



BETWEEN A ROCK AND A HARD PLACE

We have long held the view that the economic recovery and stock market rally from the bear market lows of October 2002 were unsustainable. This newsletter is jam-packed with several pieces of the economy and markets, and we'll do our very best to tie it all together on page 5 and explain what we think may be just around the corner and what to do about it.

Let's begin by reviewing the current environment. In our February 2006 newsletter we made several observations and forecasts;

- 1) The yield curve had recently been showing evidence that it was beginning to invert, and this event has historically been an indication of a forthcoming recession,
- 2) Gold would be heading much higher from the \$550 per ounce level,
- 3) The US dollar was beginning a new phase of decline,
- 4) The decline in the price of oil was only temporary and was about to move back above \$70 per barrel and,
- 5) The US stock markets would have one more "throw-over" rally to new highs to complete the 2002-2006 rally.

So far everyone of these items has either occurred or is in the process of unfolding. We'll cover all of these items but we'll first start with the housing market.

Housing weakness is reflected in the lowest housing affordability rate in 15 years, the lowest National Association of Home Builders index in 12 years, soaring inventories of both new and existing homes and reports of the leading home builders. The year-over-year increase in real disposable personal income (DPI) was only 1.1% in May, the lowest since 1994, and the January through May annualized growth was virtually unchanged. It is therefore no surprise to us that, according to the Michigan survey, consumer income expectations are the lowest since 1992. With the recent report of a drop the Conference Board's leading indicators index for May, the annualized six-month rate of change is now -0.4%. **Of the last 14 times the annualized six-month rate of change dropped below zero, 9 were followed by recessions and 11 by bear markets.**

As real estate prices spiraled upwards over the last ten years, artificially low interest rates and lax lending standards were not the only factors helping to maintain housing affordability. Just as important were the expectations of future price appreciation and the suppression of the rental market. With these two factors largely reversed, the housing market is much more vulnerable than most people currently appreciate.

Given that many people expected to extract money from future appreciation, which could help pay mortgages, taxes, maintenance, and insurance,

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S&P 500 Index Has Completed a Major Top



In May the equity markets completed a major, multi-year top. As we discussed earlier this year, they were close to completing an ending diagonal pattern. This is historically a bearish pattern. A bearish head and shoulders formation has also developed. These developments suggest that the long term trend has indeed changed from that of a bull market to the resurgence of the bear.

We now expect a stair-step decline to occur over the next several months. Furthermore, we expect this decline could very easily continue into 2007. We are currently at point 'C' in the middle chart, which represents a three step recovery rally, with the next decline about to get underway.

The next move down during the late July – early September timeframe should take us beyond the June 2006 lows. After a pause and retrace in wave IV, we should then see the equity markets move still lower in wave V as the year progresses.

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houses actually *seemed* cheaper to buy, despite soaring sticker prices. On the other side of the coin, without offering the bounty of free cash, the rental market suffered a multi-year slumber. Flat rents anchored a rock-bottom core CPI (rents make up 40% of core CPI), which allowed the Fed to keep rates low and the cheap mortgages flowing.

Now that house price appreciation is slowing, or in some cases reversing, buying houses is paradoxically becoming much more expensive and could even be potentially dangerous.

The Fed recognizes that inflation is a lagging indicator, which may further contribute to an already weakening economy. It therefore would like to pause and wait for incoming data. However, when Chairman Bernanke mentioned the possibility of a pause, inflation expectations soared, particularly in view of his 2003 remarks about throwing money out of helicopters. (Look up 'inflation' in the dictionary. The financial markets concern here would be the Fed's willingness to create more inflation by injecting more money

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into the system, even if they did stop raising rates).

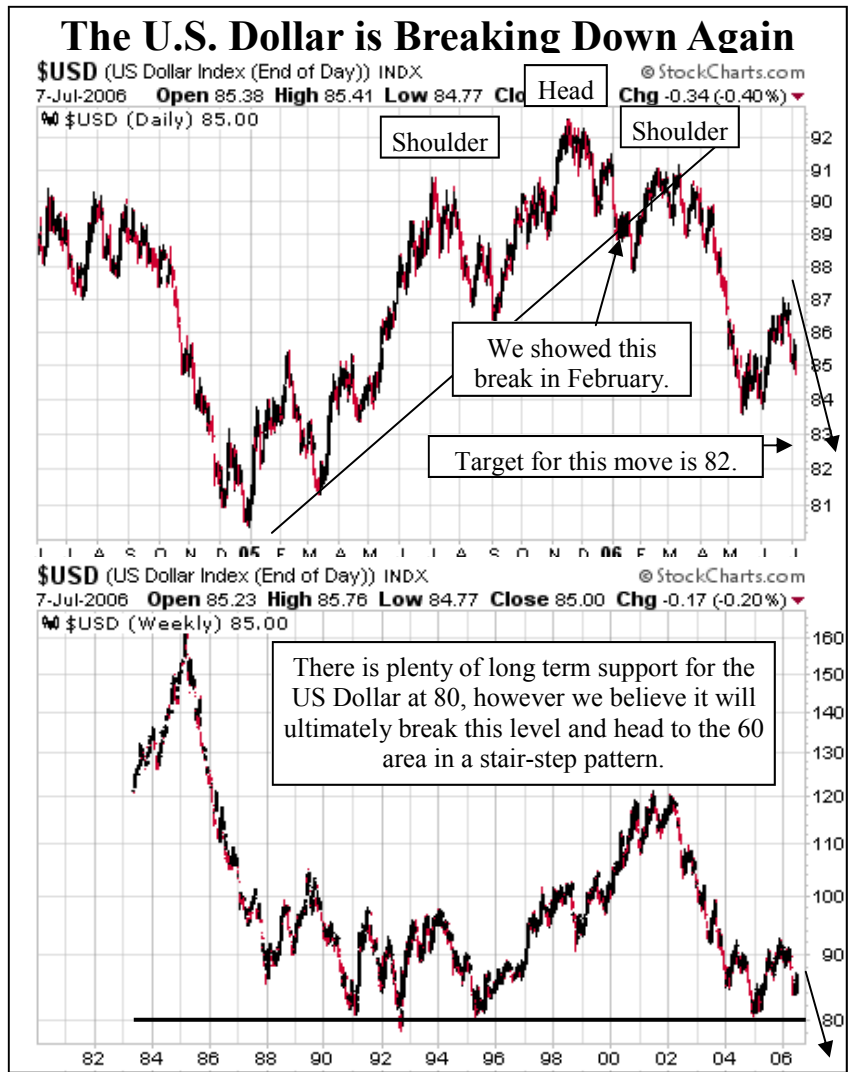
In response to investor concerns regarding rising inflation, the Fed, in our opinion, is likely to carry through with at least one more rate increase.

Soft Landing?

The hope of investors that the economy will gently ease into a soft landing is based more on myth than reality. Although many economists and strategists are forecasting a soft landing rather than a recession, the fact is that soft landings have rarely happened in the past 50 years, and the consensus of economists has rarely forecast a single recession. In addition, nearly every recession has been preceded by a bear market.

Over the last 50 years, the Fed has made three or more consecutive tightening moves 11 times, including the current period. Of the prior 10 times, 8 have led to recessions and 9 to bear markets. The only true soft landing that we're aware of occurred fol-

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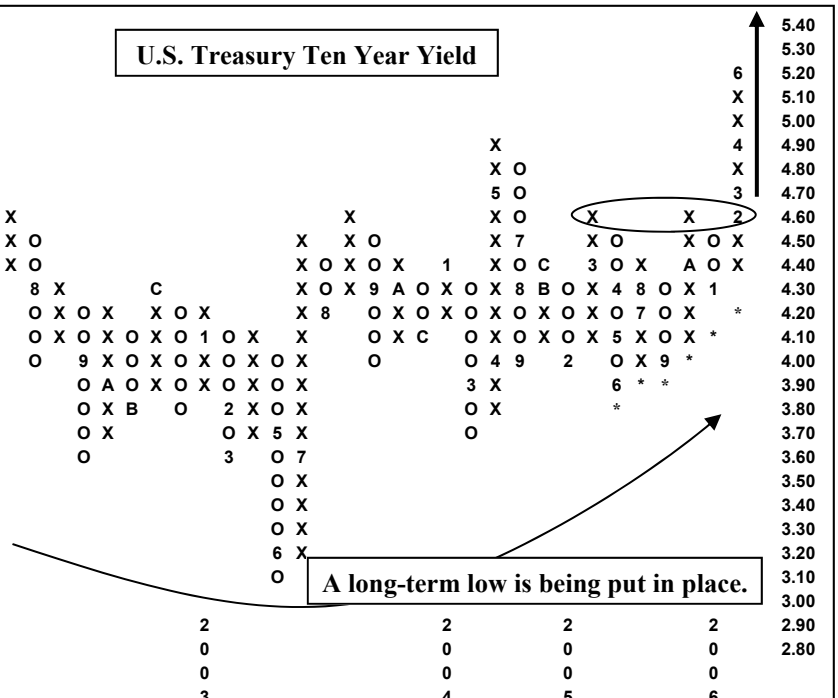


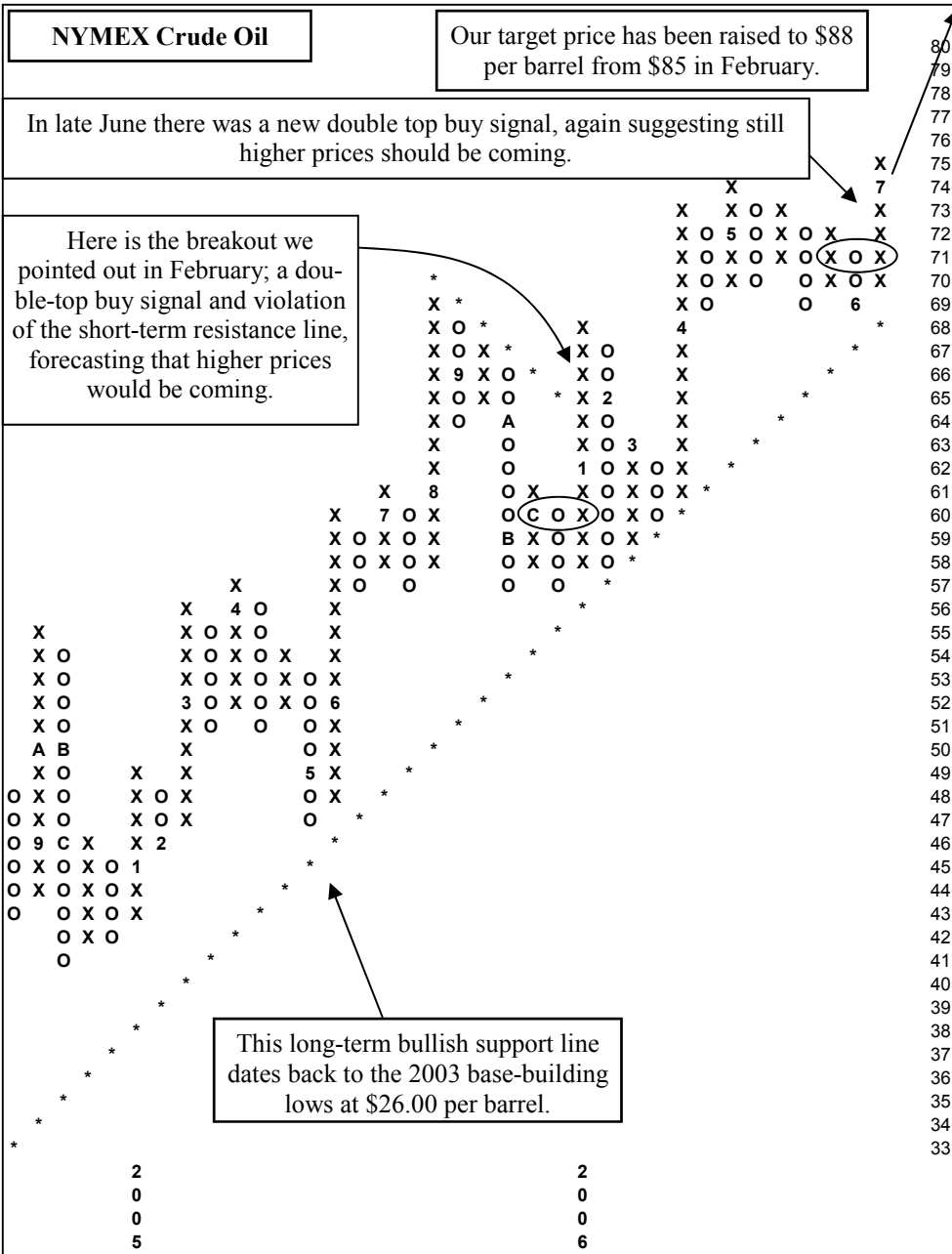
Interest Rates

Interest Rates should continue to rise, even if the Fed stops raising rates. The Federal Reserve only controls the Fed Funds rate, the rate banks charge for overnight funds. All other rates are set by market conditions.

As long as inflation persists, or the dollar remains weak, bond prices should decline, reflecting a lack of commitment to hold them longer term. Bond traders would rather sell longer maturities and buy shorter maturities if they think rates will rise. That's what's happening here and we're staying short term also.

The triple-top buy signal in March (circled) means that higher interest rates are very likely going to occur.





NYMEX Crude Oil

Back in February we commented that oil had given a new buy signal, indicating higher prices. It has done so again in July and we have also raised our target to \$88. Coming soon to a location near you is \$3.00 per gallon and heading for \$4.00.

Rock And A Hard Place, cont.

Following the tightening series of 1994, and, of course, this is the template that analysts like to use today as a comparison to the current period.

Significantly, in 9 of the 10 tightening periods the spread between the long-term Treasury rate and the t-bill yield narrowed to under 50 basis points. Once again, the exception was 1994, the one instance that was not followed by a bear market or recession. Therefore, in all 9 instances where the Fed tightened and the yield spread dropped below 50 basis points, a bear market followed—and 8 times a recession occurred as well. In the current period the Fed has hiked rates 17 straight times and the rate spread between long treasuries and t-bills has dropped below 50 basis points.

Oh! The rock and a hard place thing? After allowing a late 1990s stock market bubble and a 2003-2006 housing bubble, it would appear to us that the Fed has basically lost control. The Fed appears to feel the necessity to fight inflation until further signs of economic softening show up, and by that time, historically, it is usually too late to avoid a recession. If the Fed continues to raise interest rates, it risks slowing the economy. If it stops raising rates, it risks losing foreign central banking and other investors who support our stock and bond markets, due to a declining dollar, not to mention it's own credibility. That's a tough spot to be in.

In our view the latest market correction is the first leg down in a new cyclical bear market that is a continuation of the secular bear market that started in early 2000. This coming decline has the potential to be particularly dangerous in view of the massive consumer debt buildup, record trade deficit and the many trillions of dollars of outstanding derivatives.

Gold Versus Equities: The Long Term Implications



The price of Gold should continue to move higher...while the equity markets should continue to decline.

Notice there are times when Gold has moved in the same general direction (higher or lower, without regard to magnitude) as the S&P 500. The shaded area's between 1985 and 1988, and between 2003 and early 2006, reflect such rare occurrences. It is far more common for the two to move in opposite directions. Historically when the stock market is in trouble, investors become concerned and there's a move to a safe haven such as gold and bonds. At times when the stock market is strong there is little interest in gold.

There's a sound fundamental reason for gold and stocks to work this way. Inflation. If inflation is strong it will certainly cause the Fed to consider raising interest rates in an attempt to slow the economy down. Higher interest rates generally translate into higher borrowing costs for businesses which slows earnings growth and thus, weaker stock performance. You can see this occurring in recent stock market behavior. Gold would normally be rising during a period of inflation.

There is a caveat to all of this, however. Throughout the centuries of history, during periods when economic dominance is shifting from one country to another, the fiat (paper) currencies of countries whose dominance is diminishing is generally declining as faith in that currency wanes. This accurately reflects the transfer of wealth that is taking place (see discussion of the U.S. Dollar on page 3). During these periods gold becomes the standard bearer of wealth and prices rise due to hoarding for wealth accumulation purposes. Its price may rise as a result, even though there may be little or no inflation at the time. We believe that is precisely what is occurring today as China gradually gains economic dominance.

PUTTING ALL OF THE PIECES TOGETHER

After reviewing all of these market trends, here's what we see coming and how to position best for it. **Remember, each individual investor must assess their own risk tolerance and consult an investment advisor to determine if these solutions are right for you.**

Problem: The overall economy is weakening due to rising interest rates. Consumers in general are heavily in debt. Consumer spending had been largely driven from home equity borrowing. Lack of price appreciation in real estate and a tightening of lending standards means the home equity ATM is becoming a thing of the past.

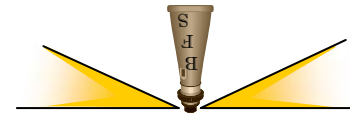
Solution: Assuming you meet the right risk profile and have consulted your financial advisor, you can consider moving assets toward short term treasuries and away from long term bonds and equities.

Problem: Higher oil prices will continue both squeeze the wallets of consumers and be reflective of inflation. Upward pressure on interest rates, higher gold and other commodity prices and lower stock prices should result.

Solution: These are higher risk solutions and are not for everyone. So again, consult your financial adviser, discuss your own specific circumstances and determine whether purchasing gold, commodities and natural resource funds and bear market (inverse) funds are suitable solutions.

Problem: The declining U.S. Dollar reflects our nations eroding wealth relative to other nations.

Solution: We'll say it again because it is that important. You must consult an investment advisor and determine how much risk you can tolerate. If it is suitable, consider international fixed income. When the dollar declines, those funds tend to do well because they are invested in foreign denominated securities. When the U.S. Dollar is strong (such as during the 1980's and 1990's) foreign investments will not do as well as domestic investments.



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Quote of the decade...

“History has not dealt kindly with the aftermath of protracted periods of low risk premiums”.

-Alan Greenspan

Editorial note: In other words, boom and bust cycles have been around for ever.

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