

October 2006

Where Do We Go From Here?

With the Dow Jones Industrial Average climbing to a new all-time high, the question that most investors are now asking is – where do we go from here? That question is best answered by first answering how we got here in the first place. To answer both of these questions, let's look at the predictions we made at the beginning of the year in our Barnyard Forecast.

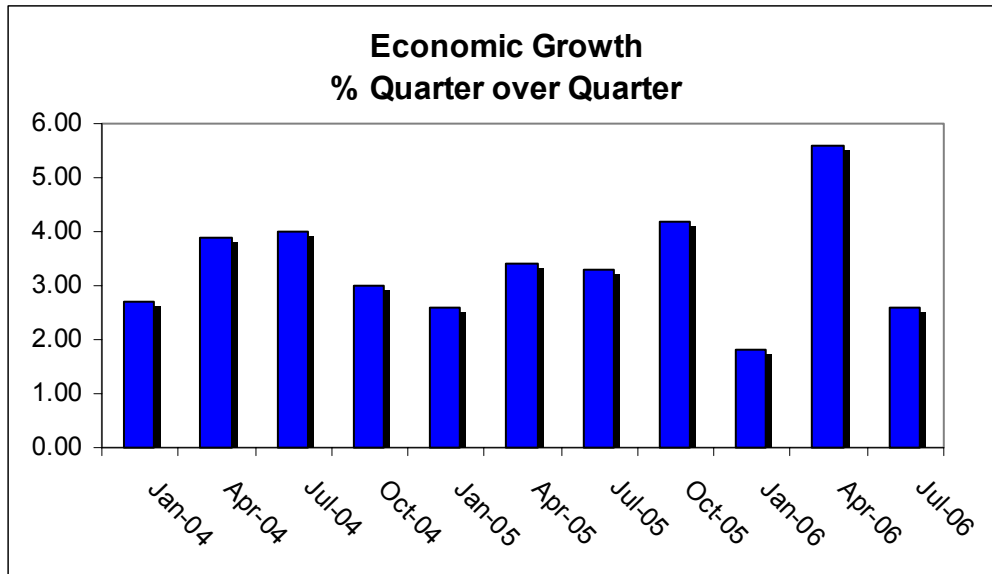
In that forecast, we said that stocks, as measured by the Dow Jones Industrials, would generate mid-double digit returns in 2006 driven by five forces: (1) Corporate earnings would remain above 10%; (2) The Fed would move to the sidelines by mid-year; (3) The yield on 10-Year US Treasury Bonds would stay below 5%; (4) Inflation would be slowing toward 2.5% by the end of the year; and (5) Stocks, which were already undervalued, were looking to rally.

Ordinarily, rising interest rates and a slowing economy would not be good news for stocks. **We were convinced, however, that the long string of rate hikes by the Federal Reserve was preventing the market from accurately valuing the strong earnings and dividend growth of the last three years.**

Thus far, in 2006, we believe the forces we predicted would be the drivers of higher stock prices have come into alignment. The Dow Jones Industrials and the S&P 500 have returned over 10% and are trying to move higher. However, let us spend some time drilling down into the data to see how the various parts of the economy are faring and if any new trends are forming.

Economy: In our Barnyard Forecast, we said that the Fed's string of rate hikes would cause the economy to slow from near 4 % in 2005 to 3% growth in 2006. Chart I shows GDP growth for the last two-and-a-half years. The effects of Hurricane Katrina can be seen in the sharp fall in fourth quarter 2005 GDP growth (period ending Jan. of 2006) and the rebound in the first quarter of 2006 (period ending Apr. of 2006). The most recent data available shows GDP growth slowed to 2.5% in the second quarter of this year.

Chart I



We expect that the economy, with a hangover effect from the rate hikes, will continue to slow modestly through the end of the year.

Going forward, for reasons we will explain later, we believe GDP growth in early 2007 may dip towards 2%.

Inflation: Chart II shows that in January of 2006 nominal inflation on an annualized basis stood at 8%. In spite of this high reading, we predicted that it would slow to the 2.5% range by year-end 2006. Judging from the data for nominal CPI (blue bars) on Chart II, our prediction appears to be close to the target. With oil prices collapsing, we are comfortable that nominal inflation for the rest of the year will be tame.

Chart II

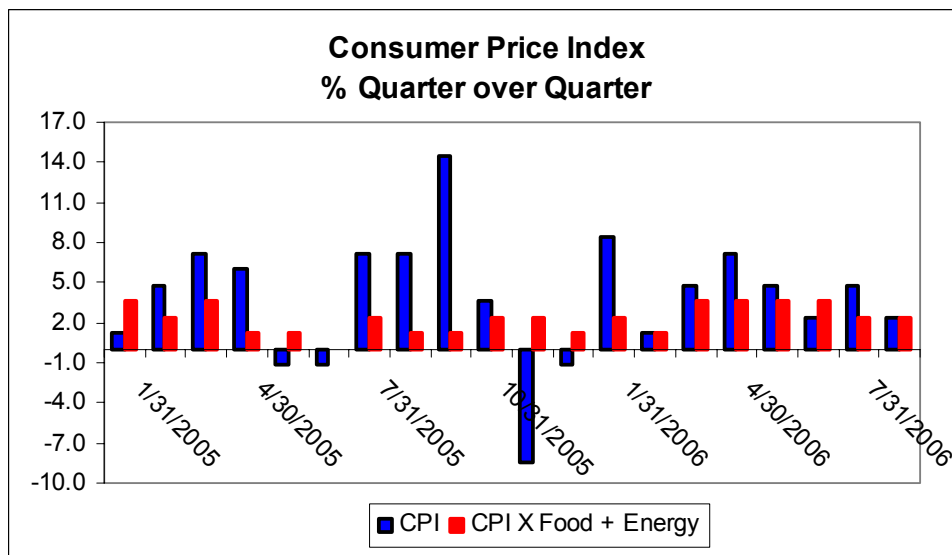


Chart II also shows how volatile nominal CPI has been over the past two years. However, looking at the Consumer Price Index excluding food and energy (red bars), we see much less volatility. The Federal Reserve targets the CPI excluding food and energy, the so-called core rate of inflation, in its policy

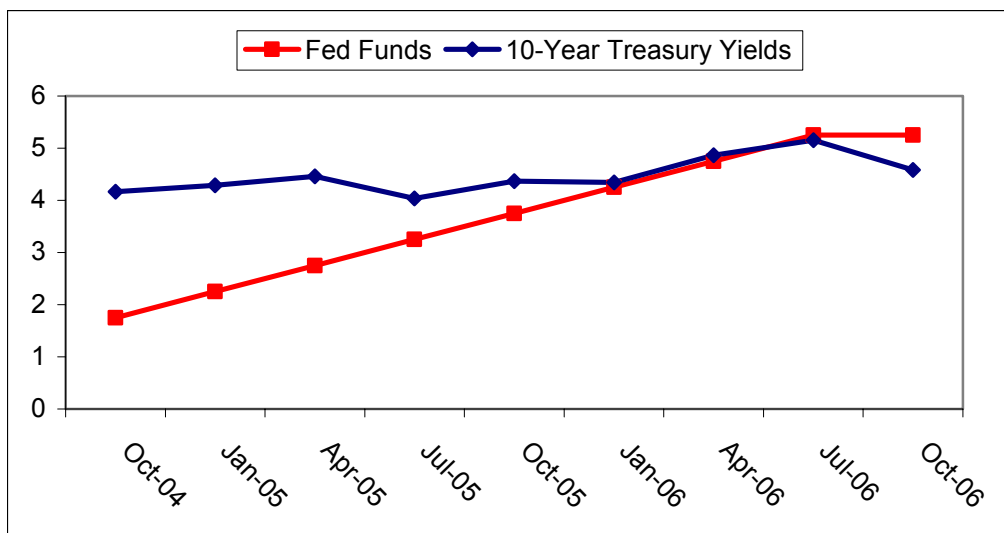
decisions. While nominal CPI is trending sharply lower, the core rate is still at a level higher than the Fed would like. For this reason, some analysts are warning that the Fed may not be done with its rate hikes. We do not agree with this thinking. We believe the slowing economy will permit the core CPI to trend lower.

Earnings: We said at the first of the year that corporate earnings would grow by 10% in 2006. That was on top of 13% in 2005 and 24% the year before. Third quarter earnings are just starting to be released, so we are only half way through the current earnings year, yet earnings growth so far has been almost 14% and continues to confound the skeptics.

While the earnings picture has been outstanding for the last three years, we believe the Double-Digit Earnings Express may begin to slow in 2007 along with the economy. We'll say more about this in our discussion of interest rates.

Interest Rates: At the first of the year, we predicted that the Fed was near the end of its long string of rate hikes. We were too optimistic in that call. The Fed hiked rates four more times in 2006 before pausing at 5.25%. Ten-year Treasury bond yields did rise as we had guessed, but again, they rose more than we expected. We predicted they would rise from their January 2006 level of 4.25% to about 5%. Ten-year bond yields overshot our estimate in May and stayed above 5% until July. Chart III shows, however, that since the Fed stopped raising rates in July, 10-year Treasury yields have fallen from near 5.25% to just above 4.6%.

Chart III



We believe the recent fall in 10-year Treasury yields has some negative implications for the housing market. Since the beginning of the Alan Greenspan era in the late 1980s, there has been roughly a 3% difference between long-term Treasury bond yields and core CPI. With core CPI currently at 2.5%, to maintain the normal spread long-term Treasury yields should be near 5.5%.

Treasury bond investors are a very sophisticated crowd. If they are currently willing to accept a yield of 4.6%, they must have very strong convictions that core inflation is going lower. They could be wrong, and if they are, interest rates will rise. We believe, however, that Treasury bond investors probably have it right – core inflation is most likely headed toward 1.5%, which would reestablish the normal 3% spread.

If you are following our logic, you might argue that falling oil prices, alone, could push inflation to as low as 1.5%, and you would be correct. However, oil prices are not in Core CPI, and the evidence shows that it is Core CPI on which bond investors focus. That means if core CPI trends lower, the fall will have to

come from components of the economy other than food and oil. The components of Core CPI with the highest weightings are healthcare and housing. There is little likelihood that the cost of healthcare is coming down. Therefore, by implication bond investors are predicting that housing will be very weak.

Housing prices have begun to weaken, with prices having fallen the last two months. For the housing market to drive core CPI lower in any meaningful way, however, would take many more months of falling prices. This is not a pleasant thought, but it is a logical one.

If the bond market is wrong, and core inflation does not fall to near 1.5%, then long-term bond yields will rise next year. That puts us somewhere between the devil and the deep blue sea in this matter of the economy and interest rates. Either interest rates stay where they are, implying that inflation will come down almost solely on the back of housing, or interest rates rise, slowing the entire economy and creating headwinds for the stock market.

There is a wild card. The wild card is the Fed. If either housing or the economy gets really rocky, the Fed will cut short-term interest rates. This would soften the blow to housing as well as to the economy.

As we said earlier, there are still many commentators who believe that the Fed has not completed its rate hikes. Based on the exercise we just went through, we believe the Fed is not only done, but that their next move will be to cut rates and sooner than most people think.

And the Dividends Say ...

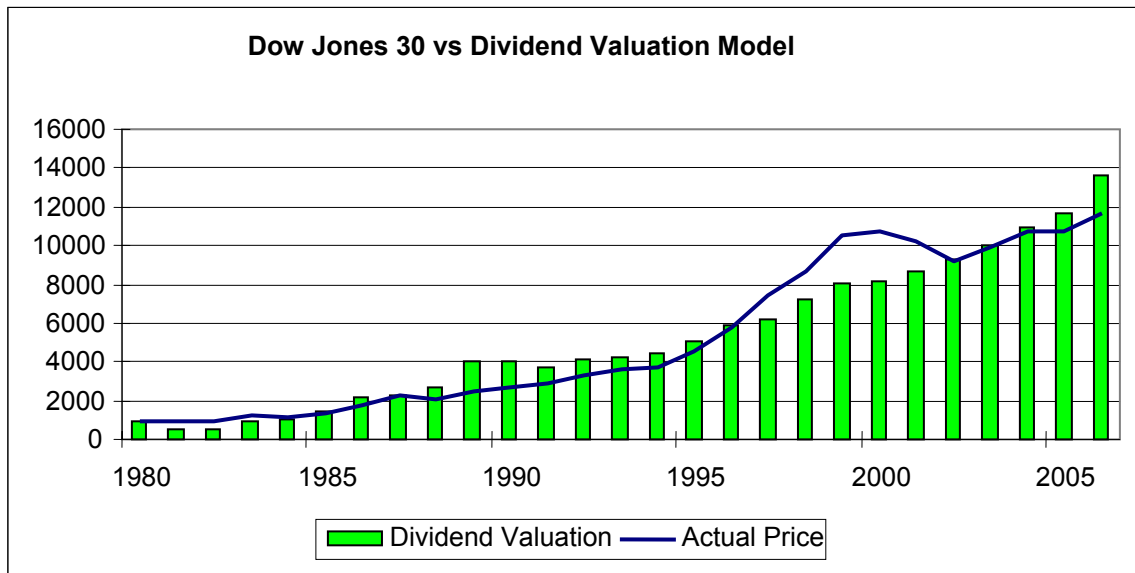
Chart IV shows the current status of our proprietary Dividend Valuation Model. The model is calculated using data from the Value-Line Investment Survey and covers the last 26 years. The green bars on the chart are the calculated values measuring the changes in dividends and interest rates versus changes in price during this time. The blue line is the average annual price of the Dow Jones Industrials.

You can easily see that there is a very high correlation between the tops of the green bars and the actual price of the Dow Jones Industrials.

If you think of the green bars as representing the Dow's intrinsic value, the market was undervalued in the early 1990s because the tops of the intrinsic value bars stayed consistently above the actual price line. Undervaluation turned to overvaluation in the mid to late 1990s. In 2003 and 2004, the market, according to the model, was about fairly valued. As we pointed out on many occasions last year, the Dow Jones became undervalued again in 2005, and our latest reading of the model shows that, even with the recent run up, the Dow's undervaluation is still over 10%.

It is important to remember that past relationships between dividends and prices do not guarantee that they will hold in the future. Having said this, the model does give us a quantitative tool that has been able to explain a surprising amount of the Dow Jones' annual movements over the last 26 years, a time of remarkable volatility in the market.

Chart IV



If you think about the above chart for a minute and how we began this letter, you may come to the same conclusion we do: ***A new all-time high for the Dow Jones is a good thing, but it's not THE THING.*** THE THING is that earnings and dividends, the authentic determinants of value, have reached an all-time high.

No one knows for sure where stock prices will go over the next twelve months, but we are confident that the authentic determinants of value – earnings and dividends – are going to rise again by about 10%. We believe this increase in value will, ultimately, be reflected in more new highs for the Dow Jones in the years to come.

Blessings,

Greg Donaldson

Mike Hull