JUNE 2005 — MARKET REPORT

WE'LL SEE A 12,000 DOW, WHEN THE FED STOPS RAISING RATES

Back in 1995, the stock market went up roughly 40% when the Federal Reserve stopped raising interest rates. That says stocks will rise again, but only when the Fed stops raising interest rates.

A few are beginning to worry that we may see a significant slowing in the economy if the Fed goes too far. The source of those concerns is the recent slowing in the rate of growth of some measures of U. S. money supply. The annual rate of growth in M-2, for example, is just 3.3%. The broader measures are growing by less than 5%. With money growth at 5% or less, and slowing, there is no concern about inflation. As long as money growth is reasonable and under control, there cannot be an outbreak of inflation.

There is a lot of confusion surrounding inflation. Many people think inflation is defined as rising prices. That is not true. Rising prices can be one consequence of inflation. Or prices can rise for many other reasons—such as improvements in the quality of a product or service. But inflation is a monetary phenomenon, pure and simple. Take oil, for example. Oil prices went up to $58 a barrel before falling. Oil is a component of the Consumer and Producer Price Indices. When oil prices rise, the indexes also must rise. A rising Consumer Price Index routinely causes a wave of inflation fears to sweep through the stock and bond markets. That fear is not warranted, because the money supply has been growing slowly. But now when oil prices fall back, the math works the other way. We will soon see declines in the Consumer and Producer Price Indices—so the fear mongers will say we are heading for deflation!

But deflation (the opposite of inflation) is also a monetary phenomenon. We won't worry about deflation unless the money supply stops growing. These inflation principles cannot be emphasized enough. Inflation can be very destructive to our portfolios and it is correct to be alert to inflation. But to do that, we must know what inflation is and isn't. Our cost of living is rising because our standard of living is rising! It would be awful to live in a nation where the cost of living was going down, as that usually means a lower standard of living.

As investors, we need to have a financial strategy that takes rising living costs into account. In personal planning, we assume that the cost of living will rise 3% a year indefinitely. That means our incomes must double in 24 years, to keep up with living costs. There are many ways to reach that goal. Real estate works for a lot of investors. But our choice is obviously long-term investing in stocks.

The Federal Reserve governors are worried about a potential inflation challenge. The current-dollar growth rate in the first quarter of 2005 was 6.7%, considerably better than the 6.2% rate of the final quarter of last year. The economy, as businesses see it, chugged along at a brisker pace last quarter.

This is remarkable, and a little bit scary. It is remarkable because high oil prices and high gasoline prices acted as a tax, a burden on businesses and consumers. That burden was greater in the first quarter than it was in the final quarter of 2004, because of the oil price spike to $58 a barrel. What will happen now that oil has fallen? Will the current-dollar growth rate surge? I'm sure that is a concern of the Federal Reserve.

WE'LL SEE A 12,000 DOW, WHEN THE FED STOPS RAISING RATES (continued)

In the third quarter of 2003, the current-dollar growth rate surged to 8.8%. In the first quarter of last year, it surged again to 7.4%. The last thing the Fed wants to see is a significant increase in the current-dollar growth rate, due to the fall in oil prices. Today's slower money growth rate may counterbalance the effect of lower oil prices. I'm sure that is the Fed's basic strategy. Still, I won't be shocked to see short-term interest rates raised again, to 3.25% or even 3.5%. But I doubt we will see rate increases beyond 3.5%. The bottom line is that we are at most a few months away from the last of the Fed's rate hikes for this cycle. That means we are, at most, a few months away from the next upward move in the U.S. stock market.

With this underlying, fundamental momentum, we have no idea why Wall Street analysts offer such anemic profit predictions. Profits have gone up, while stocks have gone nowhere or down. That is another fundamental reason to think that the next stock market move will be up -- to Dow 12000.

Another indicator that the next stock market move will be up is the increase in stock market trading volume and volatility. That combination in the past has signaled an upward surge in stock prices. Lately, the crowd has a habit of being on the wrong side of major financial issues. The crowd is looking for the stock market go lower. In this environment, that is another positive indicator.

There is another factor, affordability. As oil rose above $50, demand slowed. China's oil import growth slowed dramatically. Europe slowed demand, too. American consumers and businesses began changing their habits. Affordability is a limit in most markets. We see that in gold, other commodities and housing. When prices escalate, demand slows and prices retreat. It looks like the affordability limit in oil is about $50. Oil will still be volatile. We could even see another upward spike. But market forces are working, and the thesis (that oil is going to $105 a barrel) looks like the 1980 predictions that gold was going to $2,000 an ounce. These eye-catching predictions gain popularity at market tops. That is another reason to expect oil to fall further, maybe to $35 a barrel.

THE MESSAGE OF THE BOND MARKET IS CLEAR -- BUY QUALITY STOCKS AND HOLD ON FOR A QUANTUM INCREASE IN YOUR WEALTH.