their tremendous success in hosting the recently completed World Cup. The most recent Ifo Index of German business confidence hit a high not seen last since February of 1991. The European Central

Bank (ECB) is also on record as being concerned about inflation in this pro-growth environment, and investors should be prepared for further rate increases there.

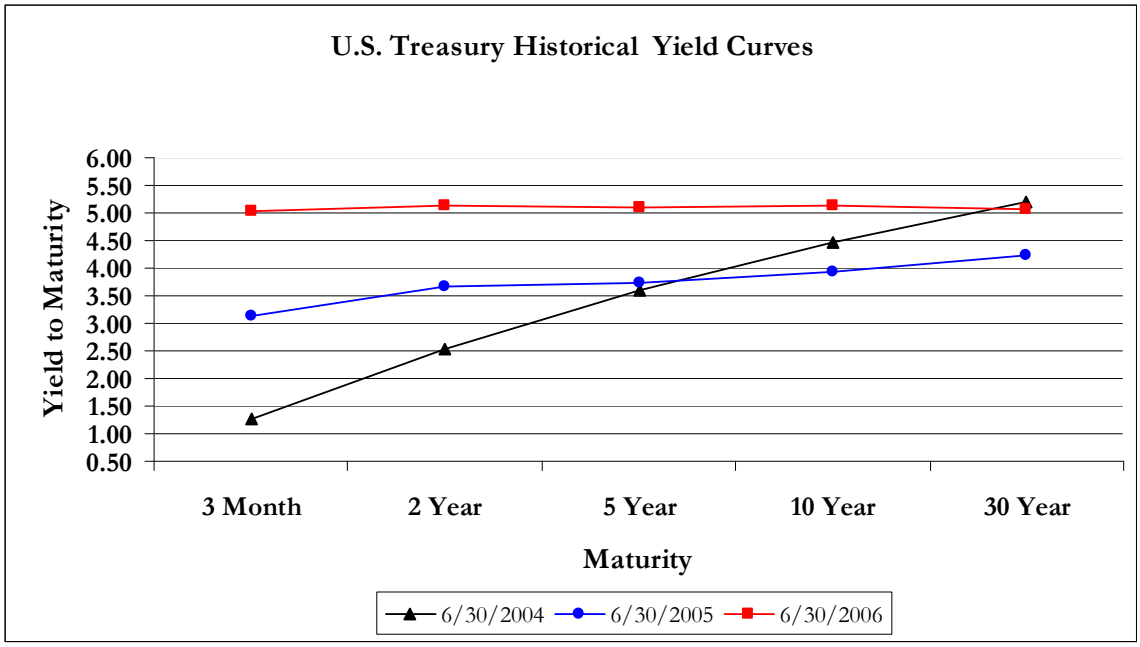
The bottom line is that these are the two largest economies in the world outside the U.S. They are both in the early stages of a long awaited rebound. Investors take note.

Lastly, in China, running in fourth place but rapidly ascending, the central bank raised bank reserve requirements by .25% to 8%, another "tightening of global liquidity" in the face of rapid growth.

This tug-of-war between growth and inflation-fighting by the world's central banks will determine how the script is written for the rest of this year. This is front and center for us, and we advise investors to extract themselves from the day to day noise of stock prices and bond yields and keep a steady eye on this fundamental sea change in the global economy.

Bonds

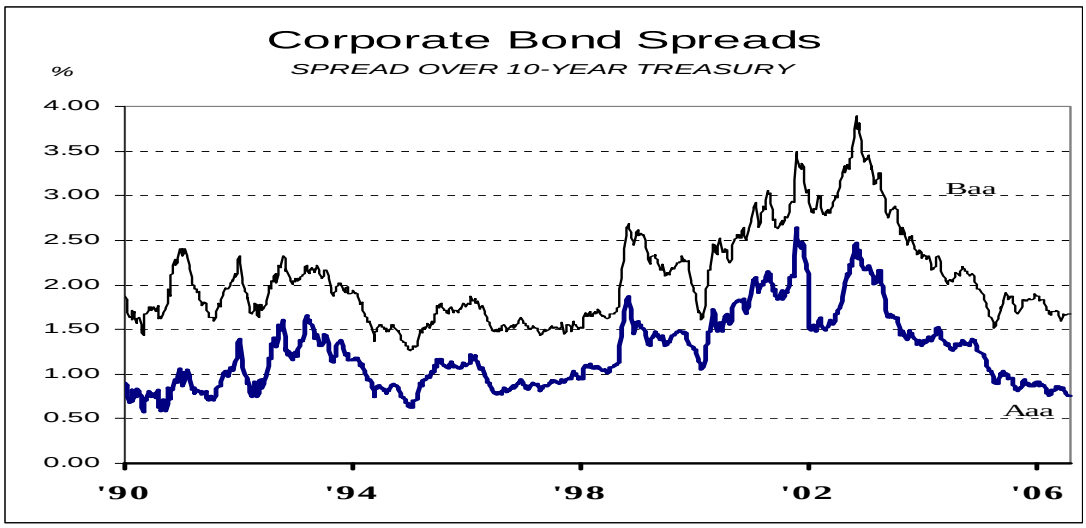
The US Treasury yield curve remains the best way to simply and collectively make judgements about future economic activity. It is now flat as can be:



However, until and unless short term rates meaningfully exceed long rates (a pronounced "inverted yield curve"), **we do not think investors need to fret about a recession**. Our view is that the yield curve will remain flat, and rate movements will be almost entirely predicated on Fed actions for the next quarter or two, with a bias towards higher rates.

The second best "recession watch indicator" comes from corporate bond spreads (the additional yield an investor receives by investing in "risky" assets like corporate bonds). They

have not widened meaningfully, and are nowhere near the spreads approached during the 2000-2002 downturn:



Source: Argus Research Co.

We expect the Fed to raise rates to 5.50% in August, and then pause. There will be no major rally in bond prices until the market is convinced that the Fed is done.

Stocks

Second quarter earnings are set to be released, with year over year growth expected to be 12.8%. However, the bulk of the increases will come from just two sectors: energy and materials. Technology will disappoint and consumer stocks are generally in a weakening trend. These observations are borne out by reviewing the returns year to date of the Dow Jones Industry Groups:

Oil & Gas	***12.74%***
Telecommunications	***12.35%***
Materials	***8.18%***
Industrials	***6.69%***
Utilities	***3.22%***
Financials	***2.57%***
Consumer Services	***1.80%***
Consumer Goods	***.19%***
Health Care	***-4.11%***
Technology	***-4.68%***

Our forecast range for the S&P 500 is 1250-1450 over the next twelve months. We are at the bottom of that range now. In order for stocks to advance broadly, the market needs a good upcoming earnings season and a Fed pause in August, with some indication that inflation is moderating. We anticipate a flattish third quarter, and a stronger fourth quarter for stock prices.

We continue to subscribe to the view that **"strategic assets" are the best place to be in the stock market**, as we discussed at length in our last letter. Although natural resource stocks suffered a brutal 2 month sell-off as the hedgies rushed for the exits, the fundamentals and news continued to improve. In mid-May, for instance, the management of Kinder Morgan, Inc. (KMI) proposed to take the nation's leading oil and gas pipeline company private in a $13.5 billion deal that would be **the largest management lead buyout in history** and one of the largest leveraged buyouts ever. Anadarko Petroleum (APC) announced that they would spend $20 billion to buy Kerr McGee (KMG) AND Western Gas Resources (WGR), at a premium of nearly 40% to the prior day's closing price of both stocks. In the steel sector, Mittal Steel (MT) emerged as the victor to acquire Arcelor of Luxembourg, paying a 43% premium over the initial offer undertaken five months ago. And Phelps Dodge (PD) agreed to acquire both Inco (N) and Falconbridge (FAL), again at significant premiums, with Canada's Teck Cominco and Switzerland's Xstrata counter-bidding. These are the type of activities that should act as a trumpet blaring in one's ear. Instead, we suspect most investors continue to follow the tick charts of their online trading services, living for the day to day thrill of winning a buck here and there. Alternatively, they follow the buy recommendations of the bulge bracket wire houses, who all parrot the same 25 tech stocks, not realizing that the tech game is mostly over for this cycle and that what they proffer as research is really nostalgia for the good old days of the Bubble.

While these deals are subject to many factors prior to closing, they suggest what we have long maintained: **it is cheaper to buy strategic assets on Wall Street than it is to create them de novo**, especially since regulatory and environmental constraints have lengthened the time required to bring on new supply. Instead of the bearish view that these companies are changing hands at the peak of the market, we subscribe to the view that highly informed buyers are acting now to lock in supplies / reserves and cost savings in the face of rising demand which will not be meaningfully curtailed with any global slowdown (i.e. these industries are no longer cyclical plays.) This significant and continuing merger activity reinforces the "watch what I do, not what I say" principle.

Meanwhile over in government-land, the Senate Foreign Relations Committee sought the sage advice of Alan Greenspan on the current energy crunch. Here's what he had to say: "The balance of world oil supply and demand has become so precarious that even small acts of sabotage or local insurrection have a significant impact on oil prices." Among other pithy comments, he noted that there were few good short term policy options for bringing down energy prices, saying that it was "not a choice between good and bad, but between not so good and worse".

Lastly, and in support of our thesis of buying strategic assets, here are a few headlines from the Wall Street Journal and the Finanacial Times over the past quarter which ought to pondered:

- Chavez Plans to Take More Control of Oil Away From Foreign Firms (WSJ 4/24/2006)

- Bolivia Seizes Natural Gas Fields in a Show of Energy Nationalism (WSJ 5/2/2006)

- Russian Minister Call for Review of Foreign Oil Projects (FT 5/26/2006)
- China's Quest for Commodities Leads to Africa (FT 6/20/2006)
- India Plans to Revive Urban Infrastructure Over Next Five Years (WSJ 6/22/2006)

Looking Ahead

We continue to believe that most investors are "under-prepared" for the inevitable and increasing globalization of the world's markets. It is our view that the primary long term ramification for investors will be a gradual and marked decline in the value of the U.S. dollar and dollar denominated assets.

The massive and intractable budget and trade deficits are being magnified by escalating spending on military operations, and a soon to arrive generational coterie of baby boomers sucking on the teat of Social Security and Medicare. When we observe the latest political scheming to avoid the painful changes that must occur, we are reminded of the old adage about "Nero fiddling while Rome burned".

The simple truth is that the U.S. is dependent on foreigners who buy our debt, which funds our massive (unearned) spending. These bonds are held by foreign central banks, who have all publicly stated that they wish to reduce their exposure to the U.S. dollar (diversifying into gold, yen, and euros primarily). At the same time, as the budget deficit increases, so does the temptation for our government to "inflate" its way out of debt by expanding the money supply (remember M1, M2, and M3?) (Parenthetically, the Federal Reserve ceased publication of M3, the broadest measure of U.S. money supply, this year. It is probably not a coincidence that it is occurring at this critical juncture).

And so we observe with great interest Russia's recent announcement that it will repay its entire $21 billion debt to the Paris Club of creditor nations by the end of August, plus a $1 billion early repayment premium. Besides the usual conclusions about how Russia is benefiting from high energy prices, the real story here is that the Russkies do not want to hold U.S debt which will be repaid in the future with depreciated dollars, so they are using their surplus dollars to maximize the value today. (A simple look at gold prices over the past 2 years confirms the logic of the Russian swap---the purchasing power of the dollar has been cut in half.)

Even further off the radar screen, the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Quatar, Saudi Arabia, and the United Arab Emirates) has announced the launch of a unified currency, scheduled for 2010. While all these nations currently peg their currency to the U.S. dollar, it is believed that they will switch to a basket arrangement well in advance of their currency merger. In plain English, they will be steadily selling dollars (U.S. bonds and other assets) and be buying gold, euros, and yen. This matters, a lot, when the collective trade surplus of these nations checked in last year at $331 billion. Who is going to buy our bonds then?

In like vein, the world's largest IPO since 2000 was completed this quarter, as the Bank of China raised $9.7 billion by listing its shares on the Hong Kong (Hang Seng) Exchange—denominated in Hong Kong dollars, not U.S.

Fortunately, there are many sound market-based alternatives for diversifying across equities, bonds, currencies, and commodities globally. In stocks, we continue to favor natural resource enterprises, non-U.S. consumer, and companies who benefit from growth in overseas economies, with modest U.S.-only exposure. In bonds, we favor cash and floating rate instruments, but are cognizant that the U.S. Fed is approaching the end of its tightening cycle and that yields may descend as the turn is reached. We think broad based indexing strategies, especially on U.S. focused indices, will disappoint, and urge investors to be prepared yet cautious this quarter, as interest rates are on the rise globally. As Jimmy Buffett sang recently, "it's always five o'clock somewhere", and we will co-opt that phrase for our strategic asset theme: "there's always a bull market somewhere".

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July 11, 2006