THE DANA VIEWPOINT

THE PAUSE THAT DIGRESSES?

August 14, 2006
Dow: 11,156

Several years ago, on a flight into San Francisco International Airport, the pilot came on the intercom and said, “Ladies and gentlemen, prepare for the softest landing you have ever experienced.” And he was correct. Last Tuesday the Fed paused after seventeen consecutive rate hikes and said that inflation is “elevated” right now but will begin to decline because economic growth is poised for a modest slowdown. In other words, a soft landing. This is not a plane the Fed is commanding. It is a $12 trillion dollar economy. Years ago economists talked about the Phillips Curve, an economic theory that postulates a trade off between inflation and unemployment. “Experts” believe that economic slowdown (soft landing) will have to be much more substantial than the Fed expects. Core inflation is at 2.6% now and climbing. Under the trade off theory (Phillips Curve), the unemployment rate has to rise by about two percentage points for an entire year to reduce inflation by one percent. This would result in a loss of about three million jobs. Not a very soft landing.

The key to the Fed’s future actions then would seem to be the strength or weakness of the current economy which ties into the notion that we are at full employment. If we are, then additional demand for workers will push up wages. Wages account for more than 75% of total production costs. If wages rise faster than productivity, we have added inflation.

We believe the economy is stronger than the last reported GDP numbers (2.5% for the second quarter). Remember, these numbers are continually revised. Even if the economy is cooling off, we can still have inflation. Dare we mention money supply again? The money spigot was wide open in 2004 and 2005 and accounted for the strong growth we are still witnessing. This administration’s tax cuts helped boost the economy much more than most realized, so the additional printing of money was just adding fuel to the fire. A fire that will be difficult to contain.

That brings us to housing. There is no doubt that easy money and low interest rates have led the way in this current economic boom. But is the bloom off this market? Yes. Is this a bubble like the stock market in 2000? No. Houses are not like stocks that can be liquidated in a moments notice. Last we heard they have not repealed the law of supply and demand. Over 70% of families in America now own their own home – the most ever. The demand for houses has pushed prices too high to be affordable for the majority; sales are slowing and prices are coming down. Builders are dropping plans for new developments as they

(CONTINUED ON REVERSE SIDE)

focus on selling what they have in inventory. Many builders are now offering incentives to buyers such as upgrades, new cars or even vacations. Houses for sale on the market are still selling, but it takes longer to sell them. We would not call this a bust, but rather a gradual decline that will probably take a good deal of time to work its way out.

So, if the housing market is slowing and consumers are not taking out second mortgages, what will keep the economy moving forward? We have talked in the past about the fact that American corporations have cut the fat and become lean and mean in order to stave off competition from Asia. Foreign companies are even moving production facilities to the US. We expect business investment to take the load off the consumer. Corporations are flush with cash and that cash will fuel the next boom in technology. The playing field is starting to level as cost of production in China is increasing making us more competitive. In addition, we still have the most skilled labor force on the planet. The percentage of parts being rejected by Chinese manufacturers is much higher than in the US. Part of the reason for that can be found in the difference in our educational systems. Decades of rule by the Communist Party has ingrained in their people not to question authority but to do things by rote. We as a society are always questioning and are much more imaginative.

In sum, we are very positive about the economic outlook here. The continuing economic growth may force the Fed to raise rates again. However, even at 6%, interest rates would only be at normal historic levels. The only way the Fed can slow current economic growth would be to choke off the money supply.

Random thought for August 2006:

Socialism: You have two cows. The government takes one and gives it to your neighbor. You form a cooperative to tell him how to manage his cow.

Capitalism: You have two cows. You sell one, buy a bull and build a herd of cows.

Michael L. Dana
Michael L. Dana
Chairman of the Board

James Ivey
James W. Ivey
President

Dana Investment Advisors welcomes any comments to their newsletter and is more than willing to discuss or explain any aspect of the letter. Feel free to call us at 262-782-3631.

If you would prefer to have our newsletter e-mailed, please send your e-mail address to newsletter@danainvestment.com. If you would like to be notified when our portfolio managers will be broadcasting in the media, please send your e-mail address to media@danainvestment.com.