INTERMISSION

As we continue to muddle through this mid-cycle slowdown I thought I'd take a look at the few items that have been on my mind for some time. For those who wish to skip that, the last part of this quarter's comments touch on the economy and the markets.

Averages bother me. Many do not know the difference between, say, the average height of a room full of third graders and the median height. In that example the similarity of the group (all third graders) makes the average height pretty close to the median height – the mid-point height if they were all lined up in ascending or descending order.

It becomes a whole new story when something less symmetrical is analyzed – say wages. The distribution of wages is skewed – a few people in the working population make a great deal of money and many, many more make far less. Yet, if one averages <u>all</u> wages, that skewedness is lost. The median wage is far different than the average wage.

Imagine 10 people, 9 of which are autoworkers at, what, $60,000 per year? The tenth is, for this example, a senior corporate type at perhaps $500,000 per year. The median wage is $60,000; the average wage is $104,000 – a person who does not exist..

My point is that when government statistics begin to talk about average household income or average new car prices, ask yourself if the data being measured is a very wide sample or a smaller, more homogenous sample like the third graders. It isn't just the size of the sample per se; it's to what degree <u>each</u> participant is common to the others.

Which leads me, somehow, to think about house prices. We all speak of the wide disparity in home prices across the land. Fact is home prices are fairly uniform. A recent Federal Reserve paper notes that the structure cost of, as I recall, a 2,000 square foot home varied from about $100,000 to $130,000. The land however, varied in order of magnitude of 40 times versus 30% or so. What value "average home price" has thus escapes me.

Remember the comment in a prior newsletter about the folks at Citigroup analyzing income and spending among consumers? It is the best explanation I've seen to clarify the strength in average consumer spending as contrasted with the swings in consumer sentiment. Here again, "average" just doesn't tell the tale. [The top 20% by income account for 60% of consumer spending and are relatively insensitive to gas prices and the like while the bottom 20% by income account for 3% or so of spending.] So we will all be careful when we speak of averages – me especially.

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The wonderful woman who types these missives, Jan Schneck, sent me the following data which also bothers me – in fact, more than the misuse of averages. A Professor Joseph Olson at the Hamline University School of Law noted the following about the 2000 Gore/Bush election:

- Gore won 19 states, Bush won 20;
- Gore won 580,000 square miles of land, Bush 2,427,000;
- By county population, Gore won 127 million and Bush won 143 million – not much of a difference.

So far, so good, I thought – seems fairly innocuous.

By murder rate per 100,000 residents in those counties, Gore 13.2 and Bush 2.1 – about a 6-fold difference.

Olson goes on to say ". . . the map of the territory Bush won was mostly the land owned by the taxpaying citizens . . . (and) Gore's territory mostly encompassed those citizens . . living off various forms of government welfare."

Maybe we need to rethink <u>all</u> the labels and measures we use.

Of late, migration has been on my mind also – being one of the statistics myself. Arthur Laffer notes the out – migration from Michigan, New York, New Jersey, Ohio – but the biggest numbers out are from California. High taxes, in virtually every case, sees these states losing to Texas, Florida, Arizona, Georgia, and so on.

Demographics (age), to puncture a favorite theme of mine, don't seem as important as taxes – which does make more sense.

And, as long as I'm on the subject, I am also changing my view on interest rates. New information leads me to suggest that the plus or minus 4 ½% needed for a range of bonds due 10 to 30 years out is headed for a range more like 3% to 3 ½%. The overwhelming amount of liquidity, globally, and the enormous pressure on wages created by ever larger numbers of people (globally) entering the work force argues for lower long-term inflation and subsequently lower bond rates.

The yield curve – that chart showing years on the horizontal axis and interest rates on the vertical – should begin to look more normal as this year progresses. By that I mean the shorter rates should drift lower – much lower - while longer rates, as noted, head for the 3 ½% range. This "normal" or upward sloping curve has not been seen in a while and is a major support to <u>both</u> higher bond prices and higher stock prices.

The warm weather and tax refunds, notes ISI, did a lot to make us all think a slowdown would not occur and, in fact, created a "growth" scare in the middle of our mid-cycle slowdown. Those days are over, unemployment claims, gas prices, cold weather, etc. all make me think we are still in the slowdown and the odds for the Fed to <u>raise</u> rates falls ever further. In the same breath we do not see rate cuts this year – no need, given the liquidity in the system <u>over and above</u> what the Fed could create.

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How, you may ask, can excess money not push inflation up? Well, as Ed Hyman notes, maybe it's going into new factories, stores, equipment, etc. Business Week noted capital spending was up 18.1% in the 4th quarter of 2006 – about half of which was overseas – a very big number in both cases. Remember, developing economies are now nearly a third of world GDP – bigger than the U. S. (ISI). The comments in the press, then, about low levels of business investment are only half the story – it's a global economy, business is flush with cash, stock buy-backs are the order of the day and , most importantly, emerging nations are beginning to exhibit the demand for goods and services we have all long expected.

Domestically, I am concerned with the recent bullish trends in the stock markets. Earnings were good, but fully half the increase in aggregate S&P earnings came from companies reducing the number of shares they have out via buy-backs.

Granted, it's not earning from continuing operations, and granted, we'd like to see earlier trends continue, but bear in mind the rate of earnings growth has been very high, so comparisons to prior periods are almost definitionally going to appear inferior. That said, the pace, not the level, of the recent moves in the stock market bother me. I still believe – insist if you will – that stocks are undervalued vis-à-vis inflation, corporate liquidity and global demand. I just am uncomfortable with how much they have moved in so short a time.

I expected more volatility and we're seeing it. I expect we'll have to prepare for a pretty hefty sell-off to work out these latest upward moves. That said, I see no reason to try and time it, exit and return or anything of that nature: the trend is up, the elements for it are legitimate and long-term investors (us) should take a deep breath and go fishing while this stock market works itself through the coming months.

Lower interest rates, higher stock prices, a recovery in the economy at large in the fall of this year and an on-going weakness in housing – at least that's how I see it. Ignore the volatility, it's easier on your nerves.

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