INVESTMENT LETTER

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The two key areas of concern to investors regarding what happens in Washington, D.C., are: (1) Fiscal Policies, and (2) Monetary Policies. We speak and write about them all the time, although they both tend to be large and vague areas not well understood by the average investor. The recent election brings both into play so we would like to discuss them briefly this month.

Fiscal policy, by way of explanation, is the broad term that covers what the federal government spends and how it gets the money to pay for what it wants from us taxpayers. The President outlines a national budget for the coming fiscal year, but it is Congress—our elected representatives—that passes the laws authorizing spending and tax rates, with the President holding veto power over items that Congress wants but he doesn't. Fiscal policy is very much in the hands of the citizens who elect these people to run our country and spend our money.

Monetary policy, on the other hand, is quite different in that it is the province of an independent, non-political Federal Reserve Board. It has to do with keeping our dollar sound, holding inflation in check, and working with the President's Treasury Secretary to implement the policies set by the Board, whose Chairman is appointed by the President for relatively long terms that overlap the political cycle so as to try to keep it free of the kind of political influences that dominate fiscal policies.

That said, and by way of providing some background to recent events, it was during the Nixon years that his Treasury Secretary and Texas politician, John Connally, created havoc in the financial world by virtually denying any need for the U.S. to defend the dollar. He proceeded to persuade the President to drop off the "gold exchange" standard which then pegged the dollar to be defended if gold rose above $41 per ounce. Connally described that kind of rigid control as anachronistic and outdated, even as Congress continued to hike federal deficits in that high-tax, high-spending environment. It was, at its worst, fiscal and monetary policies run amok.

President Ford had the unpleasant task of completing Nixon's term in office after the Nixon resignation, but could do little to reverse the damage done and could not hold back the wholesale drop in the dollar in foreign markets as inflation heated up. President Carter followed Ford and promptly appointed a nonmonetary trained industrialist, the head of Textron, as Fed Chairman. Strike Two! Nobody in political authority really understood monetary policy and the result was as expected: rampant inflation and rising interest rates that followed on the depreciation of the dollar near the end of the 1970's as politicians all but ignored the necessary fiscal disciplines.

That little history pretty well encapsulates the kind of thinking that existed back then before Paul Volcker, Fed Chairman under President Reagan, put a stop to it all by quickly getting control of money supplies which in turn dropped interbank lending rates from the 20% range back down to the 5% level. The sharp economic contraction that followed in 1981 was both predictable and unavoidable. Reagan's attempt at throttling Congressional spending habits was valiant but hard to enforce during a weakening Economy. But Volcker was arguably the monetary policy medicine that allowed the U.S. to soon enjoy the longest period of uninterrupted economic expansion through the Bush I and Clinton presidencies.

Alan Greenspan's tenure followed Volcker's at the Fed, and he remained tenacious regarding controlling monetary policies so as to hold inflation and interest rates low. Monetary policies

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were finally back under the control of financially sound leaders.

The Reagan influence eventually brought conservative fiscal policies back, but it wasn't until 1994 that it really took hold after the "Contract With America" landslide that installed a more conservative Congress. Since then, although federal spending has continued to grow so as to produce regular annual deficits *(conservative Congress??)* at least the percentage of the Economy represented by federal government spending plateaued and has held steady now for some considerable period of time.

This combination of sound monetary policies and fiscal restraint facilitated continued economic expansion with minimal inflation fears. The resulting low interest rates along with a steadily declining tax rate environment, aided big-time by the technology revolution's productivity advances, resulted in what has been a continuation of unprecedented economic growth.

Now, here in 2006, despite more economic expansion finally being confirmed by rising stock prices, there are concerns that some of those harsh history lessons may be fading from our collective memory. During those volatile days that began in the 1960's, investors were constantly admonished to keep a close watch on the political landscape. For the past couple of decades, however, such attention has been conveniently and happily unnecessary. Instead, tor focus could remain on financial matters with politics left mainly to politicians and their ilk in the media. The worry now raising its ugly head is whether or not the recent change of party control of Congress might be a sign of a return of economic trouble ahead.

The quick answer, as one who lived and suffered through the earlier difficult times, is that we think not. We say this for two big reasons: (1) the world has grown much smaller and interrelated financially so as to make all monetary policy initiatives immediately transparent, and (2) fiscal and tax policy changes now have an immediate impact in the marketplace. Both of these have in turn invaded the world of our two main political parties, despite all the rhetoric that is thrown around during campaigns like the one just past.

Clearly, terrorism and how to deal with it had many voters unhappy. But the willingness to vote to change party control of Congress clearly signaled much more. We think there was an obvious drop in voter fear of what any Congress is going to be able or willing to do that might get in the way of the economic expansion that so many are enjoying and do not want to see changed. If this is so, and especially having a seated President of the opposite party, it seems a fair bet that there are unlikely to be any damaging changes to fiscal policy for a while that need concern investors. Firming stock prices pretty much confirms that conclusion.

CONCLUSION: Sound monetary policies that are unlikely to unravel anytime soon in a transparent financial world, combined with the ugly lessons we all learned from the U.S. experiences of the 1960's, bode well for a continuation of non-inflationary economic expansion ahead. The maturation of many of the formerly backward foreign economies and creation of three major currency blocks within a highly integrated financial world make today's world much different than the one we faced several decades ago that resulted in painful foolish actions that nobody today wants to see repeated—no matter which political party one may belong to.

Roland

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