INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

MARKET SNAPSHOT: JANUARY 31, 2006 **DJIA: 10864.86** **NASDAQ: 2305.82** **S&P 500: 1280.08** **10 YEAR TREASURY NOTE: 4.52%**

FED, OIL AND IRAN

Recent softness in stock prices appeared to come rather suddenly and unexpectedly. The usual reasons given are almost always wide of the mark, fed largely by journalists and short term traders who are only rarely interested in anything beyond the immediate. We will try in this issue to expand a little on some of the key factors that we think gave rise to this sharp move, bearing in mind that share prices generally remain well below warranted levels on the basis of financial fundamentals.

Not long ago we wrote about the new Fed Chairman, Ben Bernanke, remarking that we were generally pleased little was likely to change under his stewardship. He takes office in a matter of a week or so. More recently, however, we have been getting some inputs from those who know the Fed from the inside that all may not be as well as might have been expected.

As everyone knows, the Chairman of the Federal Reserve Board himself has considerable clout over the monetary and economic policies taken by the Fed—at least those policies that are made public. This is so notwithstanding that the Federal Open Market Committee (FOMC), consisting of him plus all the Presidents of the Fed districts around the country, has the power by a group vote to make all decisions regarding changes in short term interest rates when they meet.

The other power behind these two well-known Boards is seldom mentioned but is very real, indeed. By this we mean all of the economists and staffers who work for these two Boards, and for the agencies themselves, who have the duty to do the research and to make recommendations to the members who attend the meetings. The board members, of course, have it in their power to accept or reject advice they receive. This is so because there is more than pure economics involved when decisions are made regarding banking practices and interest rates. The Board's duties also include how their decisions will impact the financial world politically.

That said, recent comments coming via some insiders, who must always be very cagey and close-mouthed about what they can tell anyone, suggest that in fact, the Chairman may have a few ideas of his own that may or may not coincide with those formerly held by Alan Greenspan. The commonly held perception has been that the Fed Chairman makes all the decisions. Wrong. What really happens is that the staffers provide information to each member of the FOMC, who in turn has a vote as to any change of policy. While the Chairman's view is the all important one, we can be certain that it is never going to happen that the Chairman will be shown to have been on the losing end of a board vote, thus he is always seen to be leading the outcome.

The current situation, wherein a new Chairman is ascending, puts a little more clout with the staffers who are not leaving and already have some influence over the voting members. The point being made for stock investors today is that the last hike in short rates by the Board was somewhat presented to the financial community as its last one. What is coming out now is that with inflation and oil prices moving upward, the thinking at the Fed is that more quarterly hikes may be needed. That is all it took to scare market traders, who promptly acted by selling stocks.

The second issue of continuously rising oil prices, while already factored into stock prices in general, got the market's attention when crude oil began rising a little faster toward the $70 per barrel level than some had predicted. That was the second cause of the sudden downturn in share prices.

The third issue bothering investors was the escalation in talk about a possible military solution to the Iranian nuclear development threats. The reaction of all free na-

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tions, plus China and Russia, against the Iranian threat meant that all were taking such threats for real and were genuinely worried.

Since the initial notice by Iran that it was breaking the IAEA seals on their nuclear facilities in order to restart processing materials that could be used to build an explosive device, saner heads began to come together around the world to try to put a halt to the hot debates. But regardless of how well or poorly things may be going with the Iranian madman leader, the damage had already been done regarding share prices. The recent sudden selloff was clearly a result of one or all of these negative events.

Another, less significant negative to share prices sprung onto the scene at the same time as these others. This had to do with some earnings weakness in the latest reporting periods of some major companies like GE and Intel. Fortunately, we believe it was of much less importance in a real sense to investors.

The more useful evaluation and explanation of such reports is that, while the financial markets like to have only good news on all fronts all of the time, the reality is that there are always ebbs and flows in a free economy, while various sectors advance, consolidate or adjust to new market conditions.

In the case of Intel, for example, many apparently viewed this major company's results as a sign that another tech bubble was about to happen because Intel's chips are so dominant in its markets. What wasn't well reported, however, was that Advanced Micro Devices (AMD), a competitor to Intel, reported a huge increase in chip demand for the same period. While no expert in this myself, it seems pretty clear that demand is still fairly healthy for such products, but that one company was just doing a little better job of anticipating and capitalizing on specific items while the other was letting itself fall behind the demand curve.

Such things in the largest economy in the world, as all know, are constantly going on and should be expected pretty much as routine. If the larger matter of the demand for high tech was softening, it should have been evident across the board in many companies. It was not.

Likewise, there is also little support for the view that the Economy in general is weakening. On the contrary, with the Fed now less clear as to what they see ahead as "growing pricing power" for major companies in the U.S., which suggests some price inflation, that has to be due—despite the real estate boom's possibly topping out—to a pretty strong Economy which is in fact the case, in our view. Employment growth is strong, unemployment is below 5% nationally, (below 4% in Florida, by the way), earnings on the whole are continuing to advance nicely, and profit margins are strong, despite occasional blips in consumer demand. Corporate spending on capital investments for the next year also looks to be stronger than it has been in quite a while.

CONCLUSION: While Iran is clearly a major issue of concern for all peoples everywhere, oil and the Fed's policies ahead are not material, nor are they issues that have not already pretty much been taken into consideration by the financial markets and by investors in common stocks. If the economy were showing genuine signs of weakness, which it is not, there could be some cause for worries. So long as corporate earnings are rising, and return rates are being maintained, corporate managers continue to manage efficiently (even having to lay off workers in a time when unemployment is near its lows), stock investors should continue to act, bearing in mind that share prices, on the whole for major companies, remain well below the levels where they would and should be normally.

Roland/Kelly

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