2007

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January 12, 2007

It has been a year, so it seems obvious that some sort of update on our thoughts is past due. Perhaps it shows either a lack of creativity or just plain stubbornness, but remarkably little of what we might say has changed from last year. Thus, the "2006" report is attached and becomes a mandatory reread. Updated views follow, and again these are the basic long-term themes, not short-term or trading oriented, and to be discussed more fully in person or in response to your valued questions and thoughts.

Inflation and Interest Rates

I still like what we wrote at this time last year. The costs of necessities like water, energy, and food will remain in an overall long-term secular uptrend – and the costs of economic raw materials such as copper, lumber, and to some extent energy I suppose, will rise and fall with the economy. The fact that many of those cyclical commodities are declining at the moment tells us almost everything we need to know -- the economy is slowing down, so inflation is rotating out of industrial commodities and into other areas…such as agriculture, more on that later.

And yes, we've certainly seen some cyclical deflation in asset prices like real estate which were fueled by the stunning expansion of financial credit, as discussed last year. Real estate tends to have long cycles, and this is a process which will continue to unwind.

The "2006" report is attached to avoid repeating comments, but again with income investments, two primary themes occupy our thinking:

- long-term bond mutual funds are less appealing than intermediate securities of known maturity
- credit spreads will widen to the detriment of lower credit quality bonds

It sounds simple if you say it quick, but these principles remain extremely important to the preservation of wealth in income securities. Credit spreads remain very thin, liquidity is overwhelming, and there is very little incentive to invest in low quality paper or junk bonds. Despite this, a tremendous amount of liquidity is being invested directly into such risky positions.

Our own position has been that high-quality intermediate securities would maintain their value. They have. We mentioned trying to buy during cyclical lows in bond prices, and this will sound goofy, but there does seem to be an 8 month ebb and flow to capital market rates in recent years. The most recent timeperiods were October/November 2005, June 2006, and strange as it sounds, our antenna will be up later in this first quarter of 2007.

Last, we admit to some nervousness about the financial and banking stocks longer term, and although there have been some breakdowns in the companies most closely tied to real estate finance, this sector will not start to crack until the credit spreads begin to widen. Expect that to happen sometime in 2007.

Gold, Currency and Energy

Simply put, gold and the dollar reversed long term trends in 2001, as previously discussed, and these new long-term trends are not even close to ending. So the price of gold will continue to rise over the long haul. Our problem is that it is very difficult at the moment to assess the intermediate term trend. Our original theme over the past few years has been that energy assets would act as a store of value. Last year we began to suggest that the relation between gold and oil might begin to tilt more towards gold in the future. Disruptions in the global petroleum supply chain remain a risk, a very likely risk. Very likely. Still, with rising liquidity in Asian economies, gold will deserve as much consideration as oil going forward, and we look forward to discussing these ideas with you further.

Gold is ultimately headed higher. Not sure about the timing, but it's eventually headed higher.

The U.S. Economy and Stock Market

Over the past several years, the stimulus provided from U.S. monetary and fiscal policy has been so large it has no historical precedent. The effects have been positive for the economy and asset prices. Not hugely so, but certainly positive. Just as the physical effects of acoustics or vibration recede over time, the effects of these fiscal and monetary policy changes are subsiding. We are back to a 'show-me' pattern for the stock market in 2007, and leadership in the market will become thinner with fewer stocks participating over time in the upmoves.

For the past several years, sector themes drove equity performance, certainly energy in the 2004-6 timeframe. Large Cap equity performance began to improve in the second half of last year, as did Health Care Pharmaceuticals, Telecommunications, and so on. Each were sectors that had previously lagged, but we look for an even thinner market in 2007, with greater variations even among and within industry groups. Macro issues such as government stimulus or federal legislation will be less important and micro issues of single company performance will become more important. Intra-market volatility has been low, the VIX volatility index has been quite low relative to history, and we expect this to change over 2007 – resulting in greater dispersion, greater volatility, and some frustration with rates of return for many investors. In this environment, Large Cap should continue its recent outperformance over Small/Mid Cap sectors, and securities providing cashflow, dividend income yields, would seem to have an advantage.

Industrial and Agricultural Commodities

Well, as we've mentioned before, our comments go out to some companies and individuals with varied interests. Most investors give little thought to the global commodity markets, but we've found value in the exercise. Cyclical inflation in certain commodity prices has moved away from industrial commodities and into agriculture.

The cost of food is going up.

We expected cattle prices to decline in the first half of last year, and prices dropped roughly 30% by May. From there, prices began to rise and this new uptrend has further to go, as feed costs are rising significantly. Meat will become more expensive.

We expected grain prices to begin rising in the second half of last year, and here we go. The price of corn has jumped 50% since the summer, soybeans and wheat are coming along as well. It's not solely ethanol demand that's driving this, though that's certainly a factor, and grains will become still more expensive before this bull market is over.

We still look for the long-term bull markets in sugar and coffee to continue into 2007. Same logic and reasons as discussed before. There will be another spike up in these food prices.

Last year we noted that cotton looked like a bull market candidate longer-term although it was still too early in the cyclical processes of that market. The time has come.

Rising grain prices naturally diverts some acreage away from cotton and Asian demand remains, so the supply/demand balance for cotton moves into bull market mode this year. Cotton is not food, but it is agriculture, and all of this fits as well into our previously stated theme of a secular global inflation in the price of necessities.

This is a short update, but many of the long-term themes discussed last year remain in place, and we don't find many intelligent reasons to change those thoughts. Will be pleased to discuss near term timing of the cyclical moves this year, and as always, I look forward to discussing actual investments and portfolios with you on a personal basis. Best thoughts to you for the New Year.

–Brian