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# 2006

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The value of this report probably comes from the simple rarity that we might actually sit down and write a report, rather than from the value of any thoughts in the document. Still, we thought it might be helpful at the beginning of the year to revisit some of the themes which have guided our work over the past few years. These are the basic long-term themes, not trading oriented, and to be discussed more fully in person or in response to your questions and thoughts. As always, we value those discussions.

## Inflation?

The future rate of inflation is one of the most, if not the most, important influences on the future value of both real and financial assets. It is especially interesting right now because we are witnessing in this decade a massive transition in both inflationary and deflationary forces.

We have seen, or will see, a unique combination of:

- secular domestic deflation in the price of goods sourced from global producers
- cyclical domestic deflation in the costs of labor, intelligence and information
- secular global inflation in the costs of necessities -- energy, water, food
- cyclical global inflation in the costs of economic raw materials such as copper, lumber

These four forces are solid. But with both deflation and inflation, impacted differently in a domestic vs global context, occurring over different long-term secular and shorter-term cyclical time periods... it is almost silly to generalize about what the single rate of inflation is. There isn't one. There are many, and they are different, depending upon which item, asset, or context is referenced. Something to think about should Dr. Bernanke pursue a single inflation target as a policy guide.

Further, we could see:

- cyclical deflation in asset prices fueled by the tremendous expansion of financial credit
- cyclical inflation in asset prices fueled by a possible future declining value of fiat money

These two forces are more suspect, but likely. Candidates to be impacted by these forces, in different ways, include real estate, precious metals, and the continued swings in foreign exchange currency moves, discussed further below.

Developing countries such as China and India, and the delicate financial position of the United States at both federal and household levels, are at the root of many of these changes. These forces explain how

inflation continues to move out of the many core CPI product items historically measured, and moves into commodity raw material items. It also explains why commodities are increasingly being viewed as an asset class, ably competing with returns from historical asset class decisions between stocks and bonds. This is an important change, and explains how investors can increasingly become frustrated with standardized pie-chart portfolios, as follows.

## Interest Rates and the Cost of Capital

Starting with the broadest possible perspective: long-term trends in the cost of debt capital (interest rates) and trends in the cost of equity capital (P/E ratios and real estate cap rates) have historically changed course perhaps only two or three times in a lifetime. The costs of debt and equity capital had been declining since the early 1980s, and the question is whether or not the early part of this decade was one of those very long-term changes in direction.

The extreme low interest rates of 2002-3 and the extreme high valuation ratios on stocks in 2000-1 are good candidates for such a long-term inflection point. Even if interest rates begin generally rising over the next 15 years, even if P/E ratios trade at lower ranges in coming years, there will be cyclical swings in both directions obviously. But as we've discussed in recent years, we remain prepared to respect those extremes and the resulting new trends.

Therefore with income investments, two primary themes occupy our thinking:

- long-term bond mutual funds are less appealing than intermediate securities of known maturity
- credit spreads will widen to the detriment of junk bonds

The latter point may be less clear, but generally speaking, credit spreads get thin and less attractive when the cost of debt/equity capital is low, and credit spreads widen out as the cost of debt/equity capital rises becoming attractive at cyclical climax. As we've discussed, credit spreads were very thin at the beginning of 2005 providing little incentive to invest in low quality paper or junk bonds. Since then, the spreads have begun to widen. Whether this is suggestive of what the next move in P/E ratios will be for the stock market, time will tell, but don't buy a junk bond if you think stocks are peaking.

Despite the Federal Reserve raising short-term interest rates throughout 2005, our position has been that high-quality intermediate securities would maintain their value. We have stuck to that position, and the result is now a flat or slightly inverted yield curve with a 2 year Treasury yielding about the same as a 10 year Treasury note. Currently the financial press is much occupied with this question of what impact an inverted yield curve might have. We don't know either, but our own comment is that the flat curve is probably temporary during early 2006... and it probably maintains one's attraction to short/intermediate quality notes as those higher yields may be temporary. So we will stick with high credit quality, we will not be locked into long-term bonds or mutual funds, and we will try to concentrate our buying during cyclical lows in bond prices. The most reliable cycle of late has been helpful every 8 or 9 months, bottomed in early November, and that subsequent rally continues.

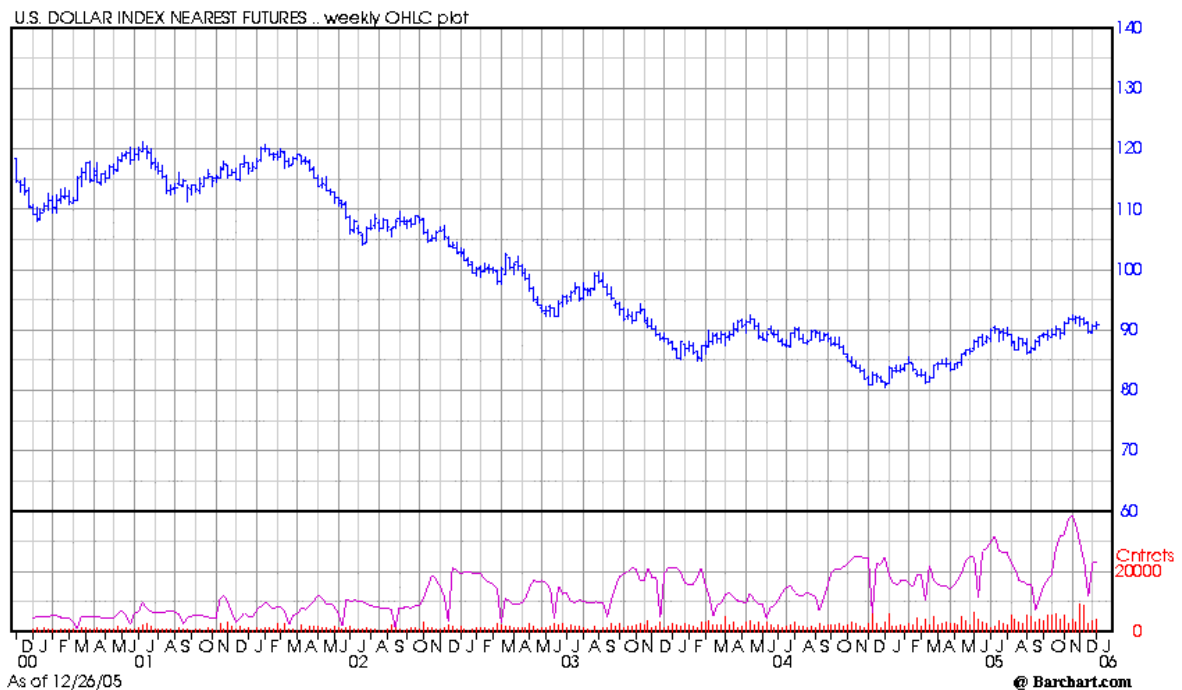
We have also found value at times in premium tax-free bonds... over time the value of the bonds declines back down to maturity par value, but the high coupon income results in an attractive yet conservative overall yield. And despite the possibility that the 20+ year decline in interest rates may be over, we still think the highest-quality intermediate income securities will maintain value and be attractive investments.

A final topic under interest rates is our long-term feeling that financial and banking stocks are not particularly attractive. The high proportion of S&P 500 earnings derived from credit, the historical high proportion of S&P 500 market capitalization from financial companies (like tech in 2000), the real estate cycle induced by previous low interest rates, the overcapitalization of hedge funds and Carl Sagan-like growth of derivatives and debt on balance sheets in the last few years, coupled with a possible change

in the long-term direction in the costs of debt... just doesn't make financial companies seem like an undiscovered jewel. These are candidates for ***cyclical deflation in asset prices fueled by the tremendous expansion of financial credit.***

## The Dollar and Gold

Tough topic. First, as discussed, our thinking on the dollar changed at the beginning of 2005, and the process of the domestic yield curve flattening during 2005 bolstered our feeling that the dollar would change trend and strengthen this past year. While the flat curve is probably temporary during the first half of 2006, that is sufficient to maintain the trend, and we suspect that the U S Dollar Index which began 2005 around 82 on the front-month futures and is currently closer to 92 can still move higher up into the mid 90s. That will have turned out to be a pretty nice move, and yet we'd still say this move is probably just an interruption or correction of the downtrend in the dollar which began at the end of 2001 at a peak index reading of about 120. Said differently, eventually that downtrend could resume and it will have a significant impact on the financial markets. One should add another comment – that it is not unusual for the currencies to have inflection points at the end of a calendar year, so here we are. Yes, we think the dollar can still move higher before the next drop, but the antennae are up.



It is unusual for the values of both gold and the dollar to be rising at the same time. It is unusual because China has never previously been this important to markets, so some of the old comparisons are no longer as valid. This is a tough topic, gold is up and the dollar is up. One must wonder if China is buying both, one for the long-term which might eventually produce a Chinese Yuan at least partially correlated to gold, and the other for the shorter-term which might eventually produce a dollar that lacks future support and is burdened with a heavy debt load.

For all the talk about U.S. reliance on foreign crude, there is remarkably little talk about the U.S. reliance on another \$2 billion in foreign capital each day, and what would happen if that flow were to change. For now, the world is kind. A weak United States economy is not in China's economic interest, but it is a difficult and uncomfortable scenario which warrants thought. Still, we must also say that historically few investment successes have been based purely on analysis of national balance of payments and current account statistics. In fact, those looking purely at this information and ignoring

the change in short-term interest rates missed the significant rally in the US Dollar during 2005. Having turned bullish on the dollar this time last year, we now assert that 2006 will see the dollar reverse trend and move lower, in concert with the already rising price of gold. But it's not happening yet.

Timing is important and gold is due for a pullback here early in 2006, but just as the costs of debt and equity capital may have reversed a long-term trend in the 2001-2002 time period, so did gold reverse it's long-term trend in 2001. It represents ***cyclical inflation in asset prices fueled by a possible future declining value of fiat money.*** In some ways, as a store of value, the same is true for:

## Energy

With a smile, we say crude oil selling for \$17 in 2001 probably qualifies as an inflection point as well, and our theme for this decade of rising energy prices remains intact. It is difficult to imagine the impact on the United States from a truly meaningful disruption in the global petroleum supply chain. Hurricanes Katrina and Rita were indeed significant, but vulnerabilities in Nigeria, Iran, Saudi Arabia, Alaska and elsewhere would be something else. We have preferred energy investments over gold as a store of value and source of return. This has seemed wise -- as to our knowledge the ratio between gold and oil has never been so lopsided in reflecting the rising price of oil relative to gold as in the third quarter of 2005.

However, in the fourth quarter of 2005 we have reduced our exposure to energy stocks and realized some of those profits, with certain understandable exceptions in some portfolios. Crude ticked over \$70 at the end of August and has not been back. Overexposure to energy stocks may have great impact on past returns but also a great risk to future returns. On a secular basis, that theme is not over, but on a shorter-term cyclical basis it is a little less comfortable to be bullish on energy. Who wasn't bullish on energy in the fourth quarter of 2005? So we are trying to maintain a little more balanced perspective. So might the relation between gold and oil begin to tilt more towards gold in the future? Stay tuned. Still, energy prices will continue to hold our attention for years to come and higher prices will eventually be considered... part of a ***secular global inflation in the cost of necessities.***

## The U.S. Economy

A most interesting discussion of the U.S. economy came from a piece written by former Chairman of the Federal Reserve Paul Volcker in The Washington Post and reflected his thoughts early in 2005. Some months old, but it addresses a longer-term view of the economy, and we include it here:

### **An Economy On Thin Ice**

*By Paul A. Volcker Sunday, April 10, 2005, Page B07, of The Washington Post*

The U.S. expansion appears on track. Europe and Japan may lack exuberance, but their economies are at least on the plus side. China and India -- with close to 40 percent of the world's population -- have sustained growth at rates that not so long ago would have seemed, if not impossible, highly improbable.

Yet, under the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks -- call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it.

We sit here absorbed in a debate about how to maintain Social Security -- and, more important, Medicare -- when the baby boomers retire. But right now, those same boomers are spending like there's no tomorrow. If we can believe the numbers, personal savings in the United States have practically disappeared.

To be sure, businesses have begun to rebuild their financial reserves. But in the space of a few years, the federal deficit has come to offset that source of national savings.

We are buying a lot of housing at rising prices, but home ownership has become a vehicle for borrowing as much as a source of financial security. As a nation we are consuming and investing about 6 percent more than we are producing.

What holds it all together is a massive and growing flow of capital from abroad, running to more than \$2 billion every working day, and growing. There is no sense of strain. As a nation we don't consciously borrow or beg. We aren't even offering attractive interest rates, nor do we have to offer our creditors protection against the risk of a declining dollar.

Most of the time, it has been private capital that has freely flowed into our markets from abroad -- where better to invest in an uncertain world, the refrain has gone, than the United States?

More recently, we've become more dependent on foreign central banks, particularly in China and Japan and elsewhere in East Asia.

It's all quite comfortable for us. We fill our shops and our garages with goods from abroad, and the competition has been a powerful restraint on our internal prices. It's surely helped keep interest rates exceptionally low despite our vanishing savings and rapid growth.

And it's comfortable for our trading partners and for those supplying the capital. Some, such as China, depend heavily on our expanding domestic markets. And for the most part, the central banks of the emerging world have been willing to hold more and more dollars, which are, after all, the closest thing the world has to a truly international currency.

The difficulty is that this seemingly comfortable pattern can't go on indefinitely. I don't know of any country that has managed to consume and invest 6 percent more than it produces for long. The United States is absorbing about 80 percent of the net flow of international capital. And at some point, both central banks and private institutions will have their fill of dollars.

I don't know whether change will come with a bang or a whimper, whether sooner or later. But as things stand, it is more likely than not that it will be financial crises rather than policy foresight that will force the change.

It's not that it is so difficult intellectually to set out a scenario for a "soft landing" and sustained growth. There is a wide area of agreement among establishment economists about a textbook pretty picture: China and other continental Asian economies should permit and encourage a substantial exchange rate appreciation against the dollar. Japan and Europe should work

promptly and aggressively toward domestic stimulus and deal more effectively and speedily with structural obstacles to growth. And the United States, by some combination of measures, should forcibly increase its rate of internal saving, thereby reducing its import demand.

But can we, with any degree of confidence today, look forward to any one of these policies being put in place any time soon, much less a combination of all?

The answer is no. So I think we are skating on increasingly thin ice. On the present trajectory, the deficits and imbalances will increase. At some point, the sense of confidence in capital markets that today so benignly supports the flow of funds to the United States and the growing world economy could fade. Then some event, or combination of events, could come along to disturb markets, with damaging volatility in both exchange markets and interest rates. We had a taste of that in the stagflation of the 1970s -- a volatile and depressed dollar, inflationary pressures, a sudden increase in interest rates and a couple of big recessions.

The clear lesson I draw is that there is a high premium on doing what we can to minimize the risks and to ensure that there is time for orderly adjustment. I'm not suggesting anything unorthodox or arcane. What is required is a willingness to act now -- and next year, and the following year, and to act even when, on the surface, everything seems so placid and favorable.

What I am talking about really boils down to the oldest lesson of economic policy: a strong sense of monetary and fiscal discipline. This is not a time for ideological intransigence and partisan posturing on the budget at the expense of the deficit rising still higher. Surely we would all be better off if other countries did their part. But their failures must not deflect us from what we can do, in our own self-interest.

A wise observer of the economic scene once commented that "what can be left to later, usually is -- and then, alas, it's too late." I don't want to let that stand as the epitaph of what has been an unparalleled period of success for the American economy and of enormous potential for the world at large.

*The writer was chairman of the Federal Reserve from 1979 to 1987. This article is adapted from a speech in February at an economic summit sponsored by the Stanford Institute for Economic Policy Research.*

## The Stock Market

That's an interesting perspective that stays in our mind, certainly with respect for the author. Such thoughts, and our concerns about the credit cycle in the U.S., are a constant backdrop to investment decisions, particularly with respect to the stock market.

Still, we are also impressed with the arguments made by many on Wall Street that, relative to earnings and projected growth, many stocks seem attractively valued. The long-term potential negatives in the stock market will have to be ignited by a catalyst, and until such a straw lands on the camel, this awkward sideways-to-up movement in equity prices can continue. The greatest winner in 2005 was easy and the same as in 2004: Energy. The losers in 2005 among S&P 500 Industrial Groups included Autos, Media, Banks, Pharmaceuticals, and Telecommunications. In the absence of

conviction on the overall direction of stocks, industry selection is very important, and as noted, we are now stepping away somewhat from energy, at least for the moment. So where might positive returns be found in 2006?

- We expect to see Large Cap equity performance improve relative to Mid Cap and Small Cap indices, particularly later in the year.
- Technology can still bounce back further early in the year with our conviction on that sector waning as the year progresses... perhaps an early semiconductor rally.
- The poor performance of Health Care Pharmaceuticals in 2005 should improve as industry news moderates, and selective outperformance will become increasingly likely as the year progresses.

Unlike the past couple of years, we do not at the moment have a dominant theme for sector outperformance in the equity markets. We also respect cycles suggesting that rallies would be stronger early in the year with the market declining later in the year, and in time, the opportunities in the energy sector are expected to again resurface as well.

## Industrial and Agricultural Commodities

This report goes out to people with varied interests, and some will have no curiosity towards other markets, but our attention is focused on the following commodity markets as part of the theme of a **secular global inflation in the price of necessities – energy, water, food**. Generally, we expect the **price of meat to decline and the price of other foodstuffs to rise over coming months**.

We do think cattle prices are peaking or did peak in the November/December period. This year does not seem to be setting up for the occasional seasonal tendency of cattle prices to rally into April. The short side of the cattle market is worth exploring.

The bull market in sugar prices remains intact. It is not over.

Yes, we are again bullish on coffee. As discussed, the long-term fundamentals of the coffee market changed dramatically by the end of 2003 and prices rallied significantly into the first half of 2005. Prices look strong again for 2006, and there has not been a significant drought/frost impact on prices in several years, so we will particularly watch the Brazilian winter beginning in May.

We can not rule out near-term weakness in the grains as 2006 begins, but as the year progresses, we look for the value of soybeans as well as corn and wheat to rise. Like coffee, these markets look particularly more interesting in the second and third quarters rather than the first quarter. Cotton fiber also looks like a candidate for a bull market in 2006, but our view is that the opportunity has not yet crystallized there and we will hold off on any commitment to cotton at the moment.

Seven pages is enough. We look forward to discussing actual investments and portfolios with you in a proper conversation in the near future, with best thoughts to you for the New Year.

–Brian

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