Commentary:

First Quarter, 2006

TV News and the Wal-Mart Economy

The U.S. stock market rang in the New Year with a strong start. The bellwether Dow Jones Industrial average broke 11,000 for the first time since 1999, and closed the quarter up 3.66%. The broader based S&P 500 returned a similar 3.7% while the NASDAQ closed the quarter up 6.8%.

This was one of the strongest first quarters for the market in recent years, reflecting strong current economic fundamentals. The U.S., as well as Euro zone, Japan, Asian, and Latin American economies are all growing, employment is healthy, business spending is improving, inflation and interest rates remain moderate, and the U.S. consumer continues to shop till he drops.

The economic news stands in stark contrast and seeming indifference to other news from around the world, which has been considerably more sobering. Between the deteriorating situation in the Middle East, ballooning deficits, rising fuel prices, the threat of pandemic flu and terrorism, not to mention the underwhelming performance of our elected officials who are their own source of global warming, we are fed a rich diet of worry.

Could it be that the market is ignoring things that will ultimately be significant? Or could it be that economy is actually stronger than anyone wants to believe?

We believe the answer to both questions is yes.

What's on TV?

Things are almost always better and worse than they seem, especially through the narrow lens of the media. Our diet of information is skewed towards the sensational, easily digestible, here and now, and black and white, and away from the complex, ambiguous, subtle, and non self-interested. We like our news to be about us.

At the moment, the economy is far better than it may seem on television. The lay-offs that are reported at General Motors, are offset by the creation of thousands of new jobs at Google and other new and growing companies throughout the country which don't go reported. Yet they matter. The pace of innovation continues in technology, healthcare, entertainment, defense, energy, communications, and financial services and this innovation creates new opportunity, new growth, new jobs, and new wealth. We believe the economy is very robust and very resilient.

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But it is not invulnerable. There are events and factors that can have a deleterious impact on our lives, maybe not today, but perhaps tomorrow. Over time, they all matter.

Events in the world, for better and worse, may seem far-off and without apparent relevance to our lives today, and yet the world is ultimately one big system and what happens in one part of the world ultimately affects what happens in another. Information, goods and services, people, capital, germs, weapons, pollution, skills, ideas and ideologies, can all flow across borders with relative ease. The bargain of globalization is that problems trade as easily as opportunities, although the opportunities far outweigh the problems.

Business Fundamentalism

We do not claim to be economists, or market strategists, but rather "business fundamentalists." We look at the world and the markets with a focus on fundamentals, valuation, and a long-term perspective. We invest in specific businesses where we like the fundamentals and opportunities for return over time.

If we look at the markets today, we think that valuation levels are reasonable, that the future direction of the markets is very much hinged on what happens next. The potential negatives are well known but include a meaningful rise in long-term rates, - something we have felt was an inevitability, but so far has not come to pass – a further deterioration in Iraq, a disruption in oil supply, some other natural disaster, terrorist act, or anything else that unglues investor sentiment and consumer and business confidence.

On the positive side, we expect strong earnings results from companies and increasing capital spending by businesses, which have been building high levels of cash and reducing debt. The M&A environment is healthy as companies merge and acquire for strategic advantage, and there are billions of dollars of investment capital in the hands of private equity firms, venture capitalists, hedge-fund managers and other investors looking for opportunities.

We think that a lot of this deal activity will transfer wealth from one group of investors to another more than it will create fundamental value for the underlying companies, but that is a subject for another ***Commentary***. In any case, it should support higher market valuations.

Finally it is impossible to overestimate the impact of China, as well as India and Brazil. These emerging markets stand to become ***eclipsing markets*** over the next decade or two, likely surpassing the United States and continental Europe in economic power. They represent markets of hundreds of millions of new consumers and businesses that will generate incremental demand for goods and services, as well as competition for scarce resources like oil and capital. **On balance, these eclipsing economies represent much more of an opportunity than a threat for us.**

The Wal-Mart Economy

The thousands of students and workers in Paris protesting over the proposed elimination of laws which give them two years of job security on their first job, stand in striking juxtaposition to the thousands of legal and illegal immigrants protesting in this country, and the many millions of aspiring workers throughout the world who are hungry for a better life and eager to work for it. Workers in Shanghai, Singapore and Bombay compete against workers in Paris, not to mention Detroit, San Francisco, and everywhere else.

Both Western Europe and the United States risk losing significant ground to economies like China and India that are lower cost, and are becoming highly skilled, and more productive. If the developed economies are the local department store, China and India are Wal-Mart and Target and they have just moved into the neighborhood. They will change the global economic landscape as surely as Wal-Mart changed the retail landscape in towns across the country. They provide great value to the community with new jobs, lower prices and greater selection, but at the expense of those businesses that compete directly against them. Similarly, we need to ensure that our economy is posed to sell to them, buy from them, and compete above and around them, but not against them.

Western Europe, in particular, looks vulnerable. Its population is 10 years older than ours, and social-welfare costs over 40% of GDP. The governments seem powerless to effect even simple reforms of the social welfare system. More competition and greater challenges are on the way.

In the United States, we need to eschew protectionist and isolationist inclinations, create incentives for new business development and investment, allow dying and dysfunctional institutions to restructure or fail without artificial life support, and foster advancement in science, technology, biotech, and alternative energy. We also need to reconsider our role as the world's military superpower. While we borrow and spend hundreds of billions in Iraq and to maintain a military presence and influence around the world, China, which is becoming our largest creditor, is investing in new productive capabilities at home, without the same burden of military spending. We should be careful lest our military ambitions undermine our economic ambitions and potential.

Over the long term, it certainly seems that emerging markets will continue to increase their share of global GDP and command a growing allocation of the world's capital. One would want to weight portfolios in favor of this trend.

On balance, then, it is hard to get overly excited about stocks in general, given current valuation levels. It is always easy for us to get excited about companies in specific.

The Thrify-Fifty

Perhaps the most interesting group of stocks to consider are the top 50 companies in the S&P that were such high-flying growth darlings of the mid-to-late '90's not to mention their heyday in the "Nifty-Fifty" early 1970's. They are now one of the most reasonably valued parts market and offer pristine balance sheets, high profit margins, and large exposure to the emerging markets. Companies like Coke, Dell, Pfizer, Intel, Microsoft, and even Wal-mart are selling at record low valuation levels relative to the S&P 500. While these companies may offer slower growth in years to come, they probably don't have a lot of downside and offer a good risk/reward.

Our focus in particular is to find companies that have either fallen out of favor with investors, or smaller growing companies that are below the radar screen. Fortunately, these kinds of companies can be found in almost all market conditions. As we believe in concentration and patience – making relatively few investments, making them large positions in our portfolios, and being willing and able to hold them for several years - we rarely have a shortage of ideas. The greatest challenge is to say no, rather than yes, to do less, rather than more.

For a description of what we are doing in our small-cap and Counterpoint portfolio strategies, please refer to our portfolio-specific letters. ***(Accredited Investors Only)***.

Jurika, Mills & Keifer

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