

January, 2006

Dear Clients and Friends,

*It is said that the present is pregnant with the future.*

~ Voltaire

The stock market barely eked out a gain in 2005, despite continued economic expansion, double-digit growth in corporate earnings and modest interest rates. One thing we know about the market is that it is rarely rational in the short term, making it hazardous to use longer term macroeconomic prospects to predict near term market moves. Even if our forecasts are correct, there is no way to know if or when the market will wake up and take notice.

In past letters we have discussed key economic and investment risks – inflation, waning consumer purchasing power, rising energy prices, the fluctuating value of the Dollar. While those risks have not necessarily diminished, we believe that the more positive economic elements from 2005 should extend into 2006, and are hopeful that stocks will “catch up” to solid underlying fundamentals. Rather than reiterate our concerns, we’d like to consider some of the things that could “go right” in 2006:

1. **Monetary Policy:** The Federal Reserve recently suggested that it is nearing the end of its rate hike campaign. If this is indeed the case, the Fed Funds rate should top out at around 5.00% in the first half of the year, alleviating the market’s concerns that the Fed will overshoot and bring about recession. Incoming Fed Chairman Bernanke was among the more vocal Fed governors expressing concern about deflation back in 2002, giving us reason to believe he is more “tuned in” to the markets than was his predecessor.
2. **Energy:** Natural gas prices have drifted downward in response to the unusually warm winter we have thus far experienced. Crude oil prices appear to have peaked in September 2005, marking the top of a \$50-\$70 range that should persist through at least the end of 2006 (the situations in Nigeria and Iran aside.) As we saw last Fall, as prices approach the top of the range, demand begins to slow. Conversely, we would expect OPEC to decrease production if prices were to drop below \$50. That being said, the evidence suggests prices in the lower half of that range will not materially slow the economy.
3. **Inflation:** Continued globalization of both manufacturing and services should keep a lid on core inflation in 2006 and perhaps into 2007. Low priced imports, thanks in part to a strong US Dollar, help explain why consumer prices are rising less rapidly than producer prices, and effectively increase consumer purchasing power. Downward pressure on wages and benefits in the auto industry and other businesses should help contain labor costs, a key component of core inflation.
4. **Interest Rates:** As the US continues to import lower-priced foreign goods, the trade deficit will remain large. Much of the money sent to foreign producers gets reinvested in US securities, especially US bonds. These purchases, coupled with low inflation expectations, help explain why bond yields should remain reasonably low in 2006.

Though the risks to economic growth should not be ignored, the factors we cite above could drive the stock market to levels that more appropriately represent the underlying values of the companies in which we invest.

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As many of you are already aware, our long-time associate Ursula Katzin has returned to Germany to care for her ailing mother. Ursula had intended to move back to Germany upon retirement, and we are hopeful that once things have settled down she will finally build her long-planned cottage in Bavaria. As you know well, Ursula was a wonder of efficiency. We are presently interviewing candidates for her replacement, and are working hard to ensure the transition is smooth and that you continue to be served in a timely and complete manner. If you are aware of a qualified individual who enjoys detail and revels in handling many tasks, please be sure to let us know.

Sincerely yours,

Mitch Schlesinger  
Managing Director