

Monthly Chartbook

March 2008

What could go right, what could go wrong?

Executive Summary

This month the Chartbook will consider possible directions the US economy and US stocks could go and what might be the factors behind such changes.

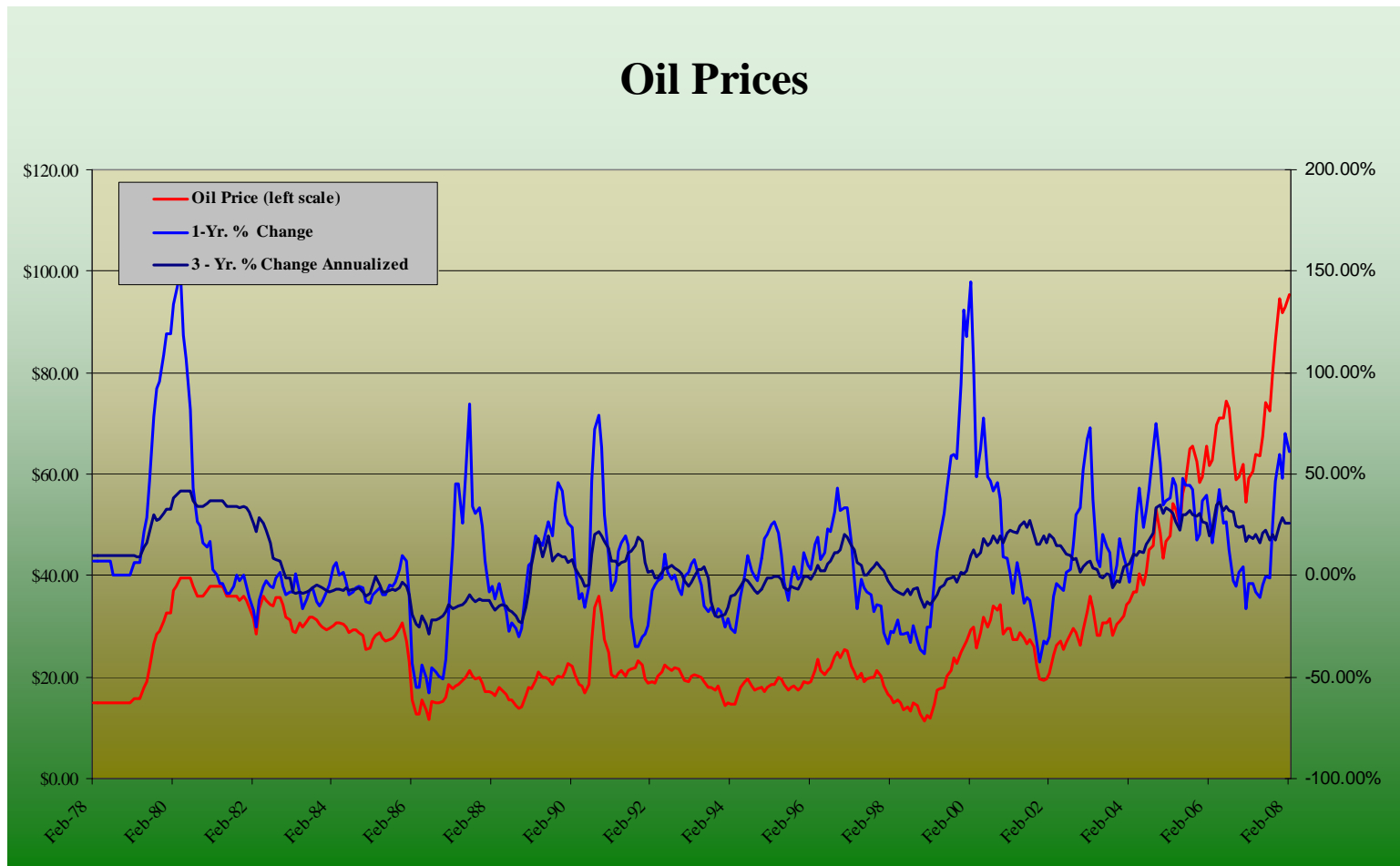
Although now is not the easiest time to make an argument for strength in the US stock market, there are a few things that could go right and offer near-term upside potential to owning US equities.

Let's start with the idea that the US \$ is over-sold... if that is indeed the case, then changes to the macro-economy could provide for a rebound in the dollar which would have a positive impact on US stock prices.

On the other hand, what could go wrong stems from the continued weakness in the dollar as Fed policy continues to "solve our problems" by printing money. Concurrent with that, we enter a period of stagflation as the market more accurately assesses the true rate of inflation.

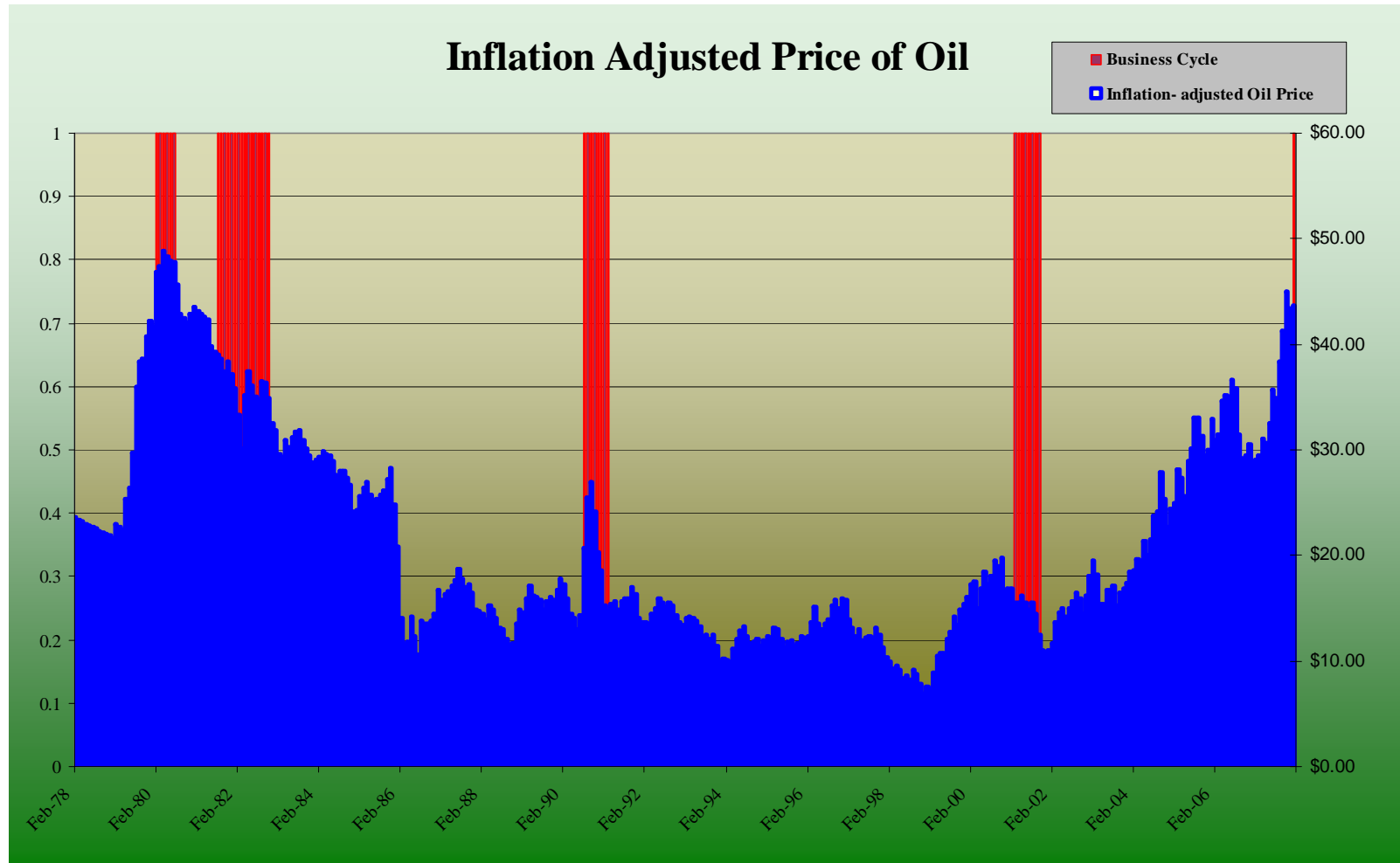
The truth likely lies somewhere in the middle, and we save our predictions until the end of the report.

What could go right?



Oil prices have increased at a 60% rate year over year and at almost 26% annualized for the past three years.

What could go right?



In addition, oil is now trading at its highest inflation-adjusted price in the last three decades.

Inflation expectations –what could go right?

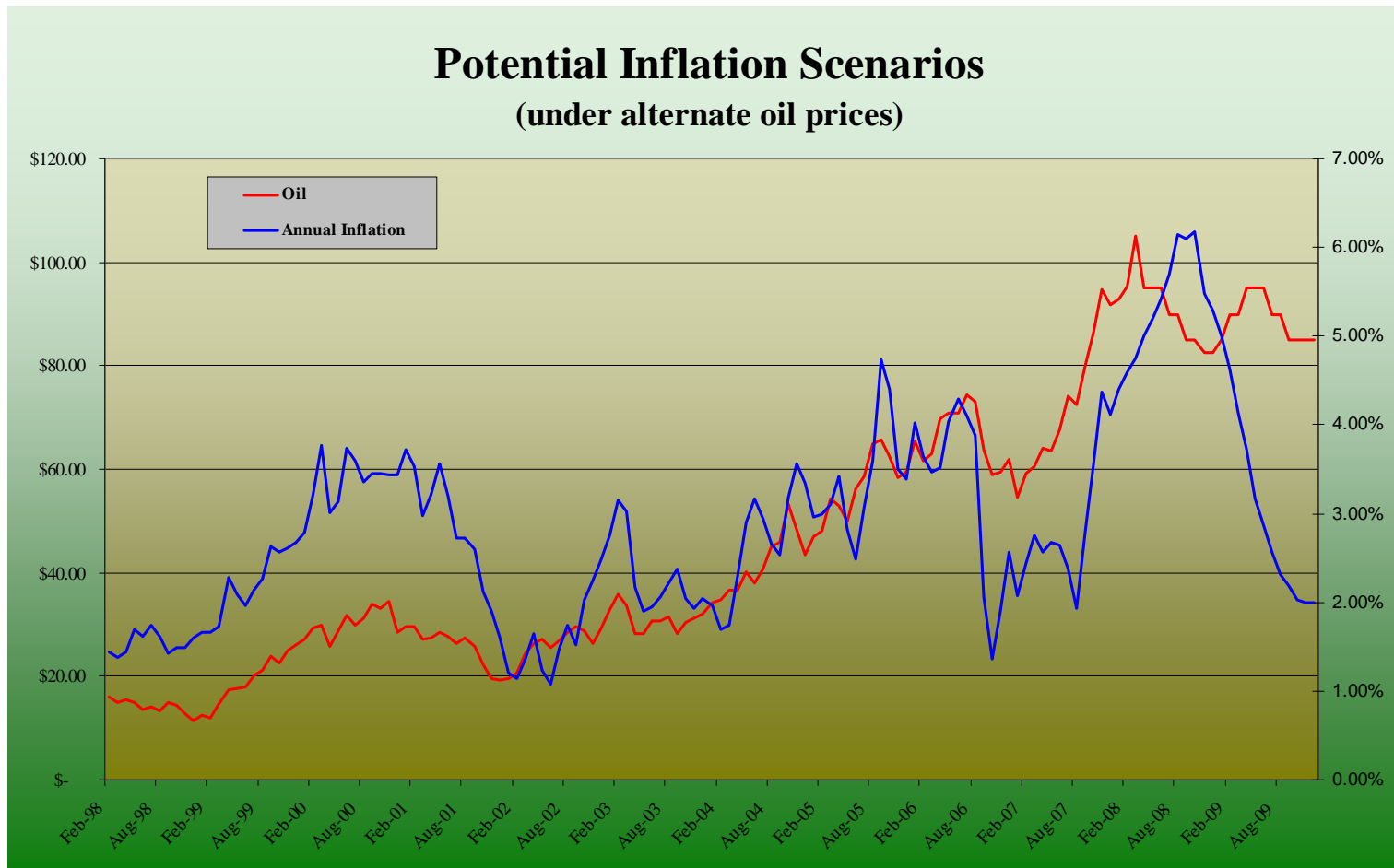
As illustrated by the previous charts, we feel the price of petroleum is divorced from its fundamental value and the commodity is trading higher primarily due to weakness in the dollar.

Therefore, let's review possible inflation rates under a different set of assumptions:

- if the price of a barrel of oil peaks this month with a month-end price near \$105 and subsequently trades in a seasonal range between \$95 and \$82.50 per barrel
- use the current year over year CPI ex Food and Energy as a static base for non-petroleum inflation (2.47%)
- weight energy inflation at 7.26% of the CPI index and the non-energy portion at the remainder
- calculate inflation at a weighted average of energy and non-energy using the predicted year over year change in energy prices and the static CPI ex Food / Energy value

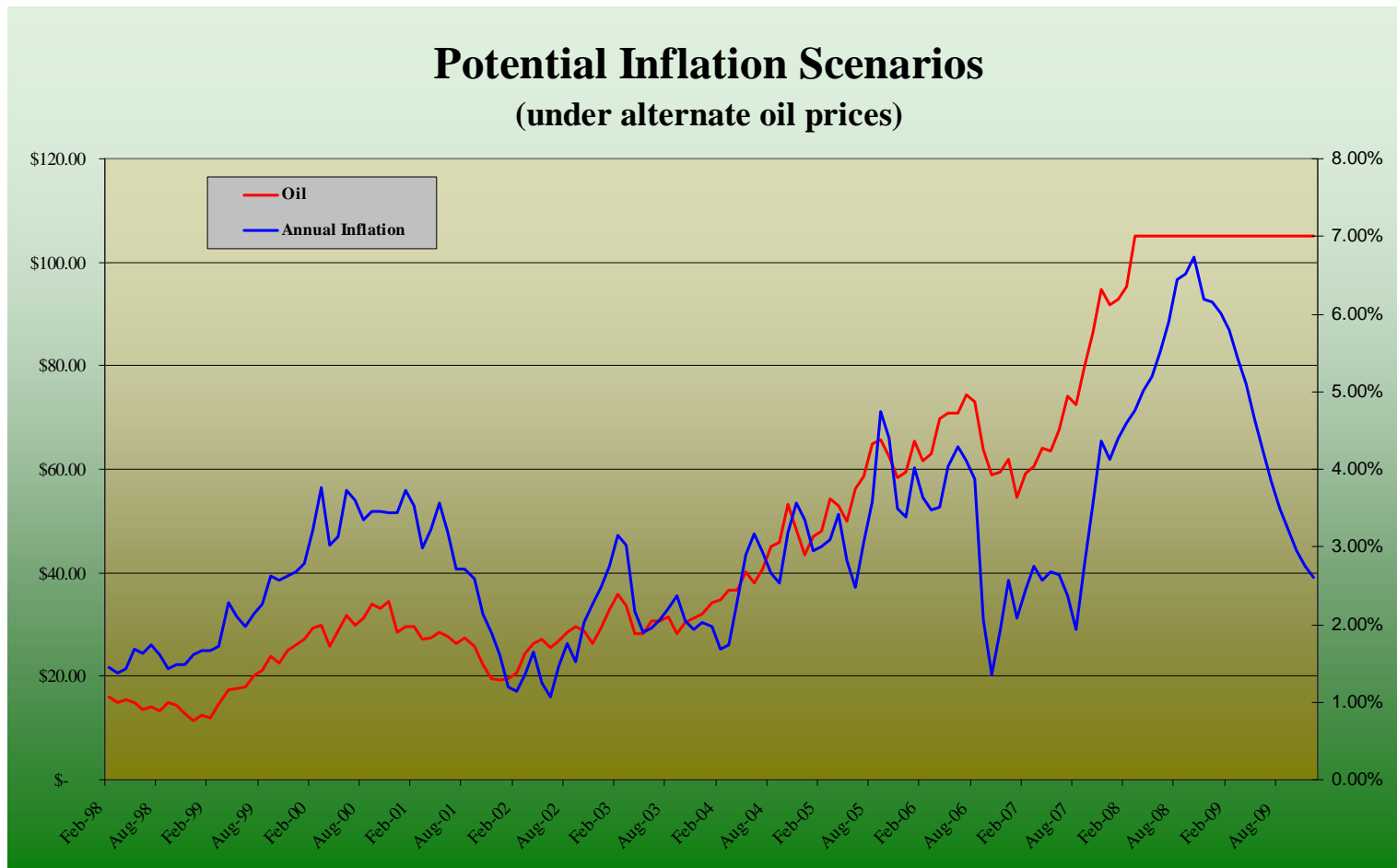
We learned during the aftermath of Hurricane Katrina that the market can discount certain price increases as temporary even as the year over year inflation numbers look challenging. While we hold the opinion that inflation is likely higher than is being measured, this realization is likely to be made *after* the period of time presented in the following analysis.

Inflation expectations –what could go right?



Under our described scenario, inflation becomes more reasonable after the “bump” for energy prices moves through. Annual change in CPI declines to around 2% as the energy component reduces pressure on the remainder of the index.

Inflation expectations –what could go right?



Even under a scenario where oil remains at \$105 per barrel, year over year CPI begins to decline after the oil price spike has worked its way through.

What could go right?

While we believe oil to be fundamentally over-valued, what will be the factor that changes the price momentum of the commodity?

The US dollar...

If there are changes in expectations with respect to Federal Reserve policy, that could strengthen the dollar from what we believe to be an over-sold position.

A dollar rally could lead to a decline in the price of oil since it is currently being partially used as a store of value (one of money's inherent definitions, but one where the United States dollar is failing its test).

This, in turn, provides the decline in inflation expectations detailed in the charts above using our potential scenarios.

The result...

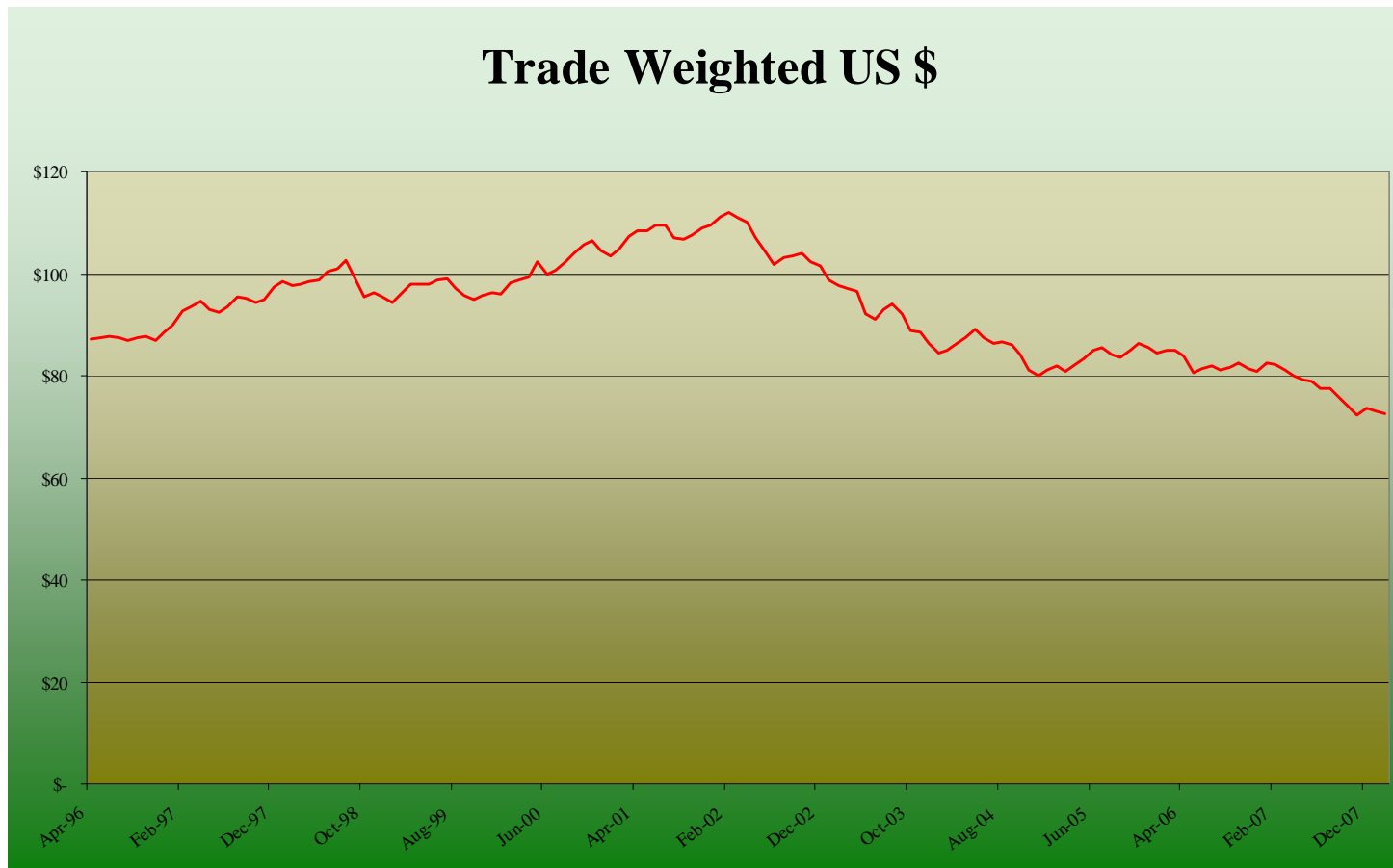
The repatriation of US dollars as domestic and international investors sell hard assets and commodities from both international and emerging markets and re-invest those assets in the United States equity markets.

The long-term effect?

While this is an appealing scenario to us as an investment firm based in the United States, we do not anticipate this being a long-term phenomenon. In essence, the dollar will rally from its over-sold position and the markets will re-orient towards the US for the near-term.

But, until some permanent steps are taken to return fiscal and monetary policy in the United States to positions of strength, there will likely be no reason to strategically over-weight our economy relative to others.

What could go right?



Thus far in 2008, the Federal Reserve has not acted like it is concerned about the sinking value of the dollar. But, it may be in the interest of other central banks to lower rates which could serve as the stimulus needed to strengthen the dollar.

What could go right?



Admittedly, the dollar and Fed policy have the deck stacked against them... lower interest rates means lower savings in a country that is already a “spender” not a “saver”. This chart also incorporates the real rate of interest after inflation and indicates it really doesn’t make much sense to save.

What could go right?

Market	Last	YTD	1 Yr	3 Yr	5 Yr	10 Yr
USA	1,210.000	-13.010%	-7.760%	2.690%	8.340%	1.580%
IRELAND	392.868	-11.070%	-28.230%	1.090%	12.680%	0.210%
NEW ZEALAND	133.636	-13.150%	-6.380%	-2.720%	12.880%	1.920%
UNITED KINGDOM	1,342.163	-15.770%	-9.960%	4.020%	12.900%	1.040%
JAPAN	2,703.446	-10.910%	-17.200%	3.130%	13.200%	1.790%
ITALY	554.664	-15.050%	-9.600%	3.000%	15.000%	3.630%
NETHERLANDS	2,546.942	-12.850%	0.850%	11.520%	17.770%	2.130%

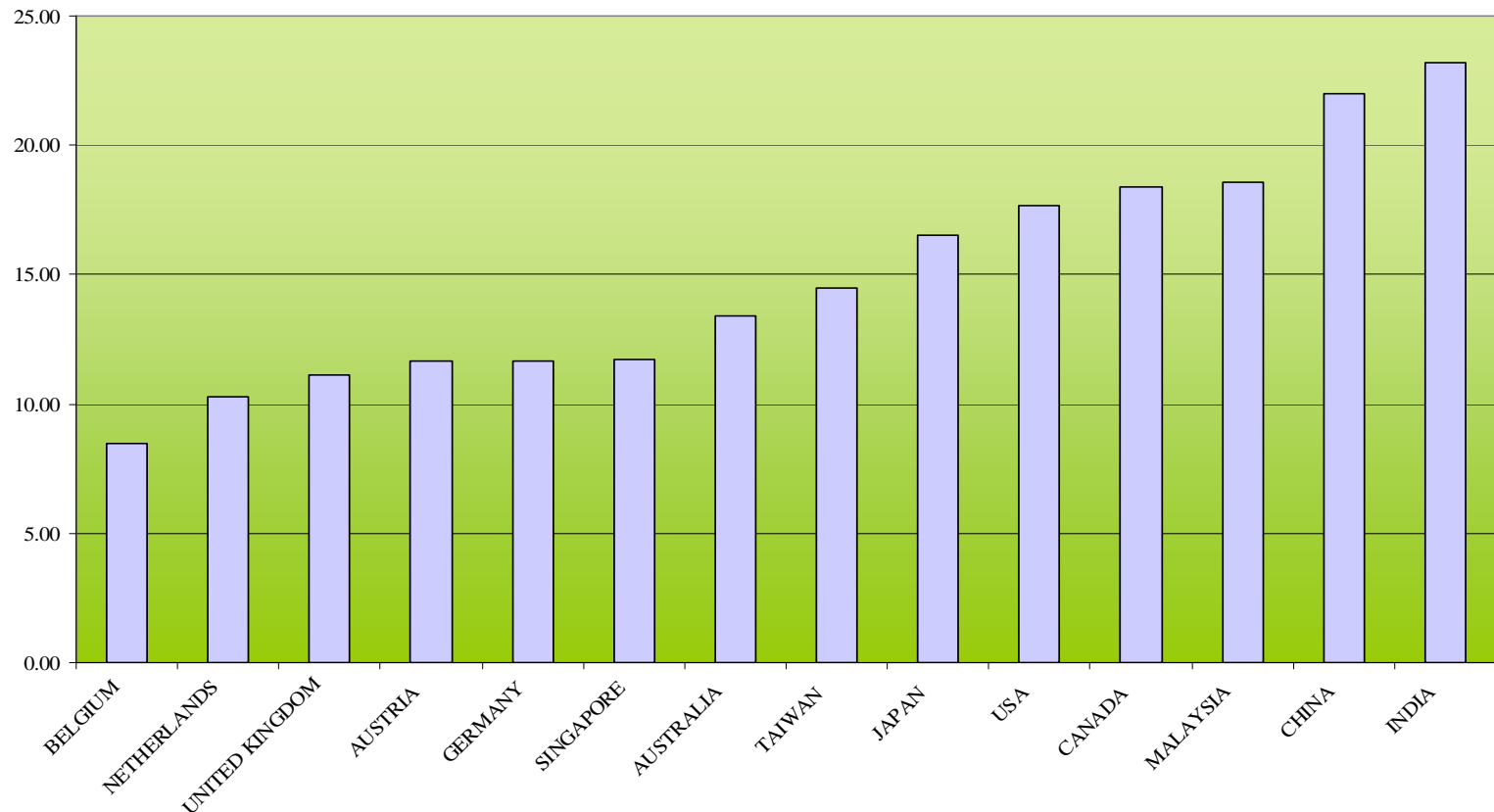
Of developed markets, the United States has the lowest annualized five year returns (as measured in US dollars).

Data provided by MSCI.

What could go right?

Relative Country Price Earnings Ratio

(based on trailing 12 months)



While the US resides at the top of the range for developed markets, the market PE is well below that of emerging economies.

This lends further credence to the idea that investors will repatriate funds.

Data provided by Standard & Poors.

What could go wrong?

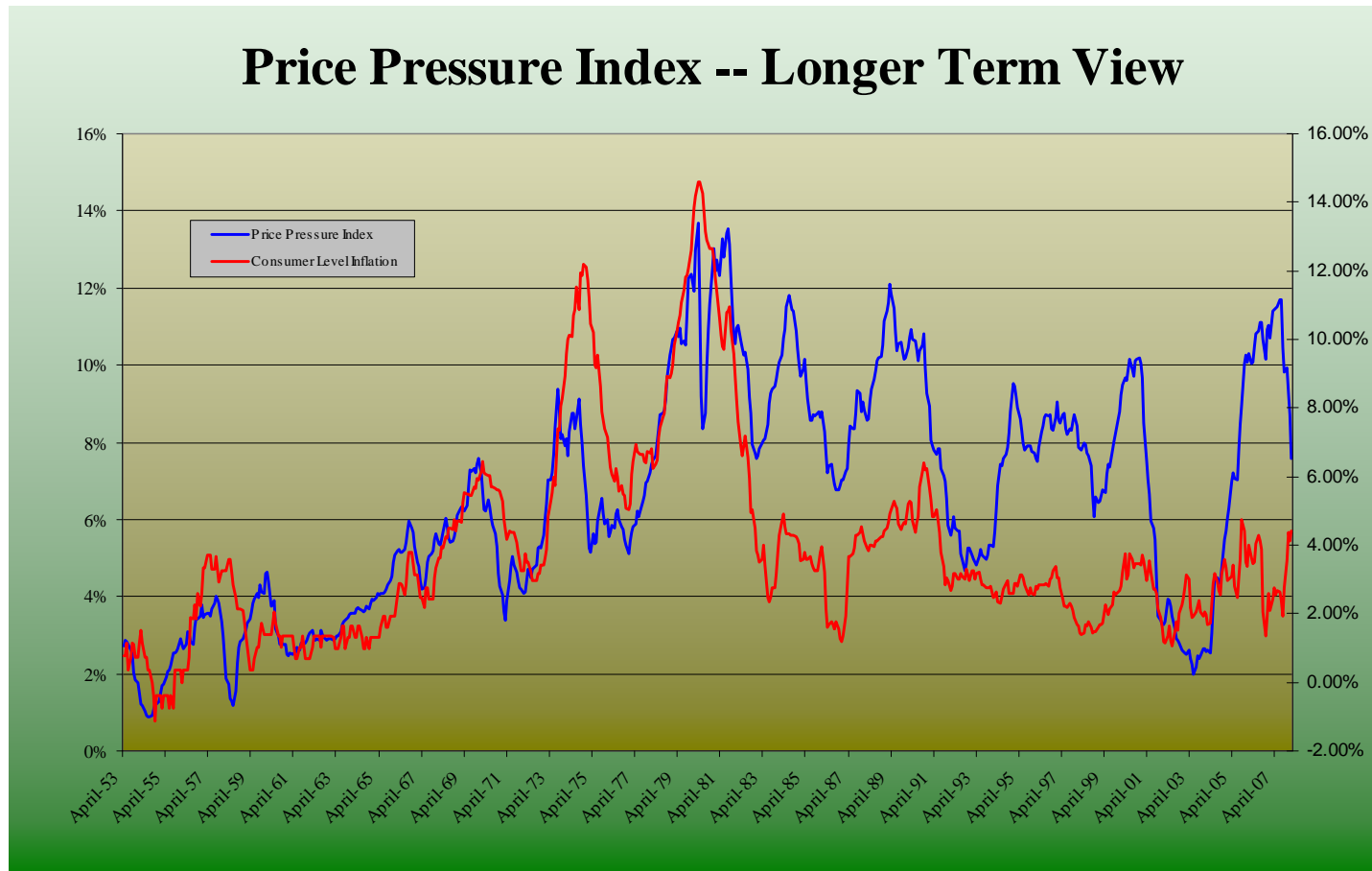
The biggest potential challenge facing the US economy is inflation. We feel there remain price pressures on US consumers as inflation is under-reported by present measurement standards, and there is also significant threat of inflation expectations becoming un-moored.

In previous Chartbooks, we have demonstrated that the market price / earnings ratio tends to be constrained by the inflation rate.

With earnings likely contracting due to financial write-offs and the high probability we are already in recession, the price component of the ratio is under pressure from both inflation and lower earnings.

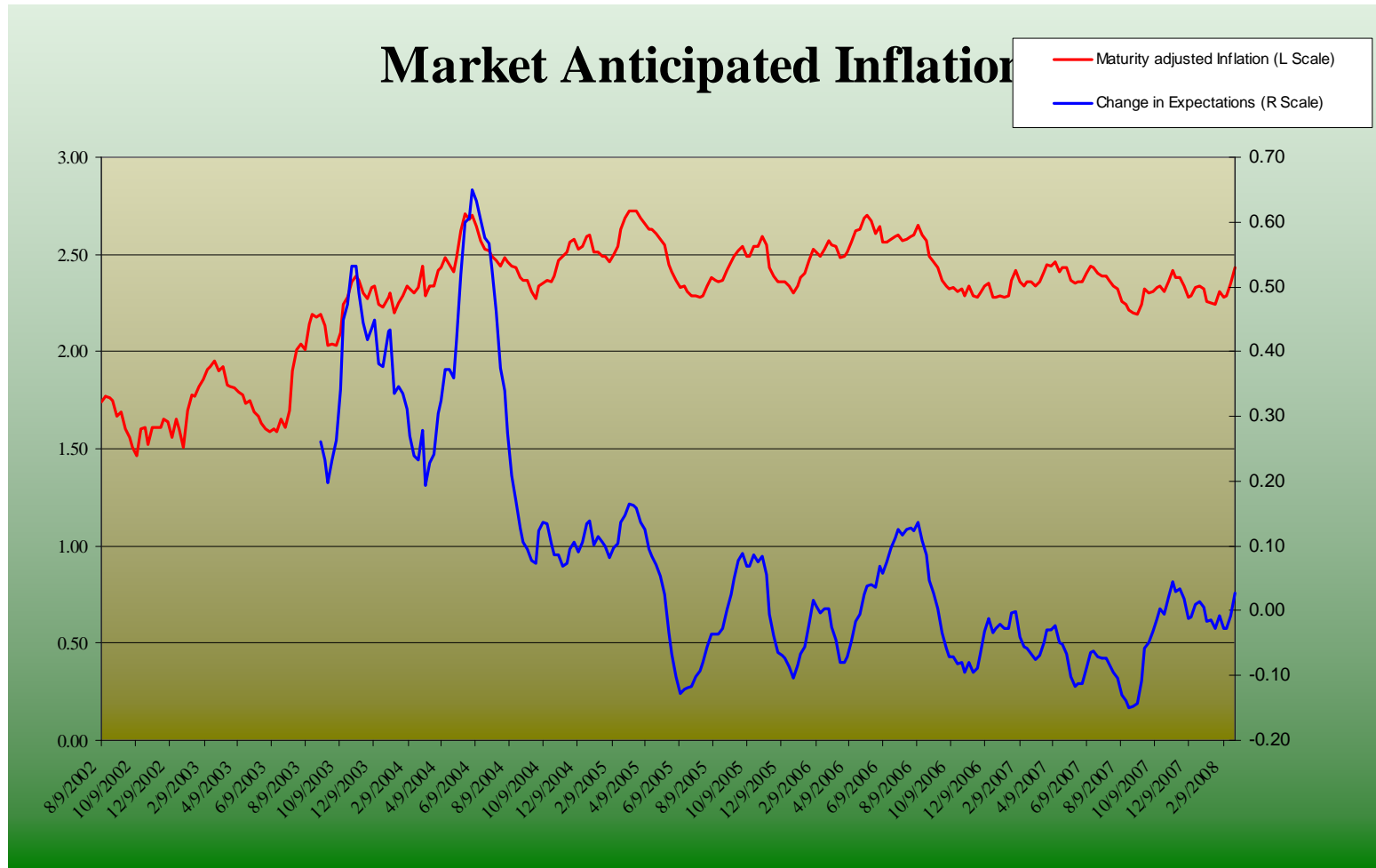
That means lower returns for the US market.

What could go wrong?



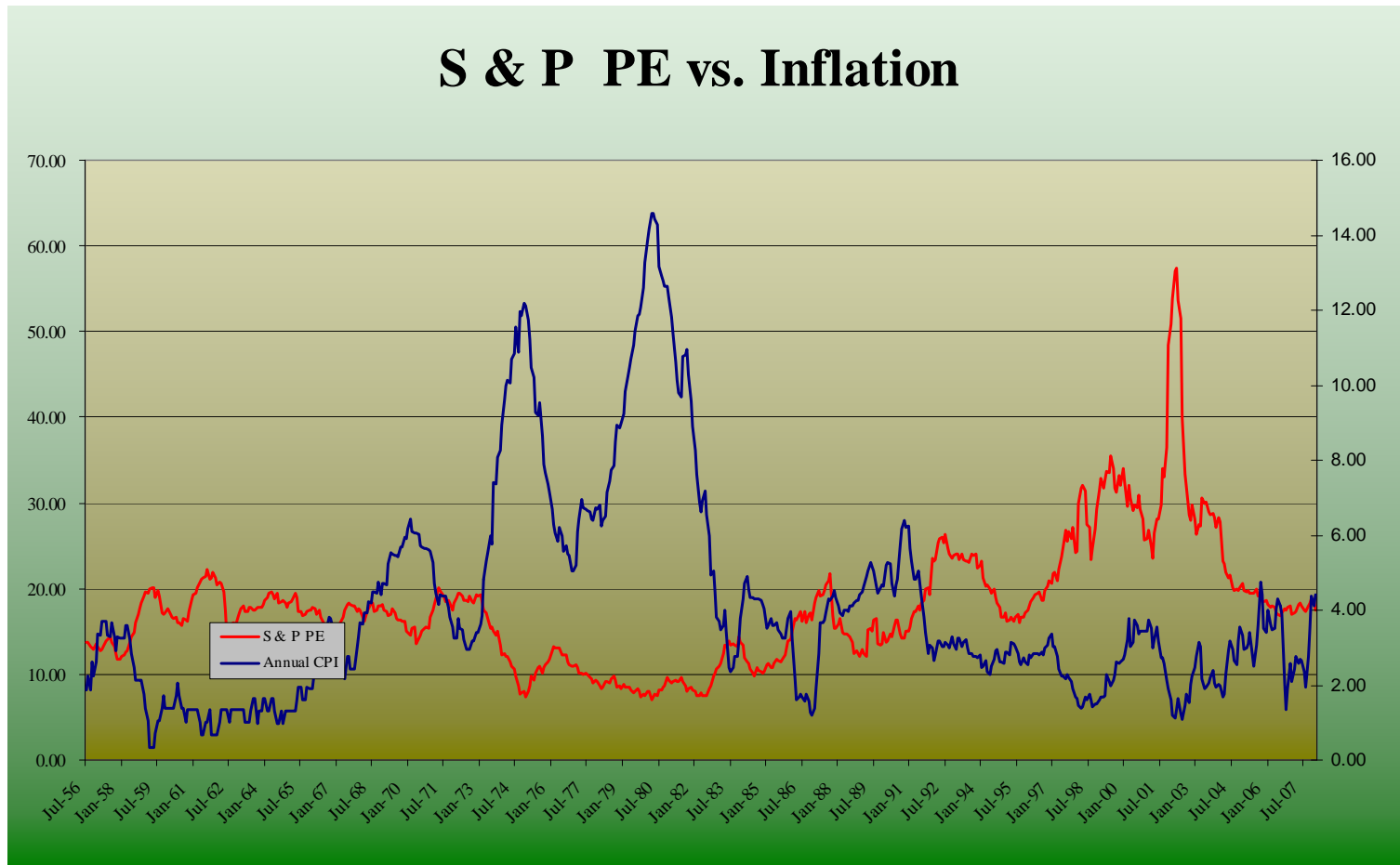
We feel there remain pressures on prices as measured by our proprietary model. The recent decline is primarily due to a lowering of interest rates, but reasonable strength in the US economy as measured by available capacity indicate continued potential increases in inflation.

What could go wrong?



The market still does not anticipate any long-term effects of the Federal Reserve's monetary policy. If there were to be a sustained increase in inflation measures that was unexpected (as would be indicated by this graph), there could be confusion and turmoil in the markets.

What could go wrong?



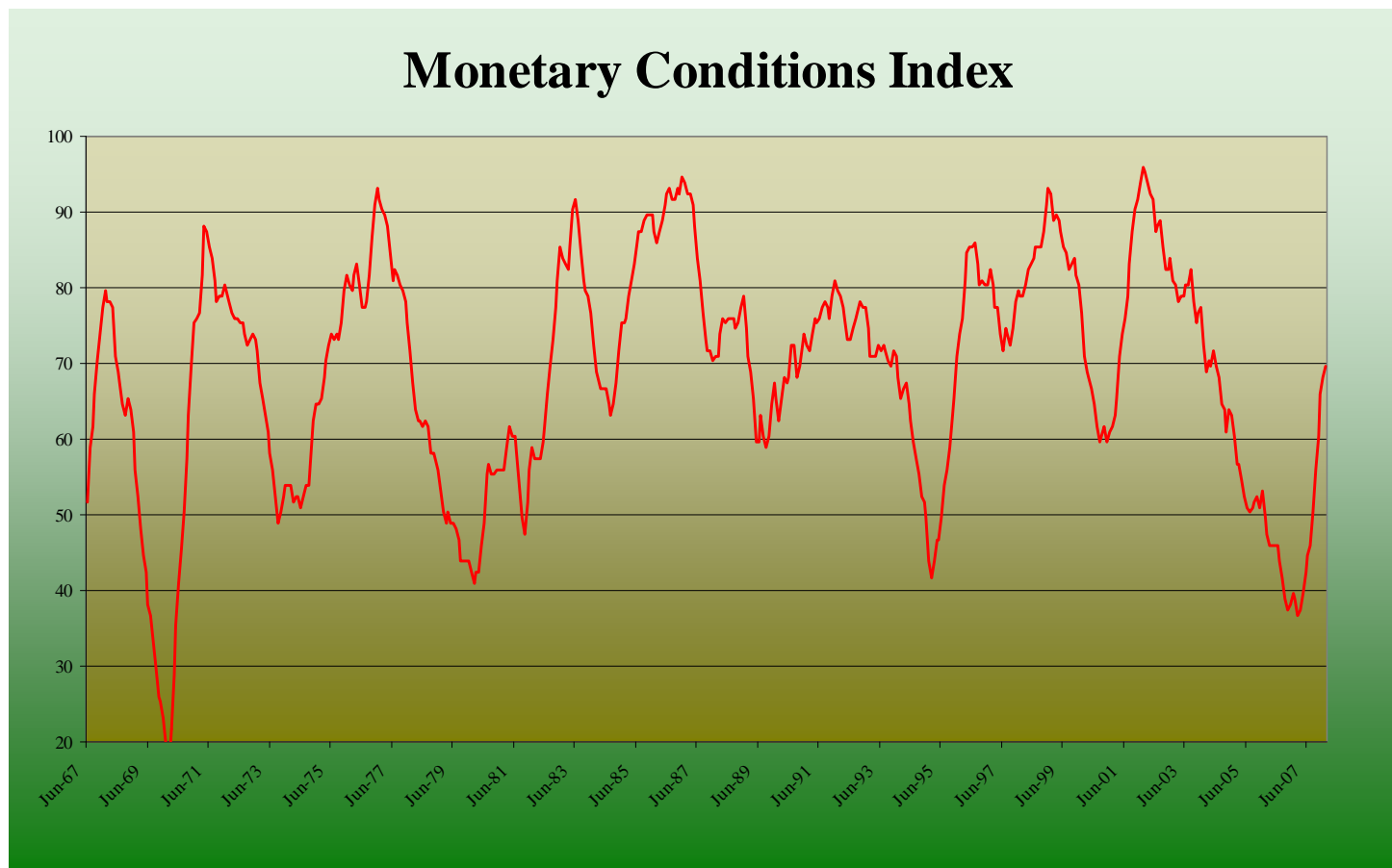
Higher inflation results in a lower PE for the market. If earnings are declining, then the PE will be forced to contract *ceteris paribus*. If earnings are contracting, then Price is the part of this equation that will be forced to move.

What could go wrong?



Earnings have declined slightly, and price has followed suit. The PE has measured only a slight decline from slightly below 19x to 17.5x as of the end of February.

What could go wrong?



Again, though, much of our thesis about what could go right is dependent upon a rally in the US dollar. Given expansionary monetary policy, this rally not occurring should also be mentioned as we review what could go wrong.

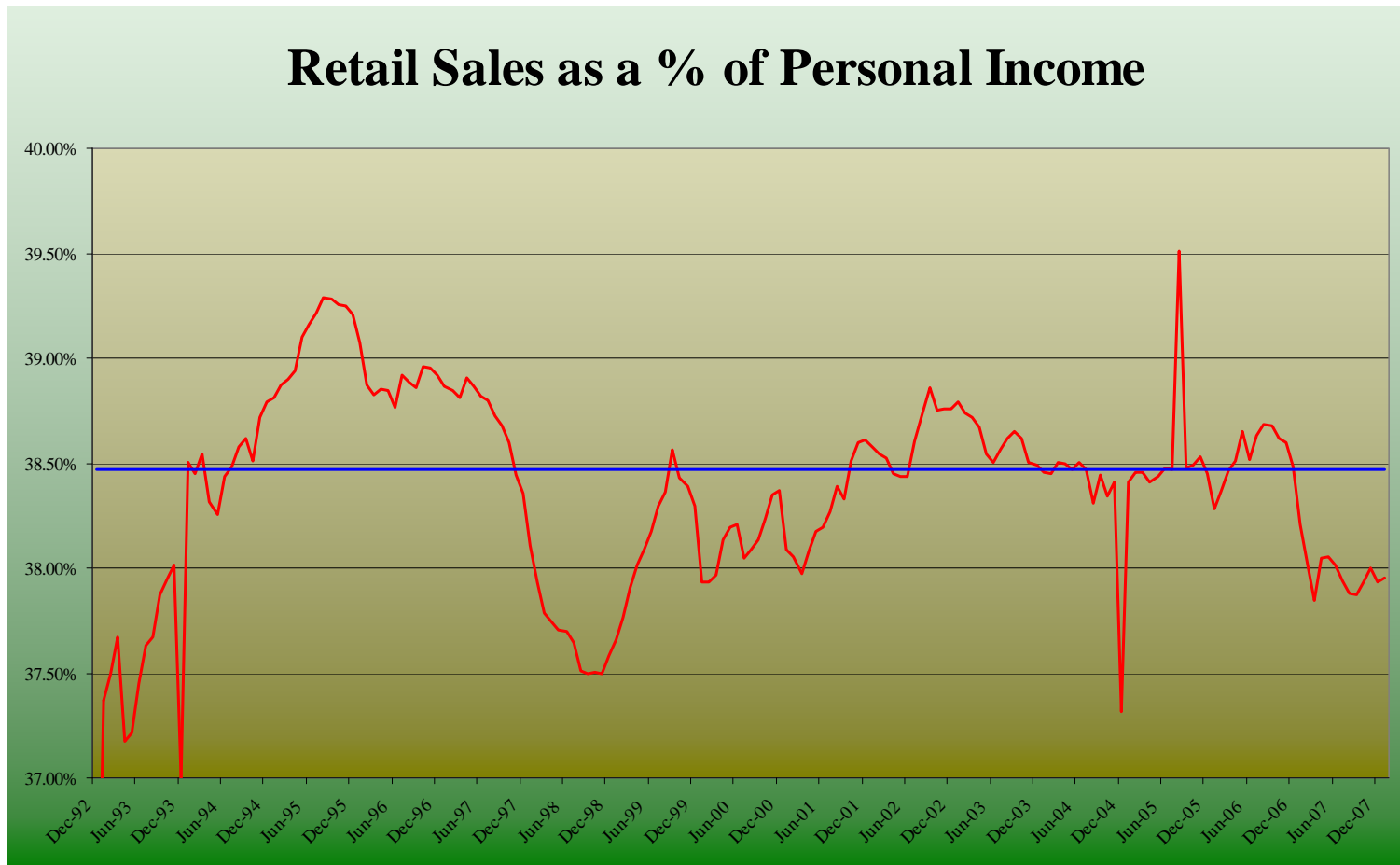
Summary

The United States markets have under-performed their peers and could see a re-bounce in the intermediate-term. That rebound will likely be due to a rally in the US dollar from an over-sold position. Factors that could lead to this rally include a return in the price of oil to its fundamentals or action by other central banks (or inaction by ours).

However, even without a decline in the price of oil, inflation expectations may remain in-line as the petroleum component of the CPI experiences year over year stagnation.

Inflation, though, is the key. If there is an unanticipated increase in this measure, there could be additional volatility ahead for US markets – especially as company earnings contract.

Review & outlook



Retailers are already in recession relative to the recent past, and company earnings are likely to follow. In our opinion, we are already in a recession.

How have we done with our predictions?

Index	Forecast for 2008	Notes (provided during year end review)	Current
S&P 500 Earnings	\$70	Negative earnings from financials will impact this.	\$78.61
Inflation (all Urban)	4.05%	Consumers will feel the pain, but it won't reach a crisis point. Lower oil prices will help.	4.4%
Employment	4.9%	Not as strong as past years; not as weak as anticipated by market pundits.	4.8%
Fed Funds	3.75%	Two more small cuts is all the Fed can stand as they begin to consider the devaluation of the dollar (and their credibility on the world stage).	3.0%
Oil	\$85	Will continue to be seen as a store of value, but its price will begin to wane by the end of the year.	\$95.35
S&P 500	\$1400	This will be a volatile year with a lot of buying opportunities on dips; the US economy muddles through its problems and is on better ground by end of the year.	\$1330
Ten Year Treas.	4.25%	No calamities as foreign buying keeps this range-bound as the dollar rebounds in strength.	3.74%

What might the next 18 months look like?

Just for fun, let's consider what the next year and a half could offer; these are not predictions, but they are based on some macro-thematic trends we believe have reasonable probabilities.

Summer 2008 – After declining from its peak to bear market levels, the US market experiences a rebound as the data indicate the housing market is no longer in decline in most of the US and economists conclude the recession will be short and shallow.

In conjunction with this, the dollar rallies and US investors (as well as intrepid overseas investors) begin to repatriate funds from other markets. The result is a sharp rebound in US markets through the fall of the year.

What might the next 18 months look like?

Fall 2008 – In the fall of the year, though, inflation begins to weigh heavily on the minds of investors. Several data points begin to supplement the anecdotal evidence of higher than expected inflation and pundits really begin to discuss the concept of stagflation.

Interest rates rise beginning in November, a combination of the market responding to possible inflation threats and the Federal Reserve “taking the punch bowl away” as they try to restore their credibility in world markets.

Late spring 2009 – After a strong correction that tests (and possibly exceeds) the lows set in the summer of 2008, the market begins to factor in higher inflation and higher interest rates. Because many sectors of the market have fundamentally weathered the storm so well due to international demand for their products or services, investors begin returning to the equity markets. A near-term low has been set and will not be tested for some time.

Late 2009 – Interest rates finally reach their peak as inflation has been tamed by relatively aggressive action by the Federal Reserve. Baby boomers seeking higher yields during retirement have a once in their lifetime opportunity to lock in.