

July, 2005

Dear Clients and Friends,

***Imagine that you own a small share of a private company that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.***

– Ben Graham, *The Intelligent Investor*, 1949

Mr. Market's manic depressive behavior seemingly ruled stock market activity last quarter. Case in point is the Dow Jones Industrial Average's 6% surge higher from April to mid-June, followed promptly by an end-of-month swoon and a sub-par finish, down 2.5% from the end of the prior period. The S&P 500 and Nasdaq indices fared somewhat better, ending more-or-less where they began despite similarly high intra-quarter volatility. And notwithstanding Fed Chairman Alan Greenspan's best (though misguided, in our view) efforts, long-term interest rates continued to trend lower.

What's driving Mr. Market's wild mood swings? If he gave us a list of reasons for his intermittent enthusiasm, it would probably include the following:

1. Corporate earnings in the aggregate are higher than they have ever been
2. Cash levels at S&P 500 corporations are at all time highs
3. Interest rates remain relatively low, and capital is quite affordable
4. Merger activity is accelerating – there were no fewer than five large deals on the front page of the Wall Street Journal this Monday morning
5. Inflation indicators have recently shown signs of moderation
6. The budget deficit is shrinking, thanks to rising tax receipts on higher corporate earnings (see #1 above.)

And his fits of fear might have these foundations:

1. Alan Greenspan and his cohorts at the Fed have a terrific track record of stopping *after they've gone too far* (reference the technology bubble of the late 1990s, and its aftermath, among other adornments in Sir Greenspan's thorny monetary policy crown)
2. The US Dollar has risen against the Euro this year, making US products less competitive overseas; this has led to reduced earnings forecasts from companies who export their goods and services
3. The price of oil continues to reach new highs, serving as an effective "tax" on business that may slow the pace of corporate and consumer spending

In our opinion, the sporadic "fear of the Fed" dominates present market behavior, and helps explain the extreme volatility we have experienced this year. Many participants now expect the Fed to end its rate hike campaign when the Fed Funds rate reaches 4%. This would leave the treasury yield curve perfectly flat, and would likely take the froth off the housing market without crushing it. The market's concern, then, is that the Fed goes too far, leading to disarray in the financial services industry and elsewhere. We expect volatility to persist until this fear is alleviated, with a renewed focus on strong business prospects thereafter.

Sincerely yours,

Mitch Schlesinger  
Managing Director