

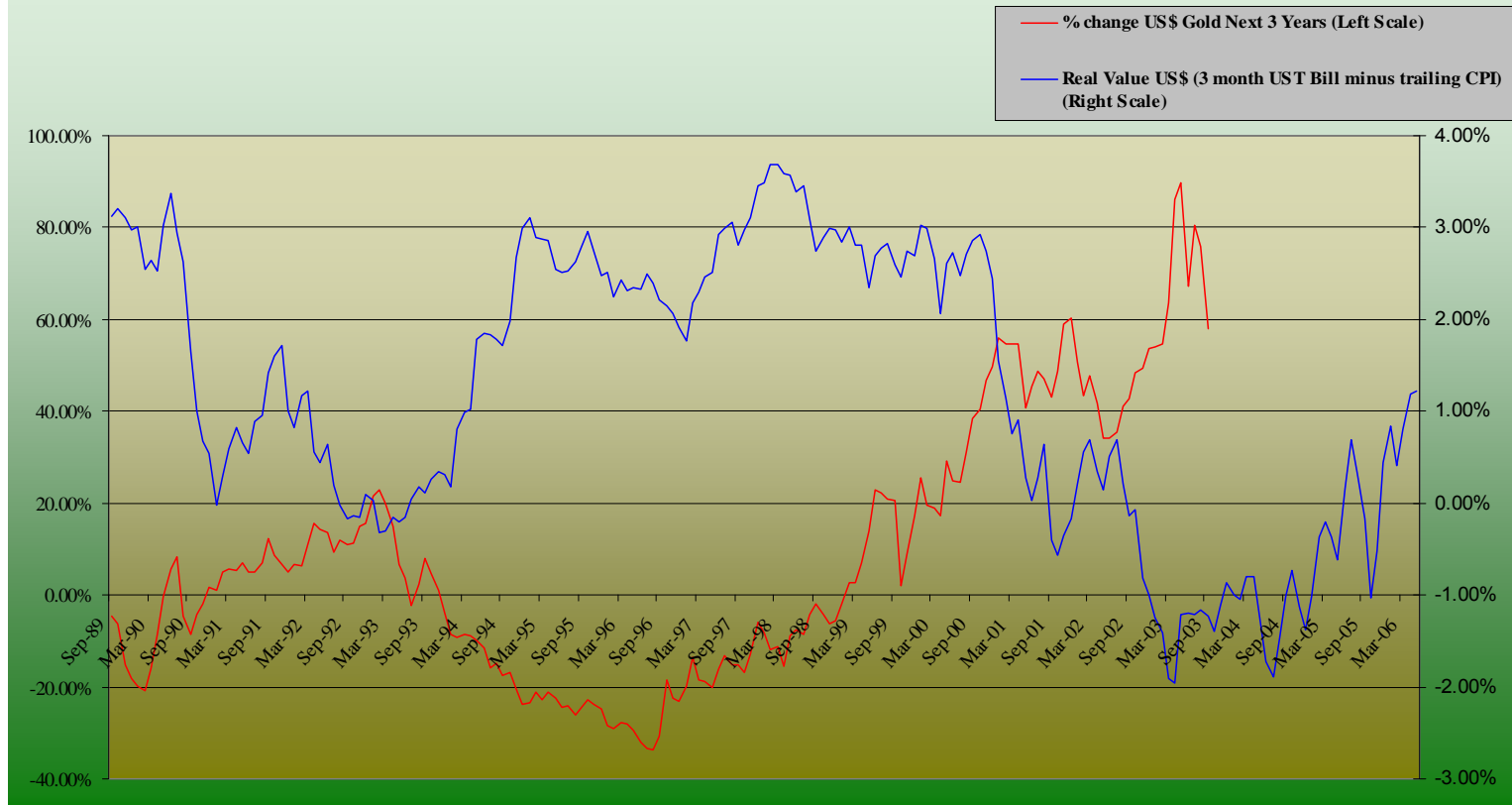
Monthly Chartbook

October 2006

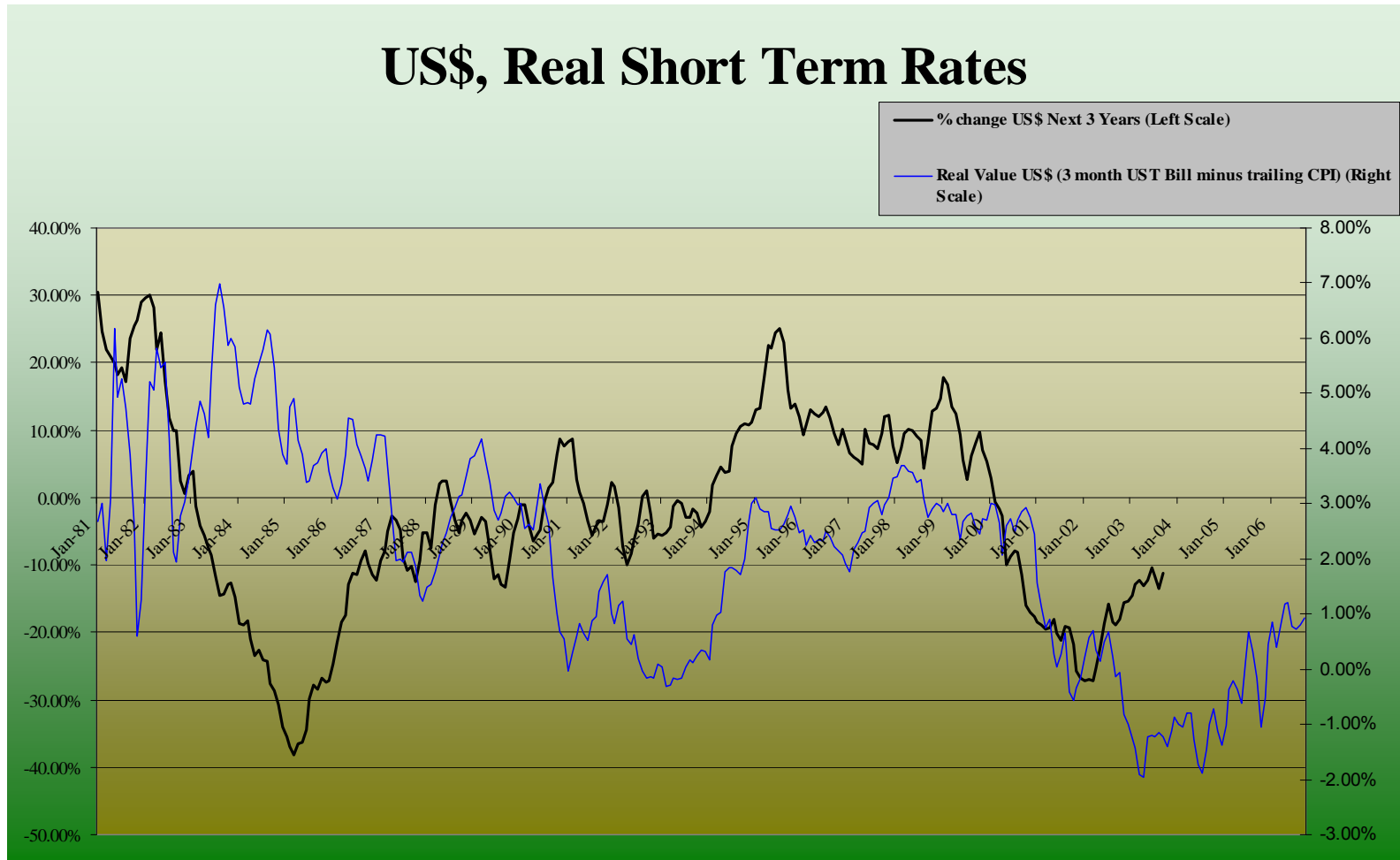
Gold, Interest Rates and the US\$

How the Fed is getting its Mojo Back

Gold, Real Short Term Interest Rates

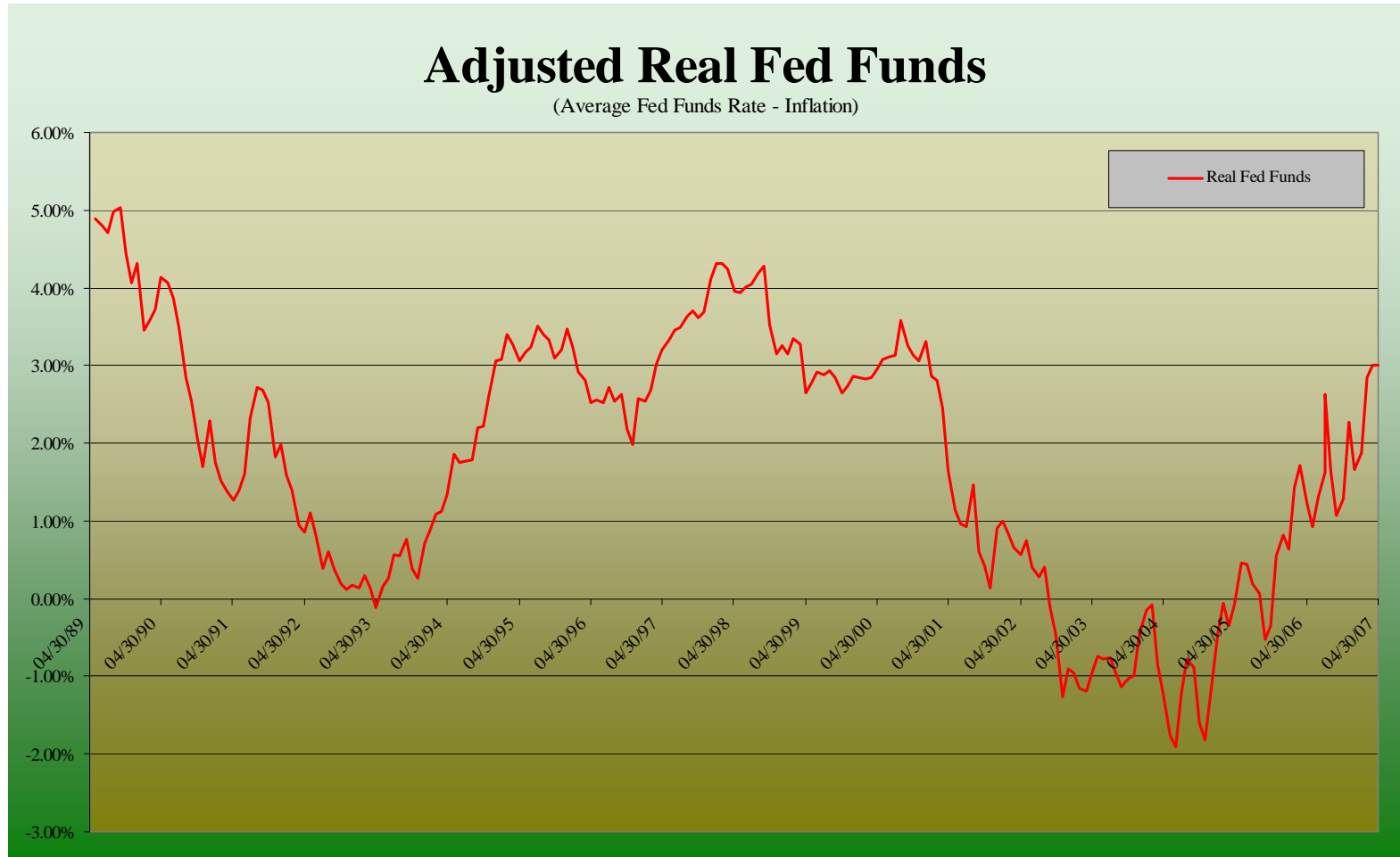


In a world awash in Fiat money, the only real value of the US dollar is the spread it earns on short term US treasury bills above inflation. The Fed's interest rate cuts to avoid a deflationary spiral held rates at negative real returns for an unprecedented amount of time. Negative real rates contributed to sharply higher gold. Only since December 2005 has the spread been positive.



Now that the US\$ has some real yield in short term treasuries, the painful slide in value has abated. The key to Fed rate cuts is lower inflation allowing for normalized real yields.

Macro-economic research



If the Fed leaves the Federal Funds Rate unchanged in the next six months, the Real Fed Funds rate will continue to climb as easing energy prices flow through the CPI. The data presented is based on oil prices static at \$70 a barrel for West Texas Intermediate.

Macro-economic research

Consider that from May 16, 2000 until June 25, 2003 as the Federal Reserve was cutting the Federal Funds rate from 6.25% to 1%, the S&P 500 *was down -32.63%*

From June 25, 2003 to June 29, 2006 while the Fed was raising rates the S&P 500 is up 30.50%

Our thesis has been that the Fed has to get some of their policy tools back. In doing so, they have to normalize real interest rates and perhaps risk a recession to do it.

While the moderation in long term treasury yields may seem like a conundrum, it will soften the blow higher short term rates have on housing, lessening the chances of a recession.

The rise in real short term interest rates is key to the Fed getting its Mojo back. Without real yield on the front end of the yield curve, the dollar will decline, gold will rise and inflation will get out of hand.

Macro-economic research

Let's see:

Yield curve: Negative

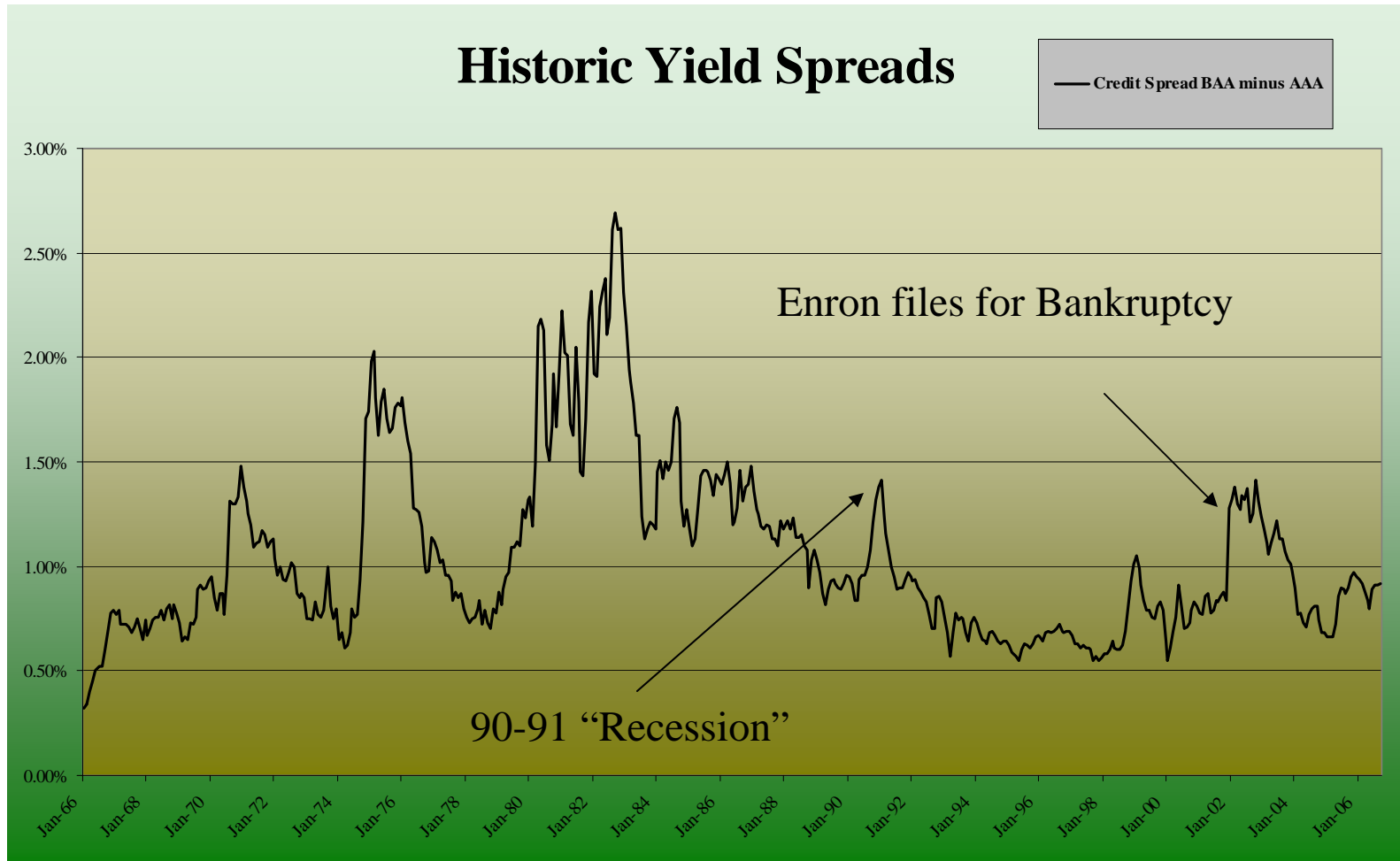
CRB: Peaked ???

Valuations: Historically high

Home Prices: Down but not out...

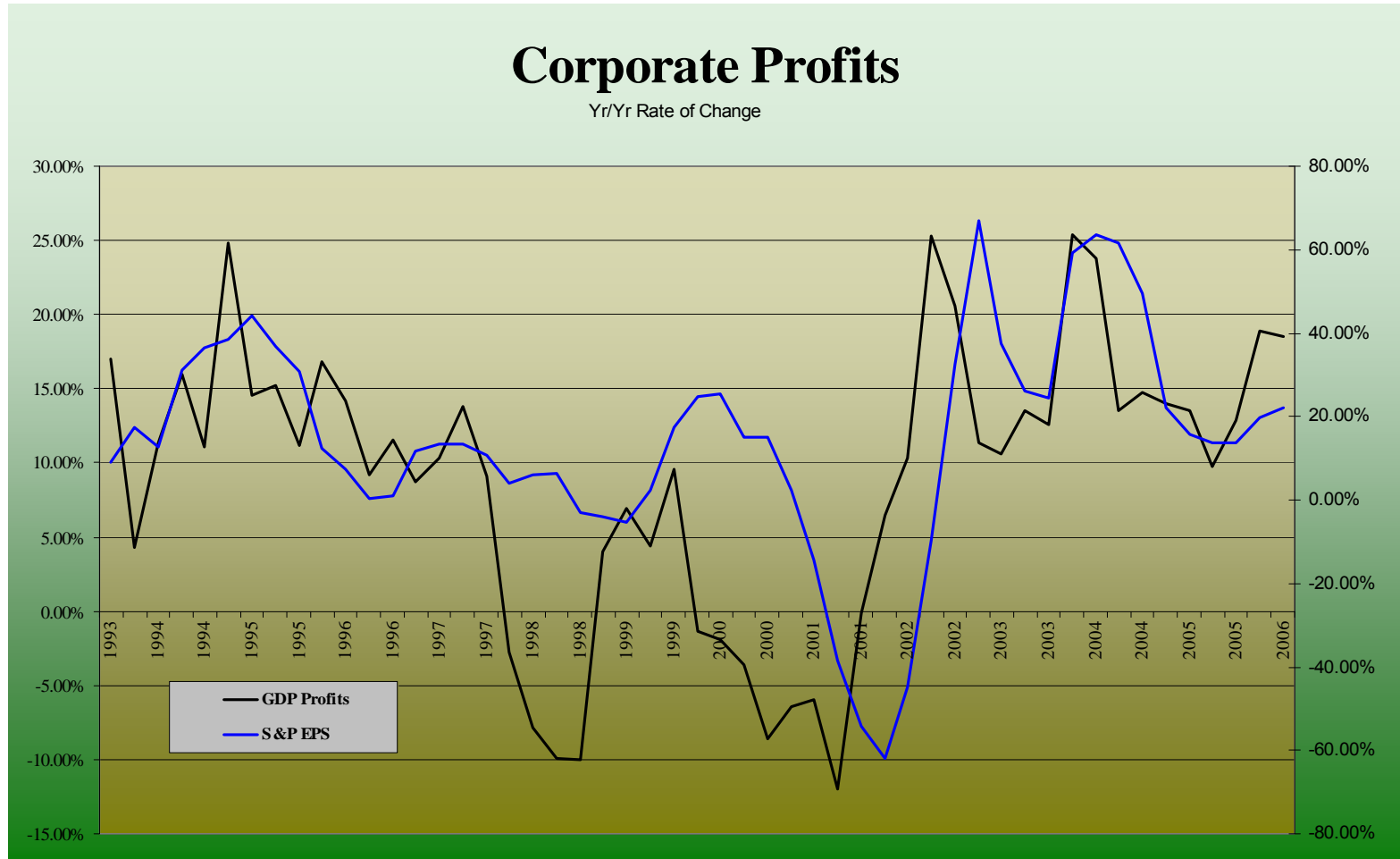
Stock Prices: Hanging in like a champ

Macro-economic research



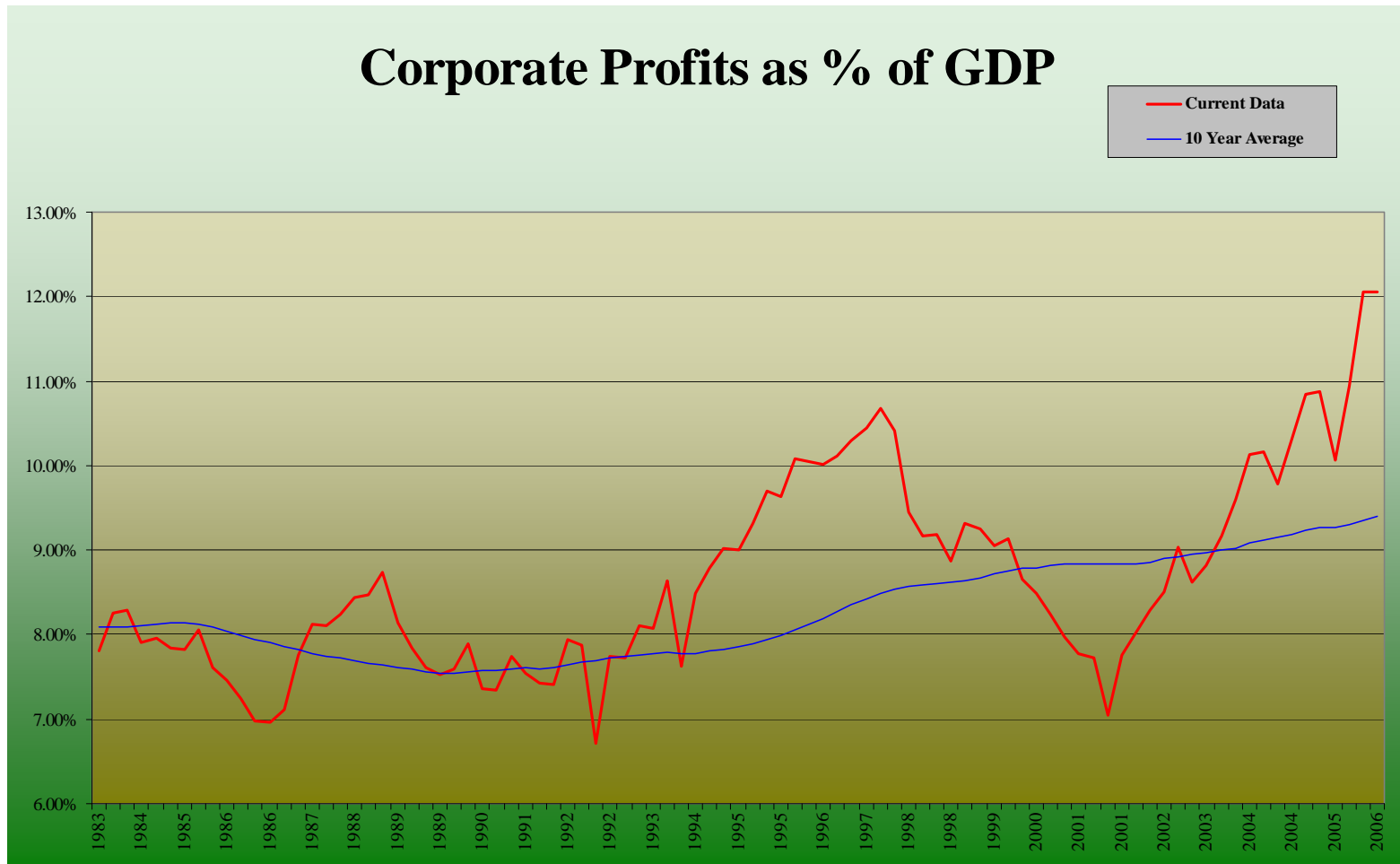
In a leveraged, finance-based economy like the USA, a pop in credit spreads would be a sign of bad things to come. Thankfully this indicator is neutral but bears close watching at this point in the business cycle.

Macro-economic research



Quarterly profit growth has been robust.

Macro-economic research



Profits as a percentage of GDP, nearing a cyclical peak?

Macro-economic research



Labor/Employment conditions are better than the employment situation indicates.

Inflation expectations

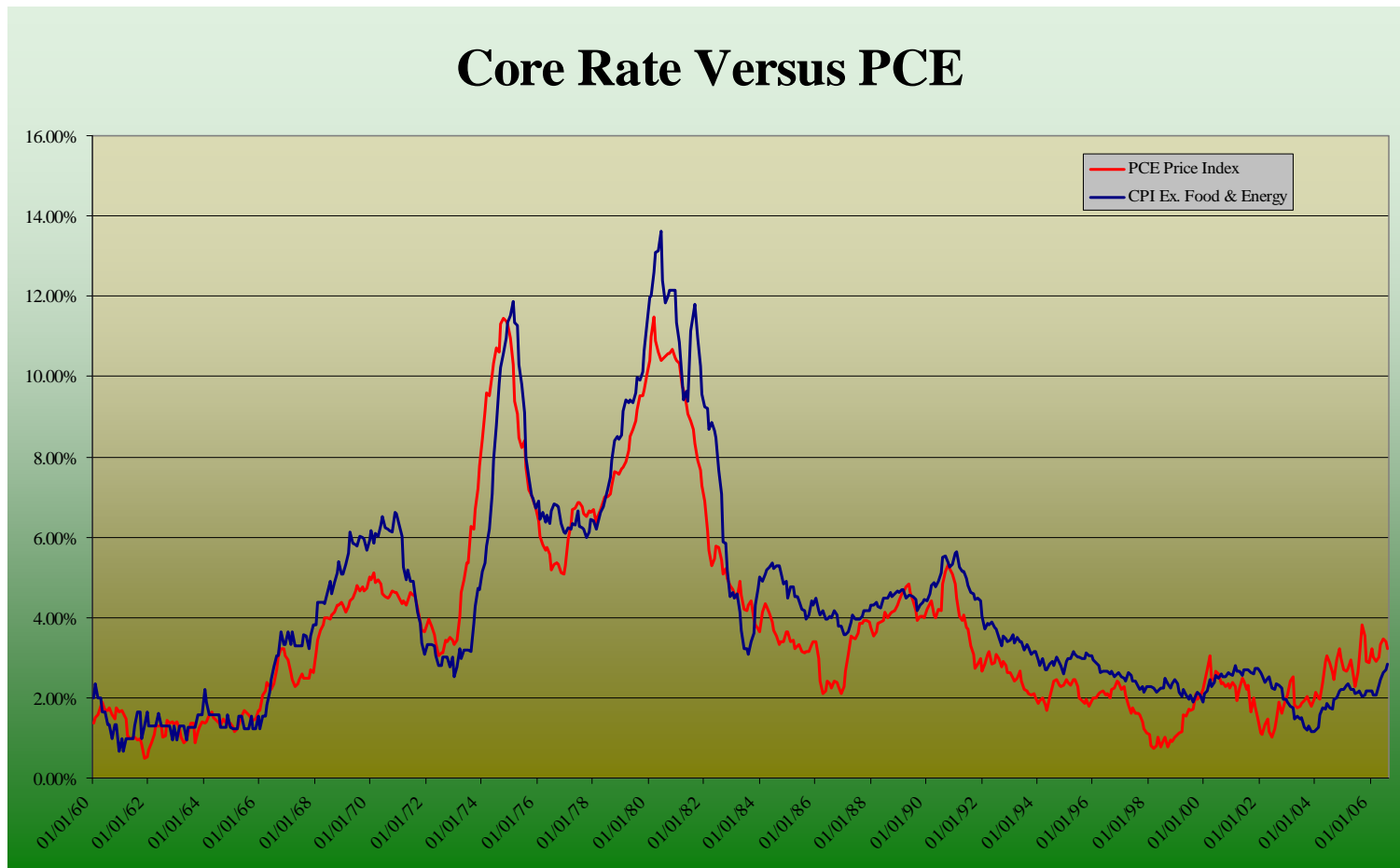
While we believe that headline CPI numbers will moderate along with energy prices, there is a risk that the return of pricing power will leave the core rate moving higher, putting the Fed on defense.

One thing we can all watch is how quickly the domestic airlines scrap the fuel surcharges. They may be tempted to hold onto them as long as they can.

We remain concerned that potential wage inflation may be over-looked by traditional employment measurements as 1099 employees and the self employed are a larger number of the populace than ever before.

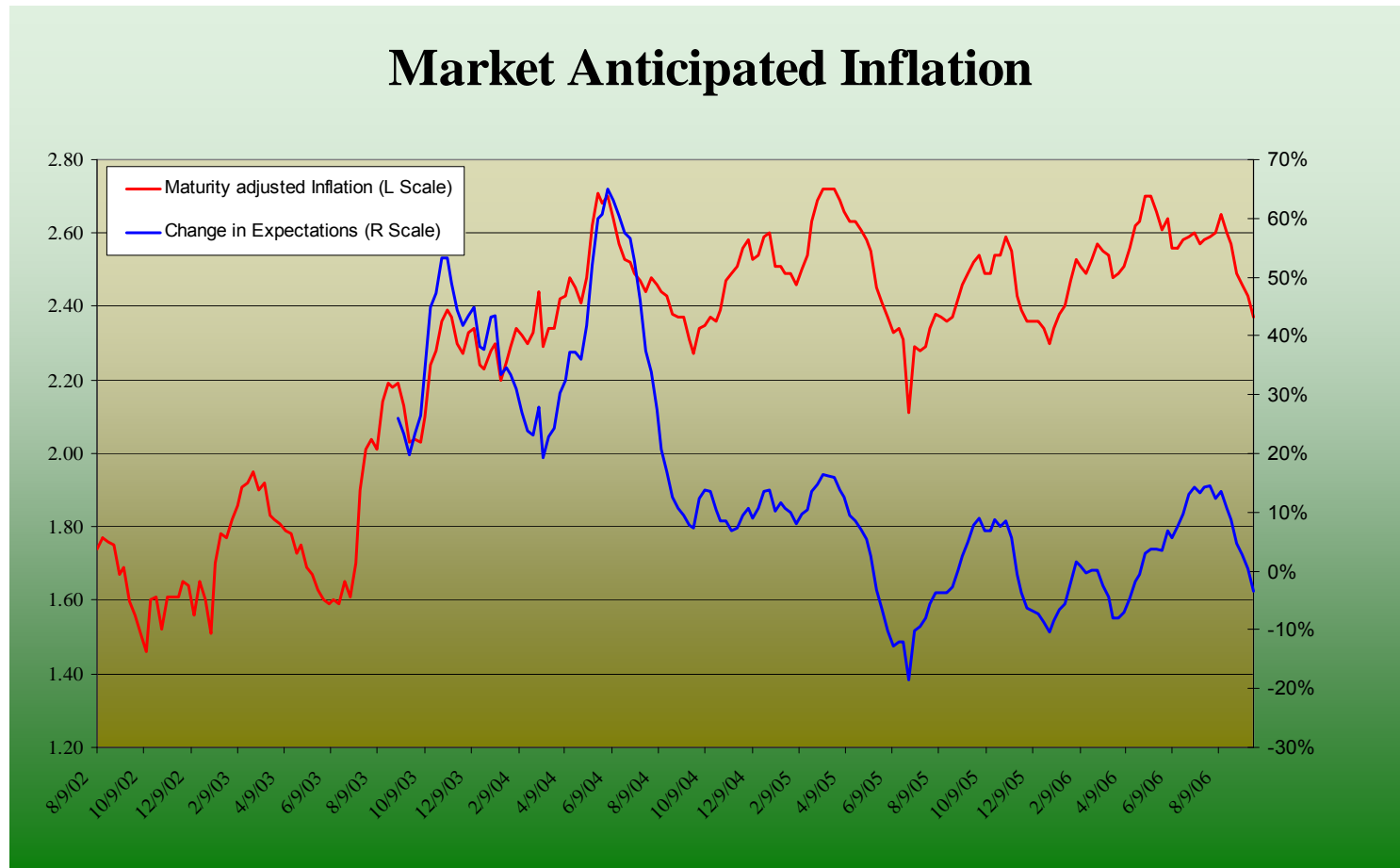
Finally, the PCE index remains above Fed targets and the core rate of inflation.

Inflation expectations



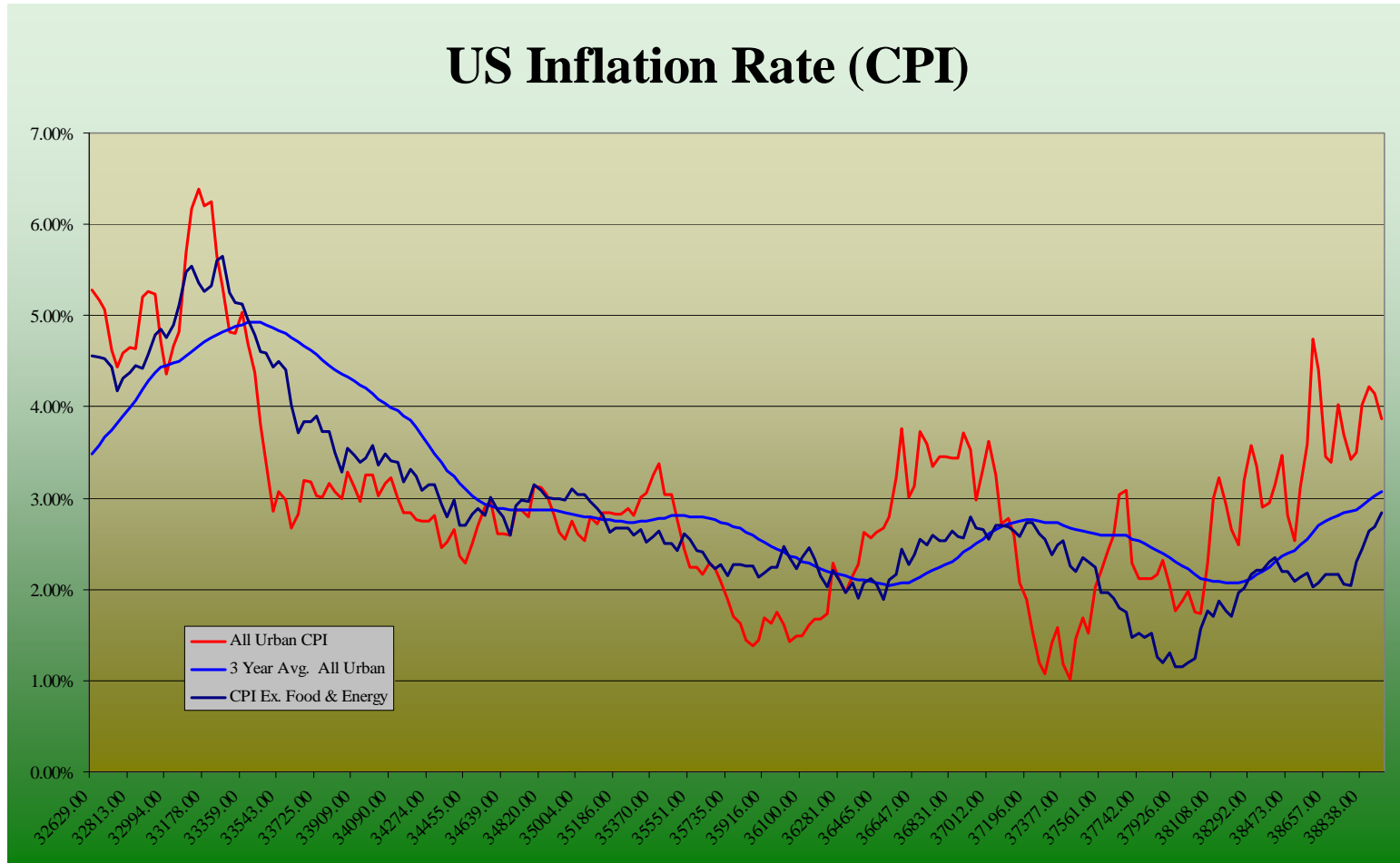
The personal consumption expenditures index remains outside of the Federal Reserve's target of 1-2% for price stability; it is currently up 3.22% yr/yr *and above the core rate of inflation.*

Inflation Expectations



Using TIPS as a guideline, the market anticipates inflation to average 2.37% in the coming ten years.

Inflation Expectations



The core rate of inflation may prove to be more stubborn than the headline All Urban CPI number.

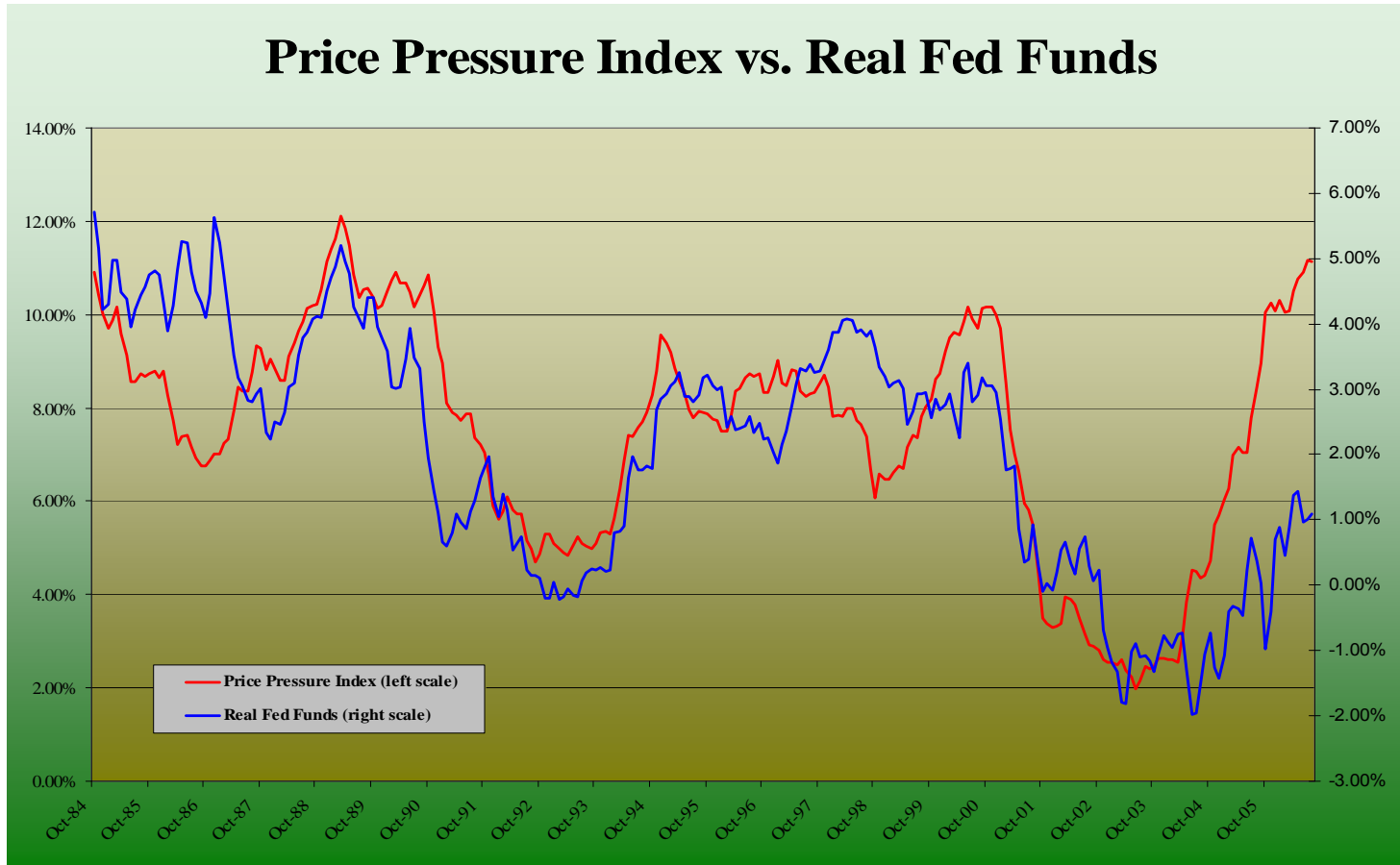
Federal Reserve Watch

After the longest stretch of negative real fed funds in modern financial history, the Fed has been working steadfastly to reel in the huge amount of liquidity created in the last five years. Bottom line, this Fed has refused to monetize rising commodity prices by printing more money.

The real risk to market participants who are expecting a cut in the Federal Funds near term is that low real rates are not the new normal and the Fed will be slow to cut rates even with falling inflation.

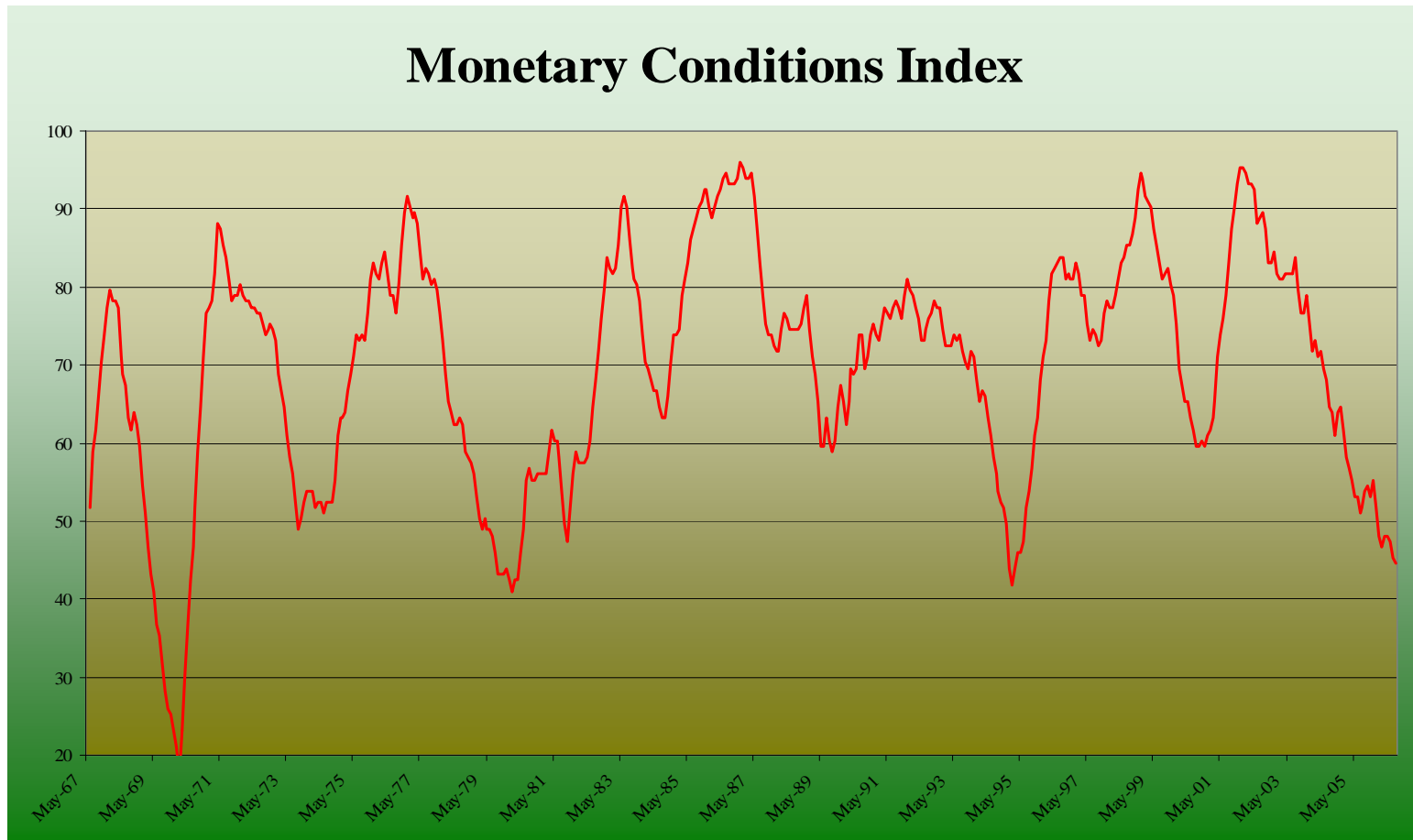
If/when inflation falls, at least the Fed has a few bullets in their gun to cut rates to fight off the next downturn.

Federal Reserve Watch



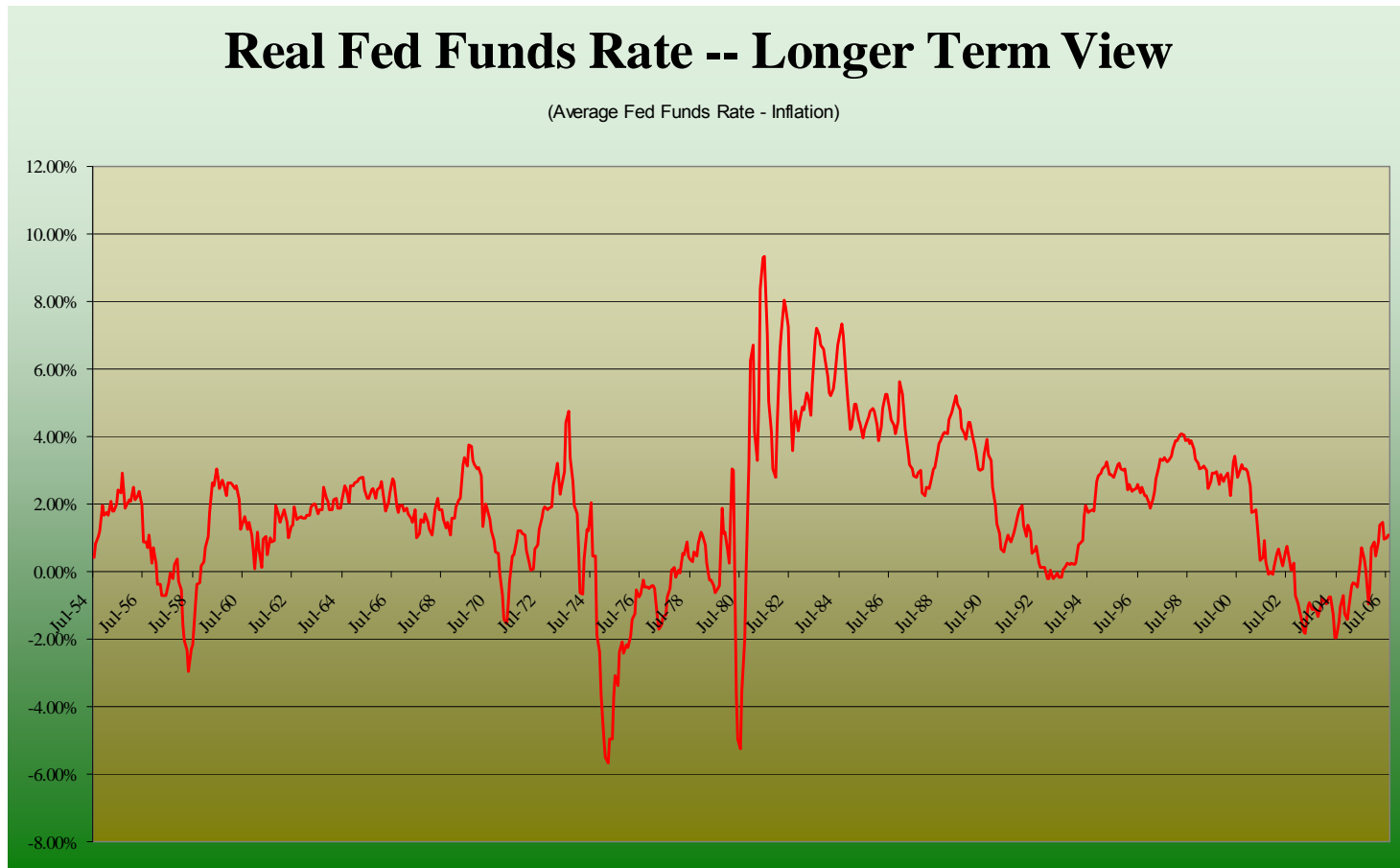
Until this relationship returns to parity, this market might be disappointed with the speed of the rate cuts it anticipates. Perhaps the Fed is done, and the next move is down... but not next month.

Federal Reserve Watch



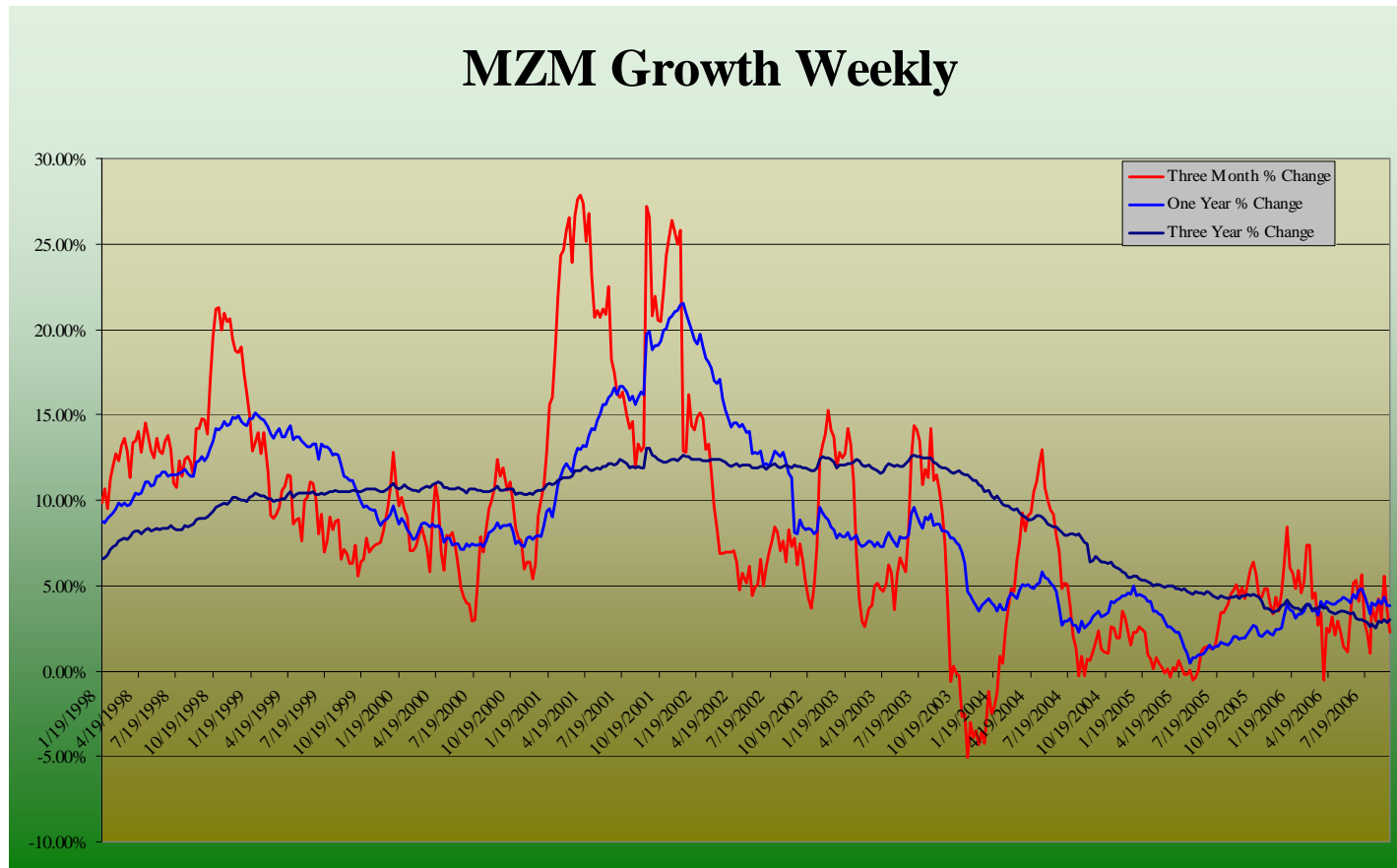
The smoothed Monetary Conditions index continues to slide. Perhaps it will put in a bottom, and it will be off to the races again. Then again, maybe not.

Federal Reserve Watch



Again, if Energy prices continue to abate and the Fed does nothing, real Fed Funds will rise as inflation falls.

Federal Reserve Watch



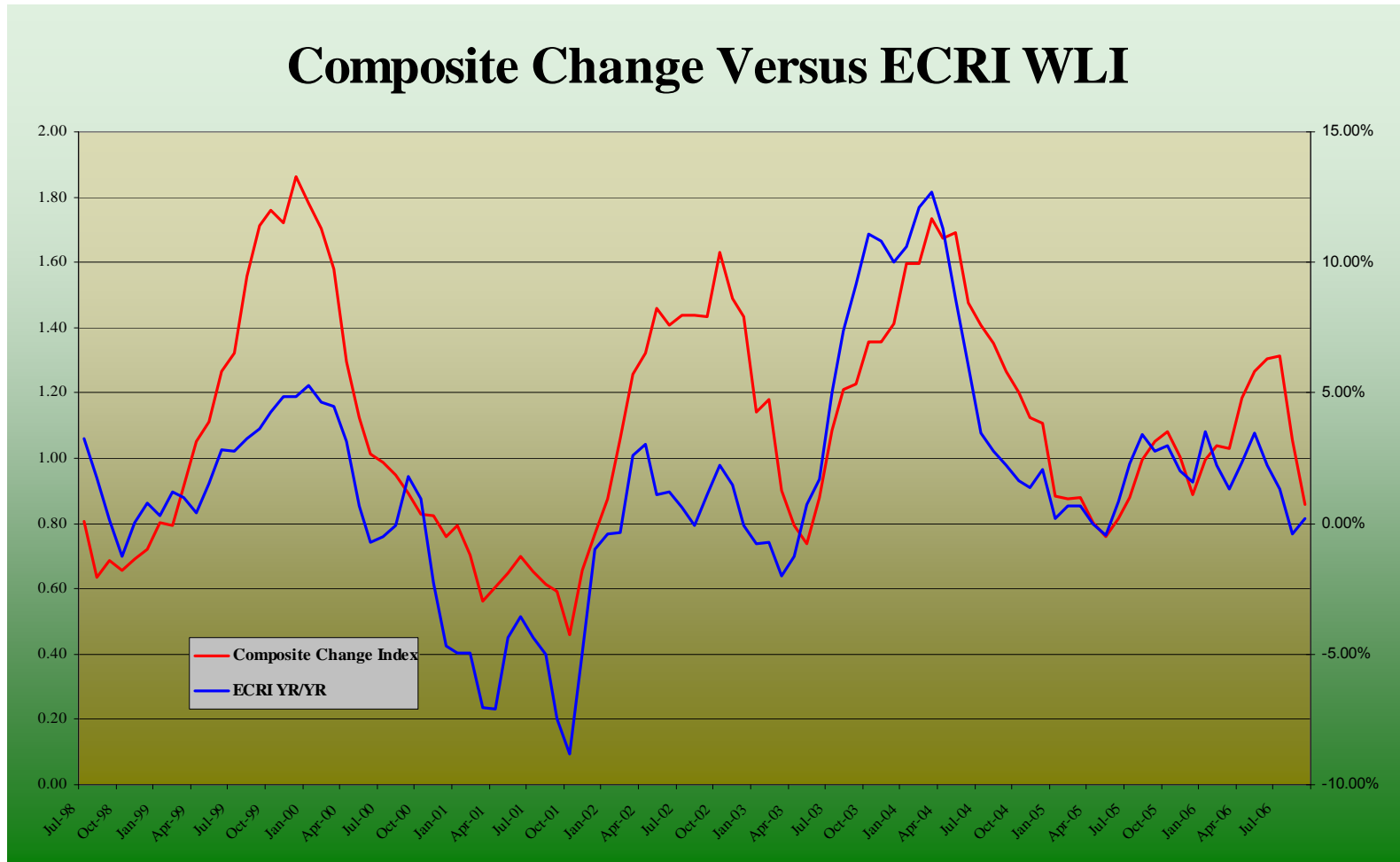
Money supply growth is moderating at best after a bottom in the one-year last summer.

Outlook and Forecast

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1335.85	Trading range	↔	1225 - 1350	End of 2006
Ten Year Treasury	4.63%	4.90%	↓	4.75%-5.25%	6 months
Inflation (all Urban)	3.88%	3.38%	↑	3.25%-3.88%	6 months
Fed Funds	5.25%	5.25%	↓	5.00%-5.50%	6-9 months
S&P 500 Earnings	\$73.34	\$75.00	↑	\$74 - \$77.50	1q2007
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

Outlook & Forecast



Walking a fine line between moderating growth and the real potential for recession...