# INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

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| MARKET SNAPSHOT: AUGUST 31, 2006 | DJIA: 11,381.15 | NASDAQ: 2,183.75 | S&P 500: 1,303.82 | 10 YEAR TREASURY NOTE: 4.73% |

## BONDS

Last month we showed you the long term stock price picture. This month we wish to show you the long term interest rate pattern. As you remember, stock prices languished when inflationary expectations rose from the late 60's until the early 80's, and interest rates rose accordingly. Absent inflation worries, interest rates are justifiably and properly closer to the 3-5% level. This can be seen clearly on the Chart on the reverse side. Rates stayed well inside this range for both the period after WWII—before inflation began to raise its ugly head due to bad Fed monetary policies that began in the early 70's—and at present wherein Fed monetary policies have clearly been aimed at holding inflation low for nearly 20 years now.

We have often written on this subject because inflation is such a prime danger to financial markets everywhere. Fortunately, world banking leaders now recognize this and work diligently to try to convince political leaders of the folly of using currency exchange rates as tools of short term economic and fiscal policies in their respective countries. Also fortunately, the financial world has become much smaller due to high tech communication and trading capabilities that allow cross-border transactions instantly, with all being transparent and easy to see by all who care or need to know about financial markets. This is especially true of banking regulators, who became much more united and cooperative with each other after the international banking scares of the 80's. Some may recall that Japan was then being talked about as becoming the banking leader of the world due to its aggressive banking rules. This all changed when the major banks around the world got together to set minimum capital standards for all banks wishing to transact among them. The result was a gradual diminution of currency exchange rate volatility and a slow but steady decline in inflation and interest rates.

With that little history as background, the purpose of this Letter is to again assert that to us, at least, it is now all but impossible for major central banks anywhere to seek to return to the days of wild swings in currencies and rates. There are far too many instant hedging capabilities and opportunities for currency and other huge traders today. This makes it almost certain that instant responses will be forthcoming that would offset any policy initiatives that had the intent of forcing market-unfriendly changes. Bottom line: the root cause of inflation *(i.e., an attempted reduction in any currency's real purchasing power*) is now essentially out of the question.

The "fixed income" markets are now functioning with a high confidence regarding inflation. Recent worries along these lines by our own Fed are daily fodder for bond and currency traders, speculating as to whether short rates will be moved up by Fed policy makers or whether tightening is now essentially over for a while. On this point let it be very clear: all this Fed talk has little to do with investing in bonds by the average investor seeking a secure income.

What does need to be understood, however, is that longer term interest rates are the first signal as to whether the markets are nervous about inflation. The record of interest rates on 10 year Government Treasuries over the past couple of decades is very clear—they are now in a steady downward pattern that is returning them into the long term 3-5% range. They are likely to remain in that range so long as inflation worries do not return.

Recall once more. When bond prices are easing, as has been true for the past several years, investors in fixed income securities, like bonds, are well advised to stay short and avoid any loss of principal due to easing bond prices. Now that the Fed seems to be done or close to done tightening, it becomes a little safer to invest in bonds having a little longer maturity.

A couple of factors are at play just now, however, that have a bearing on our own investment policies for our clients. One is that short and long term interest rates are nearly identical. This is called a flat yield curve. You should know that this is abnormal and unlikely to last long.

The second factor is that with interest rates now back down into a normal range of 3-5% and likely to stay there, stocks having similar yields offer an attractive alternative. The

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classical idea that stocks are more risky than bonds due to the risk of price change, to us, is for many good and valid reasons, up for debate in the modern world. We will hold that discussion until another day, however.

**CONCLUSION: Stocks remain the preferred investment vehicle for most client accounts, for most of a portfolio, circumstances permitting. Bonds, because they are still a favorite of many investors, are more acceptable today than they have been, but still tend to give away too much, all risks considered, versus the kinds of returns investors are likely to garner on average over time by investing in solid, dividend-paying stocks of well-managed public companies. Our general policies remain unchanged with only the timing for locking in rates for a little longer period having improved slightly.**

*Roland*

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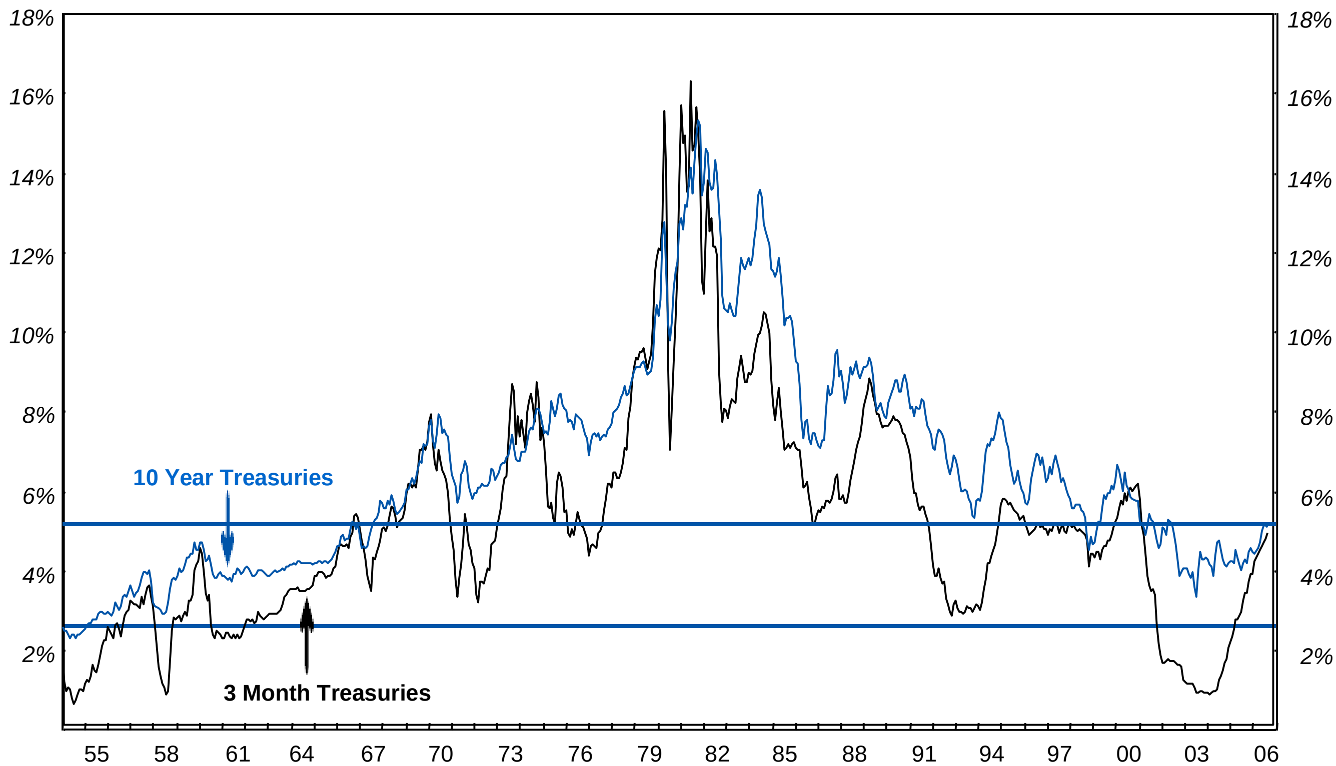
## Historical Interest Rates

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