Here is Edward Bear, coming downstairs now, bump, bump, bump on the back of his head, behind Christopher Robin. It is, as far as he knows, the only way of coming downstairs, but sometimes he feels that there really is another way, if only he could stop bumping for a moment and think of it, and then he feels that perhaps there isn't.

A. A. Milne

In spite of unprecedented economic times, the media is focused on end-of-the-world drama. Pundits predict oil at $200/barrel by 2010 (Matt Simmons, a Houston energy broker), politicians call for price controls, now begun in Hawaii, housing prices spiral north ostensibly leaving many Americans unable to buy, Katrina arrives bringing Rita in her wake while hedge fund managers leave with client money. Lest we forget, Iraq persists in being, well, Iraq. It really is "bump, bump, bump" to the thinking observer.

Most Americans save nothing, many think, and growing numbers flock to church – we're working on what that portends, but it does not seem to fit well into the Sodom and Gomorrah image we have in Europe. Europe, of course, is trying to practice universal revisionism while quietly disassembling. David Brooks at the New York Times wrote a wonderful column noting that while economies converge, cultures are diverging. Look around you – we are diverging into lifestyle segments: As we specialized our skills over the last 50 years of migration from farming to a manufacturing economy so also did we self-segregate to communities of people like us. Groupings grow rigid, zealots abound, economies converge, global inequality grows. Of course, as Brooks points out, the gospel of multiculturalism preaches that all groups are "equally wonderful" so ask no questions about enduring traits of racism or sexism.

And, amidst all that is the very real fact that terrorists' actions against us far exceed our ability to find and neutralize them: Their cost to themselves to do damage is insignificant when compared to our costs (loss of property, privacy, airport security, etc., etc.) of prevention. This point was well developed by John Nash – in 1953. . . .and we still can't manage it.

Increasingly one is left with a feeling – perhaps two – of "I've got mine, so good luck, pal" and "me, it's about me." To rein it in we create millstones like Sarbanes-Oxley and make corporate witch hunts a daytime soap opera. Blame is the game, individual accountability shrinks daily.

And yet through it all, as in countless times past, we muddle on. The evening news headlines our $700 billion trade deficit – a singularly frightening number standing alone – but we think, "Yes, and against $44 trillion in assets in the U. S., that's what? 1 ½%? I wish my debt to asset ratio looked like that." Or try it this way – last year Apple Computer added $1 billion to our trade deficit – but grew assets here by $20 billion (John Mauldin).

The Democrats note the death of the middle class and the growing number of poor – ignoring totally that the only reason why there are fewer people making $25,000 to $75,000 is because they became richer. The percentage of the population making less than $75,000 fell from 91.8% in 1967 to 73.3% in 2003. . . and home ownership rose

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from about 61% to nearly 70%. Yes, the ratio of income from top quintile to bottom quintile is 15.5 to 1, but consumption is just 4.4 to 1. Those living in the lowest income decile here are better off than most middle-class Europeans. Of these poorest members of our society, 91% own color TVs. A recent Swedish study found that the average European only lived about as well as residents of America's poorest state – Mississippi (Arthur Laffer/Bruce Bartlett). Any wonder they flock here?

Against the superficial backdrop of gloom and doom we see many things differently. As a strategy for the next few years, our view is that energy, technology and health are the places to invest. These preferred areas we'll develop for our clients, but here's an overview of how we see some of the economic factors behind that:

The Economy: We concur – it will be weak for a quarter or three as Katrina/Rita work through. We'll touch on energy in a moment, but just note that rebuilding is a plus for autos, lumber, concrete, steel – we all know the list. The "whiff of inflation" thesis now has credibility as consumers will face less supply (fuel) or increased demand (raw materials) and that will impact prices. Industrial production will show a temporary slowing as shutdowns, transportation costs, etc. work their way through our economy.

Running counterpoint, however, is the ongoing very good, very high productivity of the U. S. economy – more output for the same, or less, labor, energy or materials. Ed Yardeni makes the point that non-financial, corporate productivity, a broad measure, is up 6.8% in Q2 and 6.3% from a year ago. He believes this measure is more indicative than the still broader, non-farm, business productivity commonly quoted, being up only 2% or so. He finds productivity in the financial services sector to be nearly immeasurable and that is removed in the 6.8% number. Having worked in the industry, I'm inclined to agree. It is no wonder corporate profits are so strong. . . . and will remain so.

Real (inflation adjusted) compensation per worker is also at all-time record highs when you include not just wages, but also employers' contributions to medical care, social insurance, private benefit plans, etc. (Yardeni). This, to put it bluntly, was totally a workers cost in decades past – yet a reluctance to see it as compensation persists.

Although household debt (mortgage/credit card) is at record levels, so are household assets – up even more so. The rebuttal is, sure, because housing is rising in value. That is not the case: If you take out housing values, financial assets are still up nearly $1 trillion in the last year – more than the increase in household debt. Conclusion: The consumer is in pretty good shape and with unemployment at 5% or so nationally, can remain that way. Shocked? Yes. Capable of paying $4.00/gallon? Yes.

Energy: We find it interesting how strong the economy, and consumer spending in particular, has remained in spite of nearly $70/barrel oil. Our view is that the cost increase in oil (broadly) and gas (specifically) is relatively small in light of a significantly larger and more efficient economy and larger paychecks versus the prior "shortage."

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Consumers will pay $3 or $4 per gallon, demand will soften because of it and prices will moderate at the pump. View it as a tax and view it as a choice. New flat-screen TV? Or heating oil for the winter? At the margin, both are feasible given the real wage gains and asset growth households are experiencing. Controversial, we know – but inflation adjusted (wages and fuel costs) – we are still better off than we were the last time. It's about the choices we make, the cost of things as a percentage of income (less) and a bit of unrealistic expectations.

Of course, we'll invest in energy, but the long pull will be in alternative sources – and we don't mean hybrids. (Incidentally, while all this is going on the press claims consumer savings are nonexistent – totally ignoring the massive growth in household assets to wit, 401(k)s, IRAs, Roths, pensions, security portfolios, etc., etc.). So, we may not now want refineries in our neighborhood or drilling in Alaska, but the call will soon be, "Please, in my backyard." At some point, building efficient refineries will be a consumer demand in spite of how ugly they are. Soon, very soon, the EPA will have to explain why it required refineries to invest $47 billion in the last 10 years to meet environmental goals, not build new, cleaner, efficient plants. Our last thought, for now, on energy is this – much of the price run up in oil was fast, too fast – leading us to point the finger at hedge funds in particular and predict an equally fast drop in per barrel prices when the trading market shifts. For now, don't bet against oil – just accept that the world demand for energy will rise but not by the amount recent rates would imply and the environmental movement, having made the point, will influence safety, efficiency and cleanliness. . . .and we can afford it.

The Deficit: Falling fast. See: corporate profits, worker productivity. No credit to Washington – just credit the application of more and more technology, the off-shore move, and still low unemployment which add payroll taxes to the collection basket. Not an issue at this time. Republican spending? An issue.

Interest Rates: Because there are so many sources of funds and, we believe, still relatively benign inflation, we see a band of 4% to 5% for longer (10-year) issues and short-term rates touching 4% - a flat curve. Yes, we'd like to see a normal curve, but it probably won't happen until inflation is loud enough to get the bond guys' attention. Right now, they see the productivity/off-shore factors as holding inflation down, as do we. These hurricanes will likely end that view over the next 6-12 months. Don't make long-term bond investments. . . .rates will rise and bond values will fall as a result.

Equities: Undervalued and held down by the immediate shock of gas pump prices, hurricanes, Iraq and some upward pressure on wages. This latter may lose impetus with the AFL-CIO split and rising layoffs. In a broader sense, however, we think scars run deep and investors are very sensitive to their portfolio swings. In our view, dividend-paying stocks should, for now, be a significant part of most portfolios – even to the exclusion of bonds. That view will hold until inflation signals abound. The tax rates beg this decision. Don't forget, virtually anyone working is in the stock market via their pension plan at the very least.

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Housing: We've seen a number of good studies that make a strong case that housing affordability, not price, is the test, i.e., the cost to carry including mortgage, taxes, maintenance, etc. versus income available. That ratio is still well within historic boundaries – reflecting, again, rising real wages and low interest rates. We are living in a location showing 10%-20% annual increases, so it is hard not to think "bubble." On a national basis, however, we see not a bubble but the not so obvious demographic shift. We believe the graying boomers, large in numbers, are pulling up stakes in the rust/industrial belt and moving. As we look at housing, prices are flattish in the Midwest (all of it) and rising where the sun shines more. Add water and heating costs to the equation – a topic we'll write about in the future – and this whole demographic, red/blue politics, cultural segregation phenomena starts to take on some form. Yes, abuses in the mortgage lending, refinance world exist – but we believe bigger issues are just below the surface of rising house prices.

The Fed: They will overshoot – raise rates too long – simply because they always do and they can't afford to quit too soon. Remember the Heisenberg effect? That observing something changes it? Well, every bond trader in the world is trying to guess when they'll ease – they know it and so - they won't.

Conclusion: Watch for corrections, not total collapse, in oil and housing and be opportunistic in your buying. Focus on biotech and let the Pfizers of the world struggle with Washington on Senior Citizen drug prices. Stay short in your bond/note portfolio. Buy quality. Don't trade. Brokers get paid to churn you with a new story – not to develop a growing portfolio. In technology we are biased to software and view hardware as vulnerable. We like Japan a lot and for now are using "I" shares. We continue to look for best in the industry rather than limit ourselves, as many do, to just a specific category such as "large cap."

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