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"The good news is that the bad news is wrong."

Brian Wesbury, *Wall Street Journal* 12/2/05

In the next few pages we'd like to review a bit of 2005 and develop an outlook for 2006. Many observers of the economy are quite sure a recession is imminent and further, that inflation – serious inflation – will accompany it. We note, in response, that which Schumpeter preached long ago – the only cure for society's ills, the only way for mankind to improve its lot is through economic growth – and that entails change of much of the assumed status quo. How it is done, be it by creative destruction in a free market or the arrogant tinkering of utopia-minded politicians, will determine the level and breadth of pain this change will cause. We can continue to allow a few self-serving environmentalists to decide our energy policy, for example, or we can let market forces dictate price <u>and</u> quantity. [The best thing we can do is drive - a lot - the poorest fuel-economy vehicles we can find. This, in turn, will use up the cheapest oil (the Middle East supply) as we always buy the cheapest first, other things equal. That accomplished, we can move on, with confidence, toward alternative sources that won't be strangled at birth by a resurgence of cheap oil. It will also limit the Middle East's power to make war.]

The year 2005, demonstrated over again the utter resiliency of the economy. One by one, its primary components – wages, inflation, energy, interest rates, jobs, etc. – took hits and one by one, we demonstrated to the world the power of market forces versus managed economics. Let's look at a few of these elements:

The Federal Reserve
Since June of 2004, the Federal Reserve has been tightening the supply of money by raising the rate banks may charge each other for overnight loans – the Fed Funds rate. This has moved short-term interest rates from 1% or so to 4 ½% or so. In our view, this is en route to 4 ¾% to 5% by, let's say, spring. Although well along, we note two by-products: 1) this did not slow or stop the 2005 economy and 2) the Fed now has room, and will soon have more room, to <u>ease</u> rates should that be needed in 2006-2007. As we've noted in past musings, the economy functions quite well with rates in a 3% to 5% band – in spite of those who predicted disaster from Fed tightening. In fact, it looks like the nation's output of goods and services for 2005 will have yet again grown by 3.5% plus – and we'll guess the revisions in February or March will move it higher.

Inflation
Much like short-term rates, the economy can function with some inflation – ideally in a 2% to 3% range. We've spent most of the last few years well below that rate and, in fact, spent a bit of time worried we were headed to the Japanese world of deflation and the disaster that would cause. The spike this summer and fall in gas prices was a textbook case of why the Consumer Price Index is often quoted "ex food and energy." It is the very cyclicality of these components that makes them self correcting. When regular gas made it to $3, people used less and the Toyota Prius became the rage. [We have to digress here: buy a Prius if you 1) can drive 66,000 miles a year or more for 10 years or 2) expect gas to stay at $10/gallon – otherwise you're spending $8 to save 50 cents (Edmunds). The point is that Katrina and mass hysteria had a lot to do with a significant rise in prices within a long-term rising trend in energy costs.

We, too, see energy going higher, but 2006 should see crude oil in the $60-$70 range and gas pretty much a replay of this year. A modestly slower economy plus the return of normalcy to the Gulf area refineries will be augmented by what looks to be a mild winter, so far.

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Energy
In brief, our vision of economic growth globally to improve man's lot is obviously happening because the demand for oil is as good a gauge as any. The easy oil has been found. Therefore, we have to increase the supply of harder-to-find or harder-to-extract oil to meet demand. In that situation, what do we do? Here in the nanny state we mandate different blends for different seasons, each more costly than the last. We play with ethanol and the damage its water content causes because Archer Daniels, the biggest corn grower, is a better lobbyist than the oil companies. We ignore 180 billion barrels of Canadian oil sands, continue our 29-year-old decision not to build refineries and, best of all, tinker with price controls. Our view on energy is to own the drillers, refineries and majors with proven reserves. In no way do we see the long-term trend going away. Don't ignore Canada in this game of world oil . . . .

Housing
What a year. Cheap money had a role, of course, but we were focused on two other issues: 1) the very large number of "zero down" or "interest only" or "ARM" gimmicks and 2) the flipping. We noted in our November piece that a demographic was in place – people of a mature age moving to warmer places – but left unsaid that rates alone did not cause the boom in home prices and, in fact, a lot of it looks like pure musical chairs. Will it bust like the dot com bubble? We think not. We expect prices to flatten, maybe cool 5% to 10% in the hottest markets and, in fact, end up doing some good. That good will be the number of older homes in less than premium areas that may well be in the range of first-time buyers. New home construction will fall and we think by quite a bit – say 20% - but again, it is localized. The KB-type firms, with their nearly national reach, are already correcting for local oversupply. In short, we think the industry will do fine, but some marginal builders and some folks who have been flipping or levering will get the headlines when they get burned. In brief, it isn't just rates. Housing is a meaningful part of the economy, but the more critical element at this point is the winding down of cashing out equity. Its decline will have a short-term effect on the economy as the consumer slows his buying, but as we note a bit later on, the slowing is nominal for some good reasons.

The Consumer
You'll recall that growth in the economy is nearly 70% driven by consumer spending with the remainder a function of government spending and business or investment spending. The consumer spends depending on 1) his confidence level (up strongly of late) which is loosely tied to the president's popularity ratings; 2) his job or expected continued employment; 3) his perception of wage gains versus what things cost and 4) his day to day perception of the condition of others around him. The popular view is that the "collapse" in housing is tied to consumer spending. We suspect that yes, consumer spending is tied to cash out or refinancing activity, but as noted above, it's not the only reason consumers spend nor is it the source of their willingness or level of spending.

The massive impact of cheap Asian goods and the falling prices of so many consumer discretionary items – which are the bulk of consumer spending save for the very poor, creates a perception of well being even if wages are flat. Refinancing money, too, was about ½ plowed back into the home and the balance was substantially used to pay down debt. In brief, we're not surprised at all by the good retail numbers for Christmas. Will it slow? Sure, and until we see the expected recovery in technology and business capital spending become more well known, the consumer will be cautious – not quit – just cautious. The recovery in sectors long in a slump will replace the slowing in auto and housing sales.

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Business Fixed Investment
A 35% per year rise in oil prices has not had the impact on business many expected. In fact, corporate liquidity is as good as we've seen in nearly a decade. Aggregate earnings (we use the 500 stocks in the S&P 500) are likely to come in this year at +14% and next year at 9% or so. This liquidity and strong earnings growth, coupled with an obviously more fuel-efficient industrial sector has left the U. S. industrial economy in a position to 1) pay higher dividends, 2) deal with wage increases, 3) begin to address pension issues and 4) cope, we hope, with medical benefits. The cynic in us notes the huge amount of stock and options owned by a larger and larger number of executives, managers and workers. Do you think they are motivated to boost earnings and dividends and thus stock prices, especially given their average age and pending retirement? Consumer spending will be a battle of perceptions between wage gains and transfer costs, among all the other issues. Here again, the pending recovery in business investment and particularly technology spending should replace the decline in autos and housing.

The Economy
And so we come to a slower, transitional year. Our view is growth around 3% - quite respectable for a very mature economy in the global sense. Ed Hyman at ISI notes that we are outsourcing to a greater and greater degree that part of our economy most subject to large swings in production and inventory – the manufacturing segment. He notes that more modest business cycles are likely. Makes sense.

Commodities
Much like oil, the long list of industrial commodities – copper, tin, timber, etc – are being pulled by China. Initially, supplies were short and, in 2005 in particular, prices jumped. Our views include the strong belief that hedge funds exacerbated the initial spike, but heretofore marginal supplies are, at these prices, cost justified and new supplies are coming on line. This is a long way of saying we expect very modest price increases in 2006 particularly. Beyond that, the trend is up but at nowhere near the rates of the last few years. A range of 5% to 8% annual increase would, to our mind, allow for organic growth, inflation and stimulation of new, previously unprofitable, supplies. A side benefit is the positive impact on economies still heavily dependent on raw material exports – and their consumers.

The Yield Curve
Much has been made in recent days of the inverted yield curve. As short-term rates rose above long-term (10-year) rates, the gloom and doom crowd took cheer. Their belief that it signals a recession is the popular one. Our views vary a bit: 1) we suspect serious demand for long Treasuries (10-year) persists from Asia, the Middle East and yes, even South America. Logically, if we are buying oil, toys, cameras, orange juice and whatever from the rest of the world with all this borrowed money, refinance money and stock market profits, what do we expect the sellers to do with these dollars? Foreign buying of stocks is up, but we suspect a good amount is buying the 10-year, pulling the yield down and the price up. Couple that with deliberate Fed activity to raise short rates and you understand why Ethan Harris at Lehman Brothers said, "I think the bond market is on drugs" (referring to the bond market's view that this is a sign of pending recession.)

We know it has been a prediction of a slowdown or a recession – but a few new factors have come into play. So, no recession and it may stay inverted to which we say, so what? Lower bond prices and lower energy will help housing and lower bond prices reaffirm the simple fact that the dollar is still the preferred holding.

The Market
Obviously we're as bullish as we were some months back. The 2006 year will start fairly strong –

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at over 3% GDP – and end fairly slow – say 2 ½% GDP. We think the room the Fed has built to stimulate (raising rates so they can cut later) will come into play in late '06. Corporate earnings will face difficult comparisons – oil, for example, will be hard put to match the 2005 earnings growth rate. Banks, too, will struggle – a flat or inverted yield curve leaves little room to borrow short and lend long. Foods, retail, technology, among others, should do well. If the economy slows as we expect, then we also expect the consumer, at the margin, to shift spending patterns. Maybe a car is postponed, but gambling, small appliances, soft goods, food away from home, etc. can benefit. Much as we hate to say it, prepare for another average year in the market – a year of 3% to 6% total return. Stocks are cheap and inflation is low and earnings look good – but this sense of impending doom just won't go away.

Our Fears

This is a long list, so let's begin:

1) Iran is nuclear capable as of March 2006.
2) Israel or the U. S. will do an air strike given (1) above – using Turkey as the flyover.
3) It's a mid-term election year with a slower – repeat – slower economy.
4) A "2nd year" sell-off in the market happens (bipartisan) to presidents in their 2nd year or close to it.
5) Arnold lost every darn initiative and the Democrats think they won something.
6) The Democrats have no platform.
7) Consumers have spent beyond their means.

Enough. We can list fears every year – and this will be no exception. Although we can't cover every topic we welcome your questions or proposals for future pieces. Our last thought is this:

> *When returns are expected to be low – as they will be in 2006, risk rises. Lower volatility (price swings) in stock prices means bigger bets to achieve "expected" outcomes. Don't fall for it. Big numbers require both big bets and big leverage.*

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