Buy to the sound of cannons; sell to the sound of trumpets.
N.M Rothschild at the time of the Napoleonic Wars

Once upon a time summer was for brokers, traders and other assorted financial types to go to the beach. The markets, in turn, would wander aimlessly and await their return. It was a time to catch up on reading, plot new strategies for your portfolio or simply become reacquainted with your family…in brief, a rest from it all.

This summer doesn't appear to be following tradition. I continue to believe the summer doldrums will be along momentarily, but the traders, who should be sunbathing, insist this volatility is here to stay. It matters little for long term investors how much, week-to-week, the market expresses its volatility. But for new investors the sudden arrival of this level of volatility after nearly 3 years of more or less upward progress can be disconcerting…and can lead to bad decisions. In turn, then, let's look at some of the factors behind this more volatile summer market. In any case, markets like this, and I stress this – are better entry points than reasons to exit. More on that momentarily, from my friends at Crandall, Pierce & Co.

It seems to me that the confusion around whether, and when, the economy would slow was the first of the summer volatility triggers. Much has been written of our new Federal Reserve Chairman trying to make an early name for himself and frankly he started rather awkwardly. His agenda, though, was to cool the economy and ease the inflation threat by tightening the supply of money and do so in such a way that he didn't slam on the brakes and spin us into the recessionary wall. Raising rates also gave him room to <u>cut</u> rates later if the economy slowed too much or too soon. So, for that single agenda, he's done OK. The confusion arose around whether a slower economy was good or bad for stocks. Put another way, the majority believe, I think, that slower is better as it doesn't foster inflation while a minority want, I believe, faster earnings growth, with concomitant faster stock price movement. For early 2006, the majority view "slower is better", prevailed and stocks marched upward, with fairly low volatility. Hedge funds, by the way, don't do as well in "slow and steady" but prefer change – lots of it – and in any direction…so guess how they feel now… The second trigger is obvious to us all: When the Middle East came into sharper focus and the usual bottom feeders in the press played their "sell drama, not facts" card, I think the hedge funds exacerbated it as they became more active, especially in commodities where they had made many fortunes and seemed to be running out of ideas. The third volatility trigger was, I believe, the emergence of inflation as a factor in spite of Fed tightening to prevent it.

The irony is that Fed actions also have a lagged impact – so why investors thought tightening would immediately solve an inflation issue that had been building a modest head of steam for over a year, escapes me. In any case, the Consumer Price Index rose, reflecting oil prices as we all know, and you could hear the tide reverse as investors now thought the Fed had not only gone too far but tightening wasn't working and nascent inflation was the "proof". Many hoped the last tightening move had occurred and when it began to look like that wasn't the case the markets dropped further. The perversity of it is we all know the Fed will ultimately ease – the average is six months later – so the end of tightening becomes the beginning of hope…I said it was perverse.

It is confusing – too many interpretations, too many theories all keying off one fact – the economy was heating up. Slowing, then, is and was, prudent and many saw that alone as a good reason to buy stocks. The inflation trigger, however, picked this moment to come into focus and this issue, in conjunction with the threat to Middle East oil supplies, is causing no end of confusion about stocks. My view is that the worst is behind us as of Mid-July because stocks of quality are showing signs of investor interest and the economy is slowing. Let us count the ways: (thanks to ISI)

- Business confidence is down;
- Retail sales are weaker than expected;
- Weak activity reports from auto dealers, homebuilders, and real estate agents are heard;
- Weak cyclical, not structural, technology demand;
- Some negative earnings reports (but the quarter is likely to be up 10% plus).

And then there is oil. Global demand is up about 1 million barrels per day over the last year – leading me to believe global economic slowing isn't yet an issue and U.S. exports can continue to show solid growth. U.S. petroleum demand is about 25% of the global total so some parts of the world are still growing. (I thought the sell-off in Japanese stocks and both developed and emerging economies was and is a mistake – a knee-jerk reaction to our earlier comments). Gasoline growth continues virtually unabated, supporting our thesis that we can afford $4.00 per gallon - we may not like it and many will have to make sacrifices, but we can afford it. Incidentally, "food away from home" is approaching 30% (or more by some studies) of our food budget. I mention that because it's common to most socio-economic sectors and is my guess for what will get sacrificed to buy gas.

It's a bit hard to get your arms around at this point but back in the economic slowdown of 1995, the S&P fell 4% (so far it's down 3%) as the economy slowed (its slowing) and then the S&P rallied 40% over the next 12 months. It seems to

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me the slowdown is key to a stock market rally, that the Fed has room to ease if the economy slows too much and that the Middle East is, in spite of the violence, fighting a far bigger war than many appreciate and one I believe is being won…the birth of democracy. The jihadist agenda to preserve clerical rule and a subjugated people is fighting for its very survival, to my mind. We've seen this before in Russia, Romania, Poland – you know the list. Once these people hook to the global information grid, with all its trash, tripe and hype and begin to see others living better – or just differently, - it's then only a matter of time. Speaking of seeing this all before I enclose, with their permission, one of my favorite charts from Crandall, Pierce which makes the singular case that at the moment they occur events can easily overwhelm good markets. Horrific events should be analyzed in the context of long-term economic strength and the durability of the social structure. Investors with a long view focus on the sustainable health of the companies they own and less on the value a confused market may place on them.

What risks remain? Well, two big ones are the very low level of unemployment and the very high level of capacity utilization. At 4.6% unemployed there is real risk of wage rates rising. Also, with little expansion room in manufacturing, some shortages could develop. All in all, the economy <u>has</u> to slow and soon if inflation is to be nipped. It's for these two reasons in particular that I think one more round (60% chance) of Fed tightening is likely and even a 30% chance for one after that. This new Chairman seems to be saying that inflation will be his "cause".

As corporate profits slow and the markets take another 1 – 1 ½% drop I would advise new investors to begin to buy good stocks – a process I see evolving over the next few months at most. The hardest part of all of this is to take a global view and not let regional or local issues over-influence long-term decision making.

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