A Word From Our Friends

April 19, 2004

Comstock Partners, Inc. are old friends of ours and have the same outlook as do we concerning the economy and interest rates. As we have a time or two in the past, we wish to include their latest comments after the CPI numbers released last week. Their point is that what seems like bad news for interest rates is actually hastening the days of deflation and lower rates for <u>high quality</u> bonds. There is a decent chance that 1987 is about to be revisited again in the financial markets.

Secular Bear Market Continuing

April 15, 2004

The recent rise in inflation only confirms our long-held view that deflation is the most likely eventual outcome, and that the secular bear market will soon resume. The March increase in the CPI confirms anecdotal evidence showing increases in the prices of paper products, hotel rooms, used cars, New York City taxis and building materials. Combined with increased long bond yields and the perception of an earlier Fed tightening, rising prices mean that the Fed's game of stimulation is over. The rise in long rates will also kill the mortgage refinancing game while the Federal budget is already so deeply in deficit that no further stimulation is possible from this quarter as well.

Without further stimulation, consumer spending growth is likely to drop sharply or even show negative results. Household debt relative to GDP is at a record high while the consumer savings rate is near the low end of a 40-year range. Any rise in interest rates will increase the debt burden even more. Although March payroll employment was up strongly, total employment is still 9.4 million less than what it would have been in an average recovery, and wage increases have been slow. This means that the overall economy at this juncture is particularly rate-sensitive and will be unable to sustain adequate growth in the period ahead.

The rise in inflation and interest rates is therefore sowing the seeds of its own reversal, and is likely to be temporary. A lot of the inflationary pressures on commodities have emanated from China, and the Chinese monetary authorities have already taken what will probably be only the first in a series of monetary tightening moves. Even now, we have seen recent downturns in copper prices, scrap steel prices and the Baltic Freight Index. It is also significant that a number of key cyclical stocks have consolidated and turned down.

All of the above is consistent with our view that we are in a post-bubble period with major structural imbalances that have yet to be corrected. Stocks are in a secular bear market that started in early 2000 when the 18-year secular bull market came to an end. The stock market rise of the past year can be seen as a bear market rally or as a cyclical bull market in a secular bear market. Whatever we call it, we believe that the rise is over and that the major downtrend is now resuming. The fact that the vast majority thinks this is only a harmless correction only adds to our conviction