

*In Your Interest*  
JULY 2006 INVESTMENT LETTER

The past quarter has been the most volatile and the worst performing quarter for stocks and bonds for some time. Yet it has not come even close to being a serious decline, since a bear market is classified as a decline of at least 20%. I would like to address something in this investment letter that I have mentioned in passing for the past few quarters; stock markets go through periods of large increases followed by periods where they churn up and down around a fairly consistent level.

There is a graphic on the last page of this letter. It was taken from a recent Barron's magazine which, in turn, derived it from a family of mutual funds, Rydex. You can see that the 1920's produced an incredibly hot stock market that ended in the 1929 crash, followed by the Great Depression. The value that the market achieved in 1929 was not reclaimed until the mid 1950's, a period of 25 years. There were cyclical up and down movements over those years but the fact remains that a buy and hold philosophy would have seen dead money for 25 years.

The mid 1950's to the late 1960's saw the markets climb to about the 1000 level on the Dow Industrial Index. Markets were not able to break out of cyclical until the early 1980's.

The most recent upward movement began in 1982 and lasted until the year 2000. It is my belief that we are now on that plateau near 10,000 on the DJII. If history is a guide, this period could last for 20 years. But more importantly, these periods begin with a significant market sell-off.

It is for that reason that I have been suggesting investing in companies that have good cash flow and pay significantly higher dividends than the average company. The historical average return on common shares has been slightly over 10% per year but that includes dividends. Most recently, the Dow has gone from 1,000 to over 10,000 in 18 years. That is a compounded annual return of almost 25%. We can expect a significant decline or else a long period with little significant upside.

How are markets valued? What causes markets to experience periods of rapid increases in value? What causes markets to sell-off? These are questions suitable for three books but there are fairly simple answers that will help to understand market behavior.

The level of interest rates in the economy is extremely important in valuing markets because capital seeks its best reward. Generally, the lower the interest rate, the higher the price earnings multiple. A way to look at this is to consider the earnings yield. If a company is trading at \$25 and is earning \$1 per share we say that it has a P/E (price/earnings ratio) of 25. And if that same company will provide us with \$1 in earnings when it is trading at \$25 we say that it has an earnings yield (\$1 divided by \$25 times 100) of 4%.

So if the level of interest rates in the economy is 8% it is unlikely that you would pay \$25 for a company that earns only \$1. You might pay only \$12.50 for the stock because that is an earnings yield of 8%.

The growth rate of the company and/or the economy will also affect how markets are valued. If there has been recent innovation (remember the dot coms) or changes in worldwide economic conditions (China and India have both embraced the market economy; Eastern Europe and the Communist Bloc have integrated into the world economy) worldwide economic growth will increase. Higher worldwide economic growth will translate into faster growth in earnings for companies. A company whose earnings from year to year are \$1.00; \$1.30; \$1.65 is growing earnings at 30% per year. An investor would value that company with a P/E of at least 30 to 1 if that growth were sustainable. So it would be expected that it would trade for \$50 or more.

Another positive feature for markets are countries and companies with high cash levels and low debt. A negative for markets is rising inflation. High price/earnings ratios are associated with fast economic growth, low levels of debt and low inflation and low interest rates.

One last topic before we decide whether markets are more likely to rise or fall is to look at Globalization of markets. Prior to the 1980's if you looked at graphs of the stock markets in the major industrialized nations you would note that there were few patterns that were coincidental. Markets in Canada and the U.S. were similar but Asian and European markets were operating very independently. In fact, recessions in one area of the world were quite often overcome by the strong economies of other locations.

It is remarkable how almost all regions of the world are working in unison now. This provides for a strong world economy but may present difficulties as we get a downturn, especially in the most dominant economy, America.

The largest problem today is represented by the debt and deficits in America. The beneficiaries of this problem are the oil producing nations of the world, including Canada; as well as China and India, which are moving from third world to industrial nation status. China has embellished its growth by buying American debt in order to depress its currency and Japan has done the same. Japan has also kept its interest rates extremely low in order to overcome the deflation that has gripped the country for 15 years.

I believe that there is more risk than reward in equity markets. Japan seems to be the country that is best positioned by coming strongly out of their period of recession. If China would be forced to increase its currency that would reduce the strength of that market and would, perversely, be a positive because it would lower the growth rate to a more sustainable level. If America could retreat from Iraq that would reduce the pressure on its deficit level and benefit its currency. If Europe can expand the Euro Zone with ease and Germany and France could overcome some of their internal strains the world economy would benefit. This seems like a lot of "ifs" to be set right.

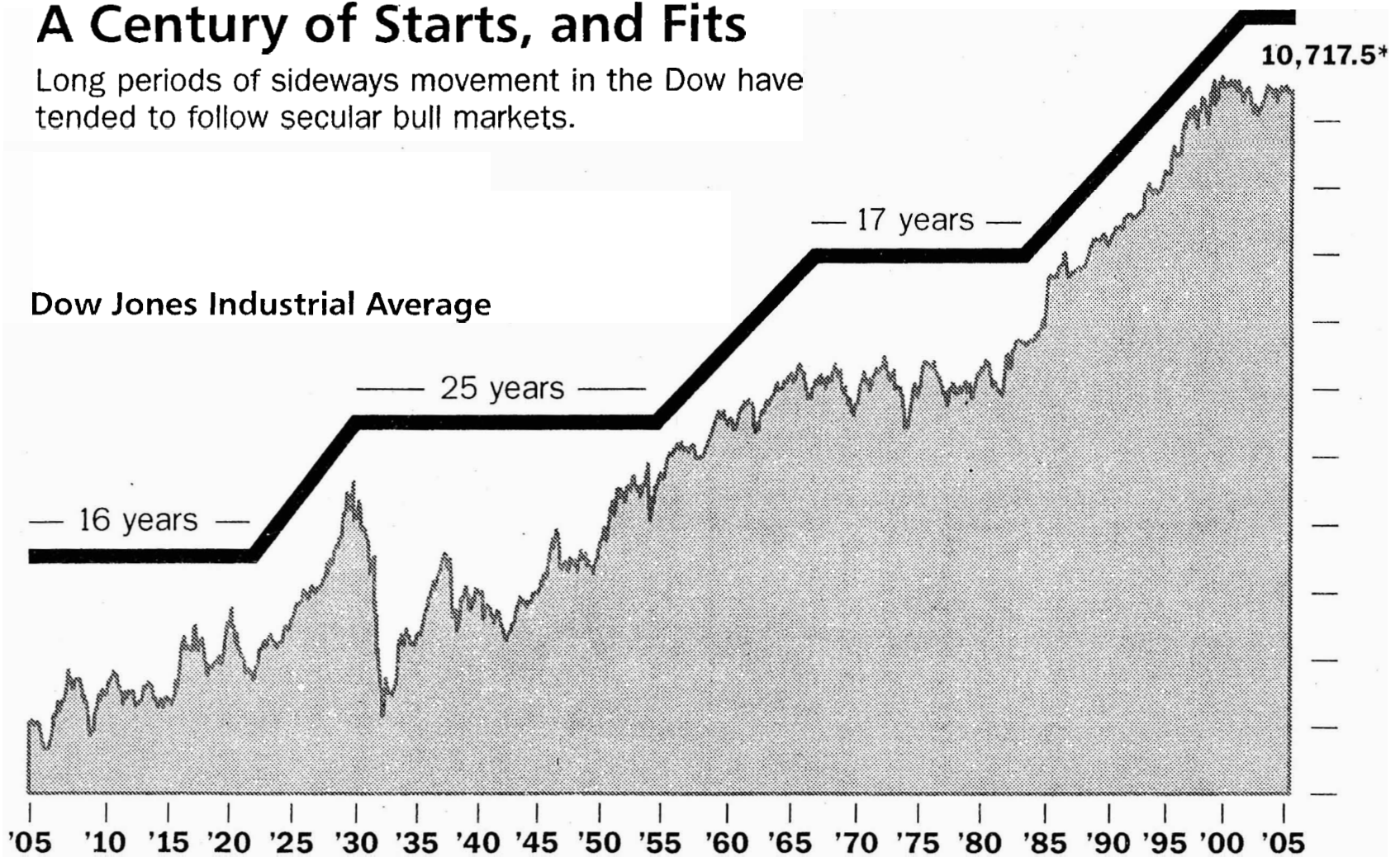
I would make the case that interest rates are rising, inflation is increasing, growth rates in nations and corporations are declining, and debt, especially in America, is rising. It is difficult to see how that translates into rising equity markets.

July 2006

Wayne D. Armitstead  
(250)727-9275

## A Century of Starts, and Fits

Long periods of sideways movement in the Dow have tended to follow secular bull markets.



\*As of Dec. 31, 2005

Source: Rydex Investments