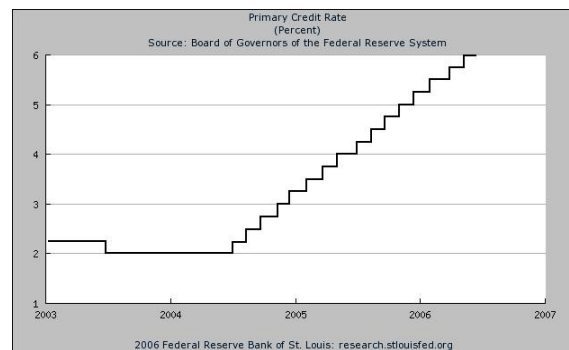


I'll build a stairway to Paradise
 With a new step ev'ry day!
 I'm gonna get there at any price;
 Stand aside, I'm on my way!

Song by the Gershwins, performed regularly at the "Fed Follies" by Alan Greenspan, currently starring Ben Bernanke.

Here's a great graph of the Federal Reserve's interest rate decisions since 2003. This is what the Fed calls the "Primary Credit Rate." Not much happened in this series until mid-2004 when the Fed started raising rates in a "measured response" to strengthening economic activity. The guessing is that there will be at least one or two more hikes in the next few months. Business growth has been very good for several years, gloomy media reports notwithstanding. The objective of all these interest rate increases is to slow economic growth which peaked at the 5.3% rate we experienced in the first quarter. Now, 5.3% is a strong showing so there is a real chance of inflation picking up. Members of the Federal Reserve Board have said as much in recent speeches. This 5.3% quarter is probably a fluke so to focus on that as a reason to raise rates seems misguided to me.



Building this "stairway to paradise" carries with it an assumption that there is one interest rate that will be perfect for business conditions. The Fed administers rates knowing that there will be a lag between the increase or decrease in interest rates and the final impact on economic activity. Some guess this lag is as short as six months to as long as two years. The increases in late-2004 could be responsible for the unpleasantness in the stock market this last six weeks as investors seem to have discovered, quite suddenly, that economic growth was at risk.

Several observers have mentioned inflation as a worry. Too much demand for too few goods and services can lead to higher prices. We are seeing that in the airline industry. The number of flights has been cut back at the same time demand for seats has gone up. Every airline has raised prices in response to higher fuel costs but I suspect the fare increases include a few more dollars just because they can get them. Even if you don't fly, if you do any shopping you have your own examples.

Inflation is both visible and invisible. Buying a tank of gasoline for \$50 instead of \$30 is certainly visible. But consider the fruits and vegetables we all buy at the supermarket. We have to pay more as consumers because they cost more to produce. We often forget that the farm's tractors, irrigation pumps and fertilizer all use, or come from, petroleum products. Once the crops are harvested, we use energy to transport them to market.

Inflation is reported two ways; the total change and the change not including food and energy. The "core" rate is fairly stable at 0.3% for the last three months. The food and energy components are such volatile series that month to month changes are almost meaningless for policy purposes. There's nothing the Fed can do about food prices or energy prices for that matter, so to raise rates because of higher food and energy prices is irresponsible. If energy and food prices fall dramatically in the next year, the Fed will find another excuse to mess with rates.

Back in March 2001, at the start of the last recession, I wrote a newsletter critical of the Fed, using the sinking of the French ocean liner Normandie as an example. In that piece, the analogy was the ever-busy Fed pouring water on a burning ship until the ship sank. Fire damage was minimal so the firefighting effort was a success. Recall that the stock market crashed in early-2000 but the Fed continued to raise rates from 5.0% to 6.0% in the first five months of 2000. It was as though the Fed slept through the crash, never thinking that rate increases could cause a recession. Well, high rates did cause a recession that started in the first quarter of 2001, almost a year after the crash. In this case, the lag between the last rate increase and the start of the recession was about seven months.

I remember when Paul Volcker was Fed chairman during the first Reagan years. The economy went far into the porcelain receptacle as a result of the Fed's tight money policy. Inflation peaked at 13.5% in 1980 but, as a result of back-to-back recessions in 1980 and 1981-82, it was only 3.2% in 1983. That's where inflation is today and it's seen as a

problem! Here's a quote from the May 11, 2006 Fed press release.

The Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives.

I think what is bothering investors the last several weeks is the troubling phrase in this Fed release about watching current economic information for guidance. The very thought that the Federal Reserve is making economic policy based on headlines in the newspaper is frightening. Aren't the hundreds of economists at the Fed supposed to make forecasts, not "respond" to "incoming information?" As stated earlier, the Fed knows that rate increases impact the economy with a long lag. Policy makers need to take a chance and stop building the "stairway to paradise" immediately. They should get out of the way and let the prior sixteen rate increases work. Otherwise, they will again overshoot and the economy will end up a mess as it has after prior tightening cycles.

On June 23 Anadarko Petroleum, a holding in many accounts, announced two acquisitions, Kerr-McGee and Western Gas. This is a very big deal, totaling \$21.1 billion. With this move, Anadarko becomes the fifth-largest oil and gas producer in the USA. Anadarko stock dropped almost 8% on the news which I believe reflects concern about the increased debt levels and the high price being paid for the acquisitions. That's the bad news. The good news is that Anadarko has acquired a terrific portfolio of domestic properties, a stable of experienced geologists and petroleum engineers, and the potential for significant cost savings during the next two or three years. There is also the opportunity to sell current assets that don't fit to help pay for the purchases. That's portfolio management! The new Anadarko will be more focused on domestic energy production at a time when foreign sources are less secure. I think this is a terrific move and that the stock deserves to trade much higher. In my opinion, the decline in the stock price reflects short-term thinking (end of quarter thinking) and not the longer term prospects. Frankly, I thought that Anadarko would be acquired before now because of its existing strong natural gas position and low share price. Anadarko could still be acquired after the dust settles. Either way, in two or three years this stock could be a big winner. Full disclosure. I own it personally and have no plans to sell because of these acquisitions.

The table below has been published in these letters before. It is a list of companies that often appear in a diversified portfolio and certainly as major holdings in index funds. I updated it from year-end 2004 to current levels. Shown are the price changes for the last eighteen months and for six and a half years, declines that are amazing.

	Price 12/31/1999	Price 12/29/2004	Price 6/29/2006	Change since 12/29/2004	Change since 12/31/1999
Wal-Mart (Retail)	69.12	53.44	48.12	-10.0	-30.4
Coca-Cola (Food)	58.25	41.56	42.76	2.9	-26.6
Intel (Technology)	41.08	23.25	18.94	-18.5	-53.9
General Electric (Industrial)	51.58	36.56	32.96	-9.8	-36.1
Merck (Pharmaceutical)	67.10	32.24	35.48	10.1	-47.1
American Int'l Group (Insurance)	72.17	65.80	58.79	-10.7	-18.5

Assume a \$2,000 investment in each of these stocks at the end of 1999. At the end of 2004, the \$12,000 had shrunk to \$8,300, a loss of almost 31%. "They will come back," some said. Well, two did by a smidgen and the rest continued to slump. The \$12,000 nest egg is now worth \$7,725, proving once again that some stocks are tennis balls and some are eggs. Tennis balls bounce. Eggs don't. Got eggs?

Have a safe and enjoyable July 4!

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