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Obviousness is always the enemy of correctness.
Bertrand Russell

Time and time again we long-term investors note that sustainable, rising stock prices reflect sustainable rising earnings – not the hope for it, not the occasional lucky stumble, but the delivery of steadily higher earnings over time, reflecting themselves in higher stock prices, *and in that order*. Therein lies the pitfall of day traders, short-term investors and market timers: The path being highly irregular, the casual observer quickly loses sight of underlying earnings trends and is distracted by all the outside "noise" around markets. These include analyst's comments, market pundits, CNN, your brother-in-law, the Federal Reserve, overpriced news letters and mutual fund advertising.

Of late, focus is on the Federal Reserve. Stocks will go much higher, the Street thinks, when the Fed cuts interest rates and makes even more money available as a result. The assumption here is that a monetary stimulus is needed to move stocks.

Traditionally, rate cuts are used to stimulate a weak economy. The problem with that is, as we've all observed, recent economic news is generally in the "solid growth continues" column, not the "oh my God a recession is imminent" column.

So we see the press and especially individual investors stressing any and all negative news. I think they collectively believe they can will the Fed to cut rates and pump the market up even further. Of course, this is the *same* press that can equally well tout nothing but good news when that is fashionable. This is probably why they are a decent indicator of what *not* to do. This noise, this distraction, ignores a remarkably resilient economy as I have stressed for the last year. There must be some remaining Puritan blood in the investor body because the inability to simply relax and enjoy a low inflation, rising earnings environment seems missing. I mean, when is enough enough? A whole investor mood shift has occurred. In the summer, investors believed the economy had slowed far too much (or would) and stocks dropped sharply. When that was no longer widely accepted (and it was *very* widely accepted), stocks rallied on the belief that the economy would be "OK" and that the Fed wouldn't raise rates any more and would soon cut rates instead, because it was a rather weak "OK" economy. Well, Christmas has come and gone, there was no rate cut package under the tree and, in fact, the economy looks to be not just "OK" but, in fact, pretty strong. So the new game goes like this:

- the economy is stronger than all thought (and that's bad?)
- that could cause inflation and
- the Fed could tighten rates again. . . . and don't forget the ever present (insert your own favorite bad news).

In July, I felt, and still feel, that not only was the economy stronger than many suspected, but also that the Fed may, in fact, tighten rates yet again to preemptively fight an inflation battle. The maddening part of all this is that rate management by the Fed is *expected* and investors should be more concerned with how well it is done, not whether it favors their personal short-term needs. If inflation, the killer of stock prices, is to be contained, then rate cuts or rate increases should be measured by how successfully inflation is kept

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4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

suppressed, for when *that* is successful, earnings move back to center stage and exert their influence on stock prices.

In that context of yet another rate increase and certainly no cuts until late in the year, I see 2007 this way:

- surprises for the next 2 or 3 months centered on a few industries showing stronger than expected earnings and the economy staying strong for the first half of the year, leading to
- modestly higher (+1%) interest rates as inflation fears trigger Fed tightening and
- a modest slowing of global growth which is viewed as really bad but, in fact, is more a return to long-term global trends – Europe in particular.

The commodities – especially oil and the metals – are still falling in price as global output slows. Most Central Banks are still tightening for fear of local inflation so slower global growth seems very likely.

Housing is benefiting from the warmest winter in half a century and my guess is we've bottomed. Existing home prices will fall some more, but builders are increasingly more active, as surveys indicate, and excesses are being wrung out of existing new-housing stock. The greatest issue here, as I've written before, is the demographic shift that is depressing prices in the "cold" states – Michigan being a case in point. "Average" price declines hide huge drags in Michigan, for example, behind modest increases out here in California, Arizona, Nevada and some parts of northern Florida.

Earnings for the 4th quarter of 2006 could easily be flat in comparison to a year ago, given the prior quarters of above-trend line growth. Additionally, oil profits have to come down as lower barrel prices flow through their corporate accounting.

Wage increases look on track for another 2%+ real gain and unemployment should remain under 5% - a significant positive and a significant influence on consumer confidence and spending.

The lagged impact of prior Fed tightening is what some of us are waiting to see – did they do enough so that our "slowing" is in sync with the global slowing or is our economic engine so strong that the Fed must take another turn of the screw? I still feel we'll see another turn and I want to stress that in spite of feeling that way for the last 8 months and knowing full well it would impact stock prices *in the short run*, the core factors of low inflation, quality earnings, rising wages, low unemployment and high liquidity argued for purchase and retention, not sale.

In the next 3 or 4 months we'll see a modest bump up in rates, a strong Gross Domestic Product for a quarter or two, much noise about "poor" 4th quarter earnings results, more objections to Fed tightening and some stock weakness. I believe the most likely scenario is flat stock prices – maybe down 2%. If it occurs, it will not be based on fundamentals, but on all the above-noted noise. It will offer new investors a window and, for some of my clients, higher rates will allow some municipal bond purchases.

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A few additional thoughts about oil. . . . I am indebted to the team at ISI for expanding a point I made some time back – that the hedge funds had a great deal to do with running up the price of oil. . . . and they are *still* net long oil. We have yet to see the squeeze on their short positions. (They can be both long and short simultaneously – what matters is their "net" – and they remain net long.) This current drop, I believe, is temporary as ISI points out, because the long-dated futures market in oil has not fallen as much as the spot market, now well under $60. The 800 lb. gorilla in all this is the derivatives market – the "paper" market of future purchase and sale commitments. The value of that market sums to over 1 ½ years of our current level of consumption. The point of all this? More volatile, short-term oil prices, ultimately a bunch of folks getting hit in the derivatives market, a few hedge funds taking big losses and, with global slowing, weaker commodity prices. . . . which leads to an even better inflation outlook. The year looks good, but try to ignore the next few months.

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