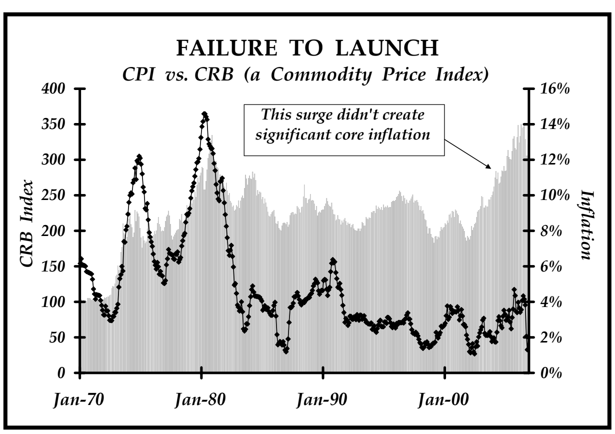
Market Letter Fourth Quarter 2006

Objects in the Mirror *By, Dean Dordevic*

We've all had that moment of introspection, especially on those long road trips with not much to see. Peering into that little convex mirror watching the world in parallax … wondering just exactly what those engineers were thinking, *"are closer than they appear"* ... a Hobson's choice of devilish little etched words. Yes we're seeing more of that very large, fast-moving double semi-trailer. But if it's closer than it looks, that's not necessarily a good thing.

The market environment that has evolved over the last several years reminds us of that passenger side rearview mirror. We watch, study and analyze reams of data with varying degrees of clarity. Some of the most important data has been so robust that it seems super-normal through our lenses (i.e. earnings and earnings growth). But there have been perplexing distortions (energy, real estate, concerns about inflation) that have had important and profound side effects. We're happy to report that more recently, the market appears to be rationalizing these distortions quite nicely. The economic equivalent of "Goldilocks" (growth that's not too strong or too weak) has appeared to return once more, and consequently, the view out of the windshield has become much more pleasant.

This earnings cycle is not yet over and it has indeed been extraordinary. Earnings have now compounded at a 16 percent annual rate for 16 consecutive quarters. This has also been accompanied by the longest string of back-to-back double-digit quarters of earnings growth in history. Yet you wouldn't know it by looking at the major market averages over the last few years. Concerns over soaring commodity prices, a residential real estate market in recession, and the fear that inflation would soon return ... have brought about pervasive P/E (valuation) contraction. Over the last three years, P/Es have contracted in fully nine of the 10 S&P 500 sectors. More importantly, since this discounting has not been isolated to a few sectors, these issues are clearly more thematic in nature. Historically, benchmarking against today's levels of interest rates and inflation, P/Es should be *expanding* rather than *contracting*.



It's our sense that the single most vexing variable that has produced this complete lack-of-respect for the power of this earnings cycle, is the concern that inflation would soon return. Our guess is that investors are from Missouri on this point, and it has taken some time for folks to get comfortable with a somewhat profound paradigm shift.

Last year, the inflation-adjusted Goldman Sachs Commodity Index (GSCI) decisively pierced the twin previous peaks last seen in the mid-1970s and early 1980s. The corresponding peaks in the core Consumer Price Index (CPI) were in excess of 11 percent and 13 percent, respectively. Amazingly, despite higher levels of inflation-adjusted commodity prices, the core CPI this time around barely cracked the 3 percent level. Why have recent commodity moves not ignited more inflation?

In the past, commodity and labor markets were much more highly correlated. That is, at about the time that a manufacturer was running out of a commodity, he was also most likely running out of labor. In this instance, commodity prices were providing information about both the commodity market and the labor market simultaneously. With markets becoming increasingly globalized, this link is now broken. There are large and highly populated countries (e.g. China, India) that in the course of their rapid development demand lots of commodities, but they are also supplying lots of labor inputs.[1] The chart on page two shows very clearly this de-linking.

The residential real estate market has clearly entered a recession. We expect an orderly unwinding of the excesses of the last five years. We also believe that this process will take somewhat longer to fully reach equilibrium than the consensus currently expects. However, the longer this process progresses without any serious, unmanageable or unpleasant bi-products, the more investors will become comfortable with the fallout from this unfolding story. More importantly, if the market appears to be successfully dealing with some of its most troubling demons, why then is the market only now beginning to revalue equities?

The simple answer to this question is that the absence of negatives is not enough. In other words, despite the market becoming much more comfortable with a host of negatives, there needs to be a catalyst to unlock and expose value. We believe this catalyst is cash.

Cash is accumulating just about everywhere. Cash levels for S&P 500 companies are at 20-year high; about $6.1 trillion as of the latest tally. Interestingly, dividends paid as a percentage of this cash flow (the dividend payout ratio), is at a 20-year low. Mutual funds, CDs, time deposits, and other cash havens have about $5.6 trillion in cash as well. What's more, the rapid accumulation of cash is a global theme. The most "interesting" pile of cash is that which resides in the so-called "private equity" world. Private equity cash is now at about $170 billion. This cash is the most interesting market fuel since it is so potentially highly leveraged. With leverage ratios of 4 to 1 not uncommon, this suggests buying power of about $680 billion in this (cash) category alone. This money is now being spent. Ten of the 12 largest deals ever have occurred in the past 18 months. Also of interest is the fact that all three of these cash catalysts are continuing to grow.

We believe that the more positive and constructive tone of the market that emerged in the second half of 2006 may very well continue into at least the first half of next year. It is clear to us that stocks have underperformed their own financial performance, and have not fully discounted the very powerful bull market in earnings growth of the last few years. Ironically, while the distortions in the past have been more negative in nature (i.e. P/E contraction), the distortions going forward might very well be of a more positive variety (i.e. P/E expansion). This powerful discounting mechanism could become its own mirror image as the new year progresses.

To be sure, this process will not be without painful setbacks and periods of consolidation. Most assuredly, it will not be a linear function. However, we do not believe that it is complete, and we will continue to monitor both its health and progress. As investors become more comfortable that their worst fears will not destroy profits or ignite inflation … the world becomes an increasingly safe haven for the investment and allocation of capital. The cash-catalyst exists in spades, and it is undoubtedly a huge plus for investors in common equity in the new year.