Stanley E. Rulapaugh, CFA **October 1, 2006**

Despite what you see and read in the news, the economy is doing just fine and it has been throughout 2006. There were a few scares in midyear but nothing lasting. Here's a review of the news that will put recent history in perspective.

In January, businessmen were optimistic because of strong finances and good earnings which meant they could continue planned spending on capital goods. Households were flush with cash and sentiment was positive because unemployment was less than 5%. Cyclical stocks, those most influenced by a good economy, were in favor.

As February started, $65 oil began to worry economists. Consumer spending continued to be robust along with business capital spending. Housing looked shaky but not enough to slow the consumer down. New home sales in March showed their largest monthly increase in thirteen years. Consumer confidence and spending held up because of the strong job market. Corporate profits were excellent. Commodity prices were rising and bond yields were at two year high. Some observers wanted the economy slow down, however. In anticipation of a weaker economy, some stock pickers recommended buying stable stocks such as tobaccos, foods and utilities, and selling industrials.

Anyone who has been around a while knows that the economy improves many more months than it falls apart. Investing for a slowdown requires the selling of stocks in some of the most dynamic areas of the market and substituting slow-growing, mundane, pedestrian issues. One of the best consumer staples stocks, Kraft Foods, has been selling around $32.00 a share for more than five years. It is certainly defensive because it never moves, and because it doesn't move, it is a great stock to own in a weak market. No one buys Kraft because it is a growth stock.

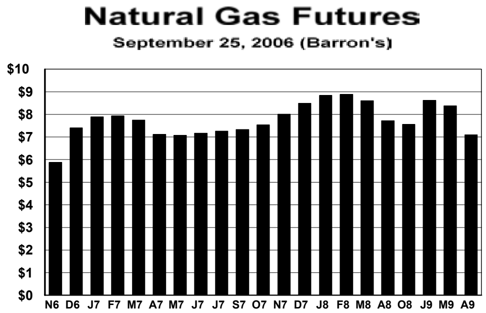
In April, the shortage of labor and strong consumer demand were concerns. Housing showed signs of slowing which generated fears the consumer would stop spending. Gasoline topped $2.75 a gallon, threatening car sales. Consumer confidence dropped bringing more recommendations to invest defensively in stable companies. Inflation gained strength in May because of rising energy prices. High interest rates and weak housing prices were a factor in early-June. Stocks that had held their own for five months, energy for example, began to slide in May as consumer confidence ebbed. Cyclical stocks dropped on fear more than fundamentals. The press began to use the word "slump" when writing about the economy even though the numbers continued to be reasonable.

July brought heightened risks for the economy. Since inflation seemed to be picking up speed, Fed rate increases were seen as inevitable. Home sales continued weak leading to a more cautious consumer. Oil approached $80.00 a barrel which everyone knew would hurt the economy. Rates continued to drop because many observers just knew the consumer was wounded and would stay away from the stores. Even Wal-Mart stock went down because, supposedly, its customers couldn't afford gas to get there. Selling cyclical stocks like retailers to buy defensive issues was in vogue. By August, even the Fed admitted it expected the economy to slow. As a result, stock and bond prices went <u>up</u> on the expectation that the Fed would soon stop raising rates. The Fed did stop, but with the caveat that more rate increases may be in our future.

Business continued to invest in plant and equipment in September. Exports were strong and consumer spending continued despite lower home sales. Virtually unseen in the popular press was the September 19 report that tax receipts paid on September 15 was a one-day record of $85.8 billion compared to a record $71.8 billion in 2005. The deficit was smaller than expected. Both the stock and bond markets improved and some forecasted that interest rates could fall below 4%. All the talk about a "hard economic landing" (recession) just a few months ago gave way to talk of a "soft landing" (a slowdown but no recession). A week ago the Conference Board reported that the consumer confidence index was nearly back to July levels, back when the "hard landing" folks scared everybody. Falling gasoline prices and a steady job market were given credit for the increase in consumer confidence. Despite all the gloom in the press, the stock market hit a six-year high Thursday.

If the economy and the stock market and corporate profits are doing fine and the economy continues growing, what are all those portfolios going to do with their slow-growing food and tobacco stocks? Trying to shuffle the contents of a portfolio based on the daily news is not only frustrating but futile. Assume that economic activity picks up instead of sliding into recession. Those defensive issues must be sold and the cyclical stocks repurchased. Getting this right is much more a matter of luck than skill and the luckiest portfolio manager will be profiled in the press and be interviewed on TV.

Oil prices and the cost of gasoline will always provoke a discussion. Turn on any stock market show now and money managers brag about selling their energy stocks at the top a few months ago and buying food stocks at the bottom. In my opinion, this activity is nothing more than a short-term trade and I'm not in the short-term trading business.



Here is a chart of the price of natural gas futures for delivery into 2009. These numbers are available every week in *Barron's* and the next few contracts are in the daily *Wall Street Journal.* The price is on the left side and the delivery date is identified on the bottom of the chart. The caption "F7" is February 2007 and so on. Gas for delivery in December is currently selling for about $7.00 per million btu. Gas for delivery in March 2007 is $7.60. If you look across the chart, gas hits $7.00 in December this year and stays above $7.00 into 2010. Professionals trade this commodity contract to hedge their future needs and they don't expect natural gas to stay at $5.40 where it is now.

After Hurricane Katrina made a mess of the Gulf of Mexico, natural gas jumped to $14.00 for a short time. It dropped back to $7.00 as the pipelines were repaired and storage refilled. September is usually a slow demand month for gas because the air-conditioning season is over and the heating season hasn't started. Another factor weighing on the price of gas has to be the forced liquidation of billions of dollars of natural gas contracts held by Amaranth Advisors, a less-than-successful hedge fund.

As gasoline falls in price and large inventories of crude are reported weekly, I'm concerned that we are becoming too complacent. Certainly, lower energy prices will help with the Christmas bills but, unless I was at lunch, I don't recall any new refineries being built. A large new energy field was discovered in the Gulf of Mexico but it will be years before it produces enough to make a difference and the production from a miles-deep oil well won't be cheap. People are buying smaller cars but the number of cars getting less than twenty miles per gallon far outnumber those getting more than twenty-five. And no one has been able to explain to me why paying $2.35 a gallon, down from $3.25, is different from paying $2.35 a gallon on the way up to who knows where. I guess it's a feel good thing.

So long as most of the oil we use is in the hands of nations unfriendly to the US and the cost of finding new sources of oil is going up and up, I'm sticking with the energy stocks. I'm not clever enough to sell energy, buy foods and then sell foods to buy energy. That's a loser's game and those who bet against a growing US economy are wrong.

With the stock market at a high and interest rates low, jobs strong, the deficit falling below forecast, gasoline prices falling, state budgets at a substantial surplus, and inflation under control, what is the problem? The problem is the reporting of the economic news on TV and in the newspapers. Bad news leads and good news gets buried. The cartoon at the top of page one says it all.

One of the phrases I'd like to banish from the language is "cautiously optimistic." It's everywhere in the print news and on TV investment shows. My feeling is the user of the phrase does not want to accept responsibility for their comments. If "whatever" turns out well, they were optimistic. If "whatever" sinks to oblivion, it's a good thing they were cautious. Ignore comments from the cautiously optimistic. They really have no opinion at all.

It is never a good idea to talk to someone who is holding a microphone. Debra Jackson of Alexandria, Louisiana said she likes shopping at the Dollar Palace because it is convenient and casual. "I don't have to get all dressed up like I'm going to Wal-Mart or something," she said.

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