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DHJ&A

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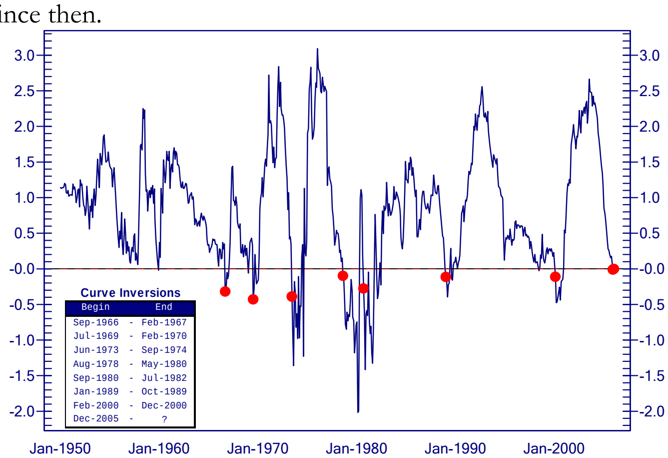
Things Are A Little Different This Time!

Since December of last year, the two-year US Treasury note has offered a yield above that of the ten-year note, resulting in an inverted yield curve. This situation is relatively unusual, in that short-term rates are lower than long-term rates about 80% of the time. An inverted yield curve develops when the Federal Reserve decides to raise short-term rates to slow down an economy that is expanding "too fast". The Fed has raised the Fed funds rate 14 times since June, 2004, from a low of 1% to the 4.5% it is today, and more increases are likely in the coming months. The fact that longer rates are below short rates means that investors expect the Fed to be successful in slowing economic growth.

In December when the "inversion" first occurred, there was a lot of noise about it on CNBC, and from business commentators generally. Recently the furor has abated; however, it is important to remember that yield curve inversions have significant implications for stock prices, price/earnings ratios, and earnings growth. Historically, an inverted yield curve has been very bearish for stock prices.

The chart below shows that there have been eight inversions since 1950. Five of them occurred between 1966 and 1980, and three since then.



Source: Bloomberg, DHJA Research

Looking at all of these occurrences, on average the S&P 500 declines at an annualized rate of -3.08% in months that the curve is inverted. Price earnings ratios contract in anticipation of a peak in earnings growth, which occurs some months later.

Average Annualized Monthly Changes Since 1950

Yield Curve Slope	Months Observed	S&P 500 Price	P/E Ratio	Reported EPS
Negative	88	-3.08%	-13.80%	28.17%
Positive	585	11.09%	6.42%	11.22%
All Months	673	9.12%	3.66%	13.08%

Historically, PE ratios start to contract just one month after the initial inversion and do not trough until 15 months later. Earnings continue to grow for several months before the tight money slows things down about 12 months later. Stock prices follow earnings for a few months, rising for 7 months, and declining for the next year. Obviously, if history repeats itself, 2006 will be a tough year for stocks. However, we believe that things are a little different this time.

Most of the yield curve inversions occurred prior to 1979. Up until then, the short-term rates that banks and savings and loans could pay for deposits were subject to Regulation Q, which prohibited them from paying more than 7% for deposits. If the Federal Reserve raised rates above that level, money would leave banks to go to unregulated investments, seeking higher returns. Bank reserves would quickly dry up and a sharp, but short, recession and market decline would result. There were 5 such declines in the short fourteen years from 1966 to 1980. Regulation Q ended with the Bank Reform Act of 1980, and since then we have had only two relatively shallow yield curve inversions before the current one. In those instances the ensuing recessions have been shorter and milder and the stock market's reaction has been less consistent.

Another differentiating factor in the current inversion is that our economic growth today is being driven to a much greater extent by growth in India, Asia, and Eastern Europe than it was in the past. We are benefiting from a capital spending and consumption explosion in these areas. Fed rate increases may slow our domestic housing and retail sectors, but will have little effect on demand outside the U.S.

Thus, we believe that an inverted yield curve is less indicative of a recession today than it has been in the past. The stock market, earnings and PE ratios will follow their normal cycles, but the economic slowdown will be less severe than history would suggest. PE's have already begun to contract. Profit margins for the S&P 500 are at all time highs and earnings growth rates will likely peak by summer. Stocks are probably in for a correction over the coming months, but the downside risk is perhaps 5-8%. PE's and stock prices should trough by late summer as expectations build for Fed easing and a return to a positively sloped yield curve. We should be set up for a typical year-end rally and perhaps have a very good year in store for the equity market in 2007. More about that next month.

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A copy of our Form ADV, Part II is available upon request.

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