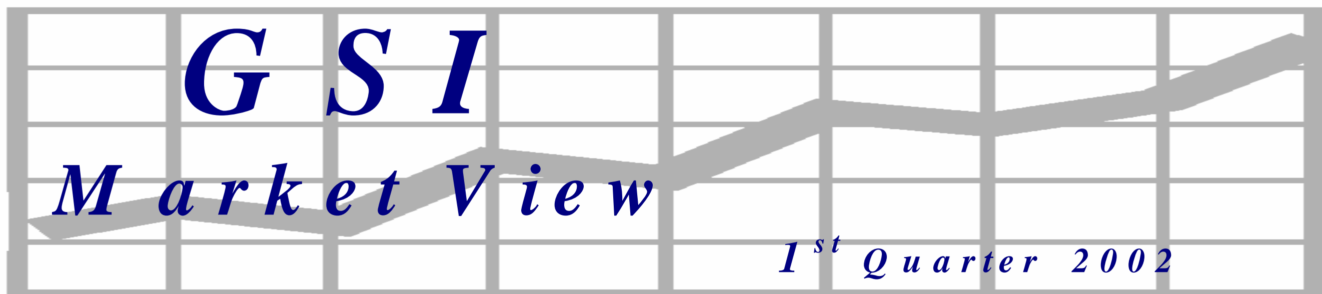


**As the saying goes... 'This too shall pass.'** Seemingly appropriate as we gazed out our window and witnessed the 8 to 9 inches of snow falling in April. We knew that the upcoming 50 degree days would melt things soon. Psychologically, however, the situation weighed heavily on the local population, with negative thoughts and commentary from nearly everyone.

**Similarly, the market, although economic indicators suggest that a recovery is underway, continues to struggle to gain ground**. *It seems as though we are living in a "one step forward, two steps back" environment in which any positive news is quickly countered and overshadowed by some sort of negative news, however meaningful it may be.* Subsequently, the media, lead by CNBC, relentlessly over hypes both old and new news in an effort to boost its ratings. What we're often left with is the impression that the whole world is collapsing and that corporate profits will never again validate any P/E multiple over 10. *Psychologically tiring for nearly everyone involved, the question at large seems to be, 'will this market ever rebound?'*

If we are merely concerned with the short-term, much of the current negativity is justifiable. *To view things from a longer-term perspective, however, Glenn and I need to filter out the current "noise" and look at what may happen over the next 12 to 24 months*.

**What we see is a likely rebound in the general markets.** To build our case we need to review a basic macro-economic equation:

***Low Inflation + Low Interest Rates + Low Oil Prices = P/E Multiple Expansion=Higher Stock Prices.***

*Loosely translated, these factors, taken individually or collectively, serve as "tax cuts" for the general economy, validating higher stock prices*. Higher stock prices help to further stimulate corporate spending. Higher corporate spending generally translates to more jobs. More jobs often mean higher income. Higher income usually stimulates consumer spending. All of these move the Fed to a tightening of interest rates in fear of rising inflation. As a result, corporate and consumer spending usually slows in the face of the higher rates, helping to diffuse potential inflation. Subsequently the cycle begins again as the economy slows and the Fed is encouraged to again lower interest rates to reinvigorate the economy. Holding the price of oil constant, it is the goal to properly manage interest rates and inflation (primarily through monetary, and, to a lesser extent, fiscal policy) in order that the equation remains in balance over the long term. *If done correctly, growth is managed and sustained.*

**Although Glenn and I believe that the US is in the early stages of an economic rebound, numerous pitfalls still exist**. *Of primary concern is the escalation of hostilities between the Palestinians and the Israelis*. The current problems have already increased the price of oil, pushing up the price of gas at the pump. Although part of the recent spike may be short-term in nature (due, in part, to the upcoming summer travel months), much of it is directly attributable to Middle East tensions. Iraq's recent move to halt oil production for one month (in a show of support for the Palestinian cause) has done nothing to help the situation either.

**Let's view the oil issue in greater detail**. As we said earlier, any spike in the price of oil translates to a tax on all who use it. The fear of an embargo and/or further increases in the price of oil however, may not be reasonable either. Energy experts argue that an oil embargo would not be in the best interest of OPEC, as member countries, especially Saudi Arabia, need revenues to support their respective economies.[i] *In short, Iraq and Iran may not be able to dictate terms to the other members of OPEC.*

**Longer-term then, it may be no more reasonable to expect to sustain the recent $28/bbl than it is to expect the price of oil decline to levels below $20/bbl**. Moreover, it is reasonable to expect oil prices to settle in the $23 range, as it is the general feeling of some that the Middle East conflict may be responsible for roughly $5/bbl. *A growing world economy could push that price up somewhat, but again according to one expert, not above $24. We would tend to agree.*

*Finally, we must remember that in the 1970's when the last embargo occurred, the world was 50% dependent on OPEC oil; now it is approximately 29% dependent*. In other words, the threat of Iraq and an OPEC embargo becomes much less frightening now than it was in those earlier years. Add to this the additional barrels currently being produced by Russia, and our dependence on OPEC declines even more. *In sum, barring a full-scale war in the Middle East, it may be reasonable to assume that the spikes in oil prices may be short-term in nature.*

**Other threats to a longer-term market rally include a confrontation with Sadam Hussein, another terrorist attack and potential Fed rate hikes**. Given the current tensions in the Middle East and the recent increase in the US unemployment rate however, the Fed is probably on the sidelines for now. The other two are, to a large extent, beyond US control.

**So, what have we been doing in our accounts?** Let's begin with our stock holdings. *Over the past year, we have been shifting to companies that are less subject to accounting criticism and with growth prospects that are more predictable*. Although very successful in the 90's, technology and telecom issues have been hard hit. These latter industries have been hurt by a reduction in capital spending due to higher interest rates and a buildup of inventory beginning in mid 1999. Capital spending has yet to recover, and its estimated improvement continues to be pushed forward. Consequently, we have been building portfolios in the consumer cyclical, consumer staple, select manufacturing, health care and financial areas. Also, our switch has been to smaller (not small) companies with steady growth prospects. *Again, barring any major conflicts or additional terrorist attacks, we feel that the market is poised for a rebound.*

**With respect to bonds or fixed income securities**, we have been using a collection of fixed income 'substitutes' in an effort to generate yield that is currently unavailable in the government and corporate bond sectors. *Specifically, we have used different REIT's (real estate investment trusts), some closed-end, convertible funds and other high income paying securities to achieve steady total returns.*

**It has truly been a bumpy road over the last 24 months with declining stock prices adversely affecting nearly everyone we know**. I will leave you with an analogous thought that I have had for nearly four months now. As a loyal and ardent supporter of the Golden Gopher hockey program at the University of Minnesota, I have lived and died a thousand times with the team. Many of you may know by now that the Gophers won their first NCAA hockey title in 23 years, removing the proverbial "800 pound gorilla" that has been on the shoulders of many Minnesota sports fans. The overwhelming theme throughout the run was…, **"it's time."** *Both Glenn and I think the same is true for a market turnaround.*

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