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Between Charybdis and Scylla

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Welcome to
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DEAR CLIENTS:

In Greek mythology, *Charybdis* was a sea monster that swallowed huge amounts of water three times a day and belched it back out. She lived in a cave on one side of a narrow strait, taking the form of a whirlpool that sucked in and destroyed anything that came within range. *Scylla* was a six-headed sea monster who lived in a cave on the opposite side of the strait. The two sides of the strait were so close together that a ship attempting to avoid Charybdis would pass too close to Scylla and vice-versa. In Homer's *The Odyssey*, Circe advised Odysseus to sail near the cave of Scylla and take the chance of losing six men rather than all of them in the whirlpool of Charybdis.

A situation where moving away from one danger causes you to be in harm's way of the other is sometimes referred to as being "stuck between a rock and a hard place." This was an accurate description of what investors faced in the second quarter as Fed chairman Ben S. Bernanke played a modern day Odysseus, trying to steer the economic ship between slower growth/recession and higher inflation, with decidedly mixed results. The good

news is that as Greek mythology was mostly just great storytelling, we think many of the monsters the Fed and investors see lurking in every dark shadow will prove to be scary tales and nothing more.

Periods ending June30, 2006 (Total Returns - Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index	NASDAQ
3-months	-1.98%	-1.44%	-7.01%
6-months	3.23%	2.71%	-1.08%
One-year	9.56%	8.63%	6.48%
Two-years	18.38%	15.48%	7.64%
Three-years	42.60%	37.53%	36.47%
Five-years	18.92%	13.09%	3.34%

THE STOCK MARKET AND THE FED

After a solid first quarter, equity markets worldwide were whipsawed by conflicting messages from the Fed. On **April 18, 2006**, the Fed released the minutes of the policy-setting Federal Open Market Committee (FOMC) meeting of March 27-28, 2006, Bernanke's first as chairman, during which the Committee voted to raise its target for the federal funds rate to 4.75%, the fifteenth consecutive 25 basis point increase. The minutes indicated, "most members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy." Although the Committee included its standard hedging language and said, "some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance," investors cheered and stocks soared. During an **April 27, 2006**, appearance before the Joint Economic Committee of the U.S. Congress, Chairman Bernanke stated, "even if in the Committee's judgment the risks to its objectives are not entirely balanced, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook." The Fed seemed to be signaling at least a pause in its inexorable campaign of tightening. Alas, hopes were quashed when the FOMC again voted on **May 10, 2006** to increase its target for the federal funds rate by 25 basis points to 5.00%, the sixteenth consecutive increase, eliminated any reference to a pause and reiterated "some further policy firming may yet be needed to address inflation risks." Chairman Bernanke threw some gasoline (\$3/gallon) on the fire during remarks to the International Monetary Conference on **June 5, 2006** when he said, "While monthly inflation data are volatile, core inflation measured over the past three

to six months has reached a level that, if sustained, would be at or above the upper end of the range that many economists, including myself, would consider consistent with price stability and the promotion of long-run growth... These are unwelcome developments."

Thus, over the span of about *six weeks*, the Fed seemingly went from a posture of "inflation is reasonably well-contained and we're probably going to at least take a pause" to "inflation is uncomfortably high and we're going to have to continue tightening." Investors already had to deal with the fear of the economic ship being driven towards the Charybdis of slower growth/recession or the Scylla of higher inflation. The Fed's rapid about-face introduced a third, even scarier monster for investors to fear: Stagflation (i.e. slower growth/recession *and* higher inflation). The reaction in worldwide equity markets was swift, with the more speculative areas (which had been doing the best) hit hardest as "fast money" headed for the exits. We'd note that introducing an element of risk that has the consequence of cooling speculative fever is not all bad.

We think it's helpful to take a couple steps back from the sound and fury surrounding the debate over what the FOMC might do at its next meeting or the meeting after that or the meeting after that. First, monetary policy (tightening/easing) works with a lag (i.e. it takes many months for a tightening/easing to impact the economy) and inflation is a lagging indicator (i.e. it reports what has already happened). Thus, the Fed is steering the ship with a policy that works with a lag and by looking at the rear view mirror, so it's *far* from precise. Second, because of these lags, the Fed tends to overshoot on the upside and downside. As recently as **August 12, 2003**, less

than three short years ago, the FOMC announced it was keeping its target for the federal funds rate at 1%, saying, "the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise of inflation from its already low level." Further, "The Committee judges that, on balance, the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future. In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period." Thus, the FOMC viewed the risk of inflation becoming undesirably *low* as justification for keeping federal funds at 1% less than three years ago and the risk of inflation becoming undesirably *high* as reason for increasing federal funds to 5.25% currently. Disinflation/deflation didn't happen back then (and the Fed overshot to the downside) and we don't believe inflation is about to take-off now (meaning the Fed is overshooting to the upside).

The Fed has a tough job and we don't mean to bash them. Our point is we don't invest based upon the next wiggle in Fed policy and our *long-term* success won't be impacted one iota. We were clearly early, but still believe the Fed is nearing the end of its tightening campaign and this will be good for the equity market. We've stated our case that stock prices are ultimately driven by interest rates and corporate earnings. Our friends at ISI Group estimate 2006 S&P 500 operating earnings will increase by 9.9% from 2005, a slowdown from the 13.4% increase of the prior year, but solid nonetheless. In addition, *The Wall Street Journal* reported global merger and acquisition announcements totaling \$1.83 *trillion* occurred in the first half of 2006, up 43% from last year, as credit remained plentiful (albeit more expensive) and corporations and private equity firms

competed to put their capital to work. We think solid earnings growth combined with the high level of M&A activity will lead to higher stock prices.

BOND STRATEGY COMMENTARY

The FOMC raised its target for federal funds to 5.25% on **June 29, 2006**, its seventeenth consecutive 25 basis point increase, stating "recent indicators suggest that economic growth is moderating from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices." It added, "the extent and timing of any additional firming that may be needed to address these (inflation) risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." Investors were relieved the Fed did not indicate further rate increases were a foregone conclusion and both stocks and bonds rallied.

We have begun moving out of our shorter-maturity U.S. Treasury securities and locking-in better rates in higher-quality corporate and agency securities. Although the yield curve remains relatively flat (i.e. investors don't pick-up much yield for lengthening maturity), we view this as a good opportunity to lock-in attractive longer-term rates. While spreads have widened in the high-yield market, they remain narrow by historical standards. We favor higher-quality names that will give us a boost in yield and hope to take advantage of wider spreads whenever they develop.



SUMMARY

There is a lot of uncertainty and fear and no shortage of economic, political and geo-political storm clouds on the horizon. This has *always* been the case. Our charge remains to keep our eyes focused squarely on the prize of *long-term* performance. We like what we own, are close to fully invested and are prepared to ride out the storm until this pervasive pall lifts and sunnier skies prevail.

We thank you for the trust and confidence you've placed in us.

KM WELCOMES TERI STRIETELMEIER

We are pleased to announce Teri Strietelmeier has recently joined our business as an Equity Trader. Teri formerly held the same position with Reams Asset Management Company and also worked at Irwin Union Bank & Trust Co. Teri graduated from Franklin (IN) College with a Bachelor of Arts degree in Finance. Welcome aboard!

Regards,

Kirr, Marbach & Company, LLC
