The Wheels are Coming Off the Economy

July 17, 2006

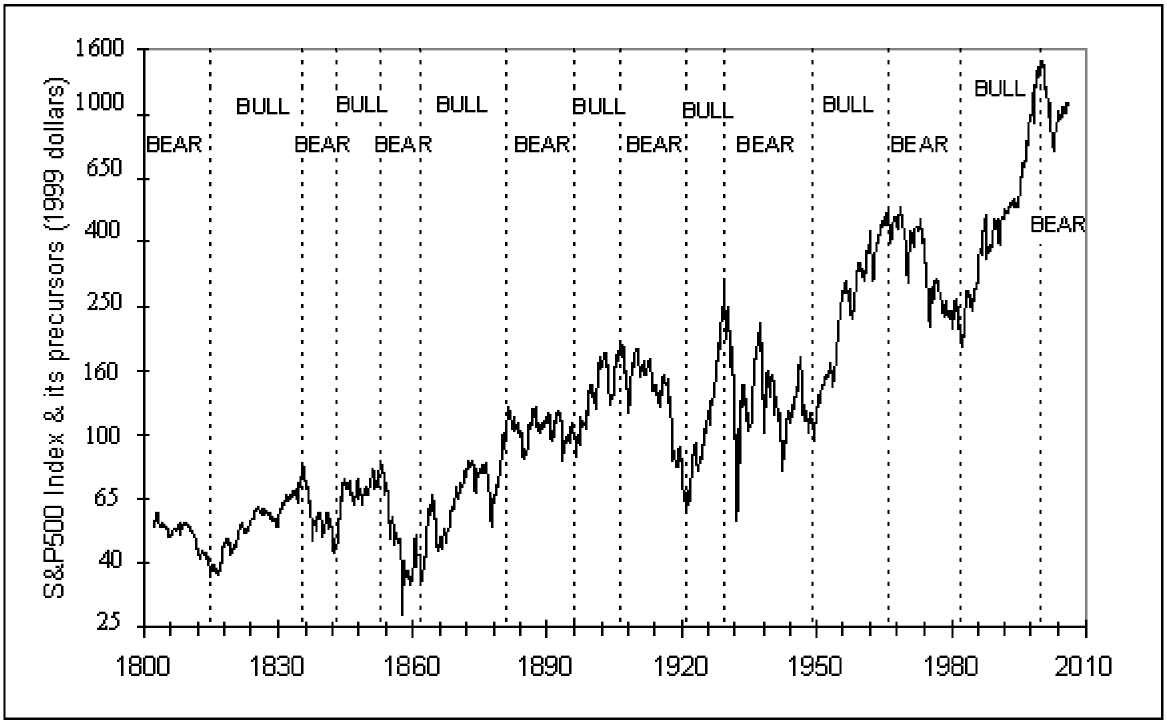
It seems rather obvious that when the preliminary GDP numbers come out later this month it will show that the consumer is backing out of the spending stream. Retail sales are going south, if one measures them on a real basis (Ex-inflation). All those circumstances we have mentioned this past year are now coming into play. The catalyst is the housing market. It is destined to be much worse than many are forecasting.

We believe the Fed will start cutting rates during the 4th Quarter 2006. Many will believe that this will reignite the housing market as long rates decline. Our opinion is otherwise. Defaults are rising sharply, up approximately 25% over a year ago. What lenders will continue to lend into a market inundated with defaults? As you might recall, most of the mortgage money has come from the commercial banks over the last eighteen months. There are two interesting aspects about that which is certain.

1. **Banks are always the last in. Only when everyone else has "proven" a trend do they participate.**
2. **Besides being the marginal player, banks are always the first to run. LIFO is their game, Last In First Out.**

Over the last six months, as long-term government bonds have declined in value we have been beating the table for all to buy. At the same time, our recommendation has been to sell common stocks. We continue to support this as the proper allocation of assets. It is not too late.

Please note the following two charts – The first is a picture of the trend in 30-year government bonds. The second being the record of bull and bear markets in common stocks. Both asset classes are in the trend revealed. Bull for government bonds. Bear for common stocks.


S&P500 Index & its precursors (1999 dollars)
1600
1000
650
400
250
160
100
65
40
25
1800
1830
1860
1890
1920
1950
1980
2010
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