

ENTERING A PERIOD OF STAGFLATION? & POTPOURRI

June 8, 2006

Are we entering a period of Stagflation? That is the question.

At the appointed hour, precisely 8:30 am Eastern Time, the Labor Department announced on Friday, June 2nd that U.S. May nonfarm payrolls were up 75,000 and that the jobless rate was 4.6%, the lowest since July 2001. These employment figures are often revised as has been the case with sharp downward revisions for previous months.

The 75,000 figure was 100,000 fewer jobs than expected and was the smallest gain since Hurricane Katrina last October. "Take the latest payroll figure, which for once truly deserved the term dismal." *The Financial Times*. June 3, 2006

Following the news there was a dramatic rally in the bond markets as the Fed funds futures contract reflected the expectations of another Federal Reserve rate increase (which would be the 17th in a row) to decline to 48% from 72%. The Fed's decision would take place on June 29th. Sentiment now is less than 50% that the Fed Funds rate will be raised from the present 5% to 5 1/4%. These numbers represent bets and can change instantaneously as they did after the poor employment figure announcement.

While none of us deals in Federal Funds, the effects of changes in that rate are very important as the banks' prime lending rate is typically 3% above that rate. Therefore, a 5% Fed Funds rate results in an 8% prime rate – the lowest rate that people and companies with prime credit ratings can ordinarily borrow. A 1/4 point increase would mean an 8 1/4% prime rate.

Stagflation presents a dilemma as, simply put, it describes an economy that is slowing down while inflation is accelerating, and many important economic figures suggest that is what is beginning to happen.

Gasoline prices have risen sharply as we all know. Energy prices across the board have risen sharply. The effect of those price increases is the same as a tax on each of us, i.e. people have less to spend at Wal-Mart.

Commodity prices had gone through the roof until recent sharp declines, largely we think, due to massive speculation by hedge funds and other speculators.

Almost all cyclical measures are negative: weakness in retail employment, a decline in manufacturing jobs and shrinking earnings growth according to official sources.

Perhaps most important of all is the slowing housing market which in recent years has been the growth engine of the economy. Higher interest rates and energy costs are finally slowing U.S. economic growth.

As recently as May 5th the Dow Industrials closed at 11577 just 145 points short of its record close in January 2000. The "talking heads" will tell you that is a new 6-year high, and that is true.

What they don't tell you is that it has taken six years to get back to January 2000 levels. Did you ever notice that on any given day when the market really takes a beating, all the reporters will tell you is that the sell-off is a result of "profit taking?" We do not know who started that, but it has worked for decades as market crashes have been sold to

the public as being the result of “profit taking.”

The strength had also been in the S&P 500 and NASDAQ which, unfortunately, at that time was still down around 50% from its all-time high.

In less than a month, as of May 31st, the S&P 500 ended with its worst May for 22 years, and the NASDAQ Composite had its worst May showing in six years.

The U. S. dollar is in the tank and, in our estimation, probably headed lower – especially if the Chinese and Japanese let their currencies weaken against the dollar.

Ask yourself the simple question: How can stocks show strength in the face of higher interest rates and exorbitantly high fuel costs? Your answer is correct.

We hope for a “soft landing,” and so, we bet, does the Federal Reserve.

The macro Global economic/political scene will be extremely important in determining how the stock and bond markets will react from this point forward.

POTPOURRI

GENERAL MOTORS: Last fall we wrote in our Commentary “American Pie”

“When the Delphi Corporation declared bankruptcy on Saturday October 8, 2005, the American Labor Movement, as we know it, came to an end.”

Within days from now the Delphi union (UAW) will vote whether or not to strike. If it does strike, General Motors will very quickly run out of essential parts and have to close many plants. General Motors

cannot afford to have this happen; nor can we as a country. Delphi workers will not be the only losers.

IBM: On April 26th the WSJ reported “IBM Chief Offers an Upbeat Outlook” at its annual meeting.

A highlight was CEO Samuel J. Palmisano’s discussion of the freeze on employee pensions, announced earlier this year, and stopping the accrual of new benefits in 2007.

Mr. Palmisano defended his own compensation of \$6.9 million plus \$9.5 million realized from options.

“One shareholder and IBM employee, Jim Askew, said he believes Mr. Palmisano’s executive pension could entitle him to between \$10,000 and \$22,000 a day upon retirement. ‘Is \$10,000 a day enough?’ he asked Mr. Palmisano. ‘Do you think you could live on that?’”

Only three questions were taken from the floor. IBM’s was a very short meeting.

CHINESE BANKS: The *Financial Times* reported on May 3rd that “Beijing’s bad loans may outstrip reserves...”

“China’s total liabilities for non-performing loans may be as high as \$900bn, dwarfing official estimates and outstripping the country’s massive foreign exchange reserves... The study, part of Ernst & Young’s annual global survey of NPLs, says China’s big four state banks alone have bad loans worth \$358bn or more than twice official estimates.” China’s foreign exchange reserves are estimated to be \$875 billion.

On May 24, 2006 the Bank of China I.P.O. raised \$9.7 billion – that could still be

high as \$11.15 billion – in the world’s biggest public offering in six years. We understand that total demand for the shares was as high as \$109 billion.

P.S. The Bank of China officially disclosed prior to the I.P.O that last year its employees had been accused of criminal conduct in 75 cases involving \$151 million.

***“THE BATTLE OF WATERLOO
WAS WON ON THE PLAYING FIELDS OF
ETON”***

For some probably highly irrational reason we think of Hedge Funds when we remember that quote. Perhaps it’s because we wonder if Eton’s were level fields.

The headline of June 2nd’s *Financial Times* was: “ECB warns of hedge fund threat to stability.”

The following are comments from that article:

“Hedge funds have created a ‘major risk’ to global financial stability for which there are no obvious remedies, the European Central Bank warned yesterday in one of the bluntest official statements yet on the rapidly growing sector.

“In a clear hint of rising official nervousness in Europe about the multibillion-dollar industry, the ECB ranked an ‘idiosyncratic collapse of a key hedge fund or a cluster of smaller funds’ in the same category as a possible bird flu pandemic as the types of shocks that could trigger fresh disruption in financial markets.”

FREE TELEPHONE CALLS

On your computer go to Skype.com and download. You will be able to have

unlimited free computer-to-computer telephone conversations anywhere in the world 24/7. All you need is your computer, its speakers, a microphone that can be bought at Radio Shack for about \$12 and friends’ computers to call. There is a very small charge for calls to landlines or mobile phones.

On May 15th Skype announced “Free calls within the US and Canada to all phones.” These calls to all US and Canadian telephones will be totally free until the end of the year. Skype 2.0 now offers video calling.

A Swede, Niklas Zennstrom, age 40, launched Skype in 2003 and sold it to Ebay last year. “He and Mr. Friis have a strong incentive to stay, with revenue and profit targets that, if met, would push Skype’s final sale price from \$2.6bn to more than \$4bn under an earn-out arrangement. April 19th *Financial Times*

Mr. Zennstrom says “It’s everyone’s obligation to fight against monopolies and also companies that provide bad service.”

As of this writing Skype has 6,236,727 Users Online. That’s a real-time number for online users only at the moment I checked it.

Try it, you’ll like it. Thank you notes may be sent to this Commentary’s address.

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