



THE DANA VIEWPOINT

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## CHANGING OF THE GUARD

*January 10, 2006*

*Dow: 11,011*

Alan Greenspan will be leaving as head of the Federal Reserve Board at the end of this month to be replaced by Ben Bernanke as everyone knows by now. The markets have had their ups and downs over the past eighteen years which implies that the markets are much bigger than one man. Mr. Greenspan oversaw the stock market crash in 1987, to the technology boom of the 90s, to the stock market collapse in the early part of the new century, to the current recovery. So what does Alan leave his successor?

First of all a strong economy. Economic growth as measured by Gross Domestic Product (GDP) will come in at close to 4% for 2005. The fifty-six expert economists are predicting a growth of 3.5% in the first half of this year and a slowing to 3.1% in the second half (How can anyone predict GDP growth down to decimal points?).

Secondly, a very manageable rate of inflation. Core inflation (less food and oil) of less than 2%. We feel that China has had more impact on our low rate of inflation than any Fed policies. China has become the low-cost provider of manufactured goods to the world holding inflation down. This will continue for a while longer, but soon we will see worker revolts in China as they demand higher wages, health care and retirement benefits. Also, the rest of the global community will put pressure on the Chinese to clean up the environment. All this will raise China's cost of manufacturing and in turn start the wheels slowly turning to inflation.

Thirdly, a low interest rate environment. In spite of thirteen Fed increases in the last eighteen months from 1% to 4.25% (and at least one more at the end of this month), interest rates remain at historic low levels. In fact, there is concern now of an inversion of the yield curve where short-term rates (two year) exceed long-term rates (10 years). That happened briefly last week. Economists are worried that an inversion of this type will lead to a recession as it often has in the past – but not always. This has led to the conundrum that Greenspan leaves Bernanke. Usually all interest rates rise together. However, because of the heavy purchase of long-term treasury bonds by foreign investors, long rates have been kept at low levels. This conundrum is also evident in Britain, Germany and Japan as cash circulating around the world is also finding its way into long-term government bonds in these countries. This is all part of the ongoing globalization. Other large economy countries are on the watch for inflation so their central banks are

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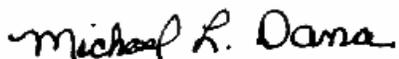
directly controlling short-term interest rates and indirectly influencing long rates like the US.

Who let the dogs out? It is the Chinese year of the dog. In the West, dogs are considered loyal, faithful and man's best friend. In Chinese astrology the dog is a bit more unpredictable, having trouble trusting others and being prone to telling little white lies. So what can we expect out of China this year? It is difficult to find information coming out of China that is trustworthy. There is a definite bias in the media to report glowing articles about the tremendous growth opportunities for American corporations in China. Most of this is designed to keep American dollars flowing in to build modern factories and take advantage of cheap labor to produce goods for one billion Chinese and the rest of the world. We are still cautious about this semi, pseudo, quasi capitalism. The communist party is still in control and is subsidizing most of their economic growth, so you have to question the stability of their banking system. The party's propaganda machine is keeping a lid on problems that are boiling beneath the surface. However, there are now over four hundred million cell phones in China, and if you dig deep enough, you will find that some of these problems are getting out. Most recently has been the pollution of a river and the anger expressed by citizens that led to riots that had to be put down by state police. We think American corporations should move a little more cautiously before pouring so much money into China.

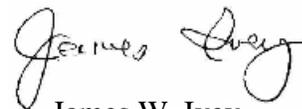
China is also planning for the 2008 Olympics, and they want to make a strong impression of their advances to the rest of the world. They have been building high rise structures like crazy and most of them sit half empty. They look impressive however.

There is no question that China is an economic force to be reckoned with, but their economy is only 15% the size of ours and their growth will slow. Additionally, you can't have your cake and eat it too. Communism and capitalism will not work in the same mix, and this may be China's most insurmountable problem.

**Random thought for January 2006:** Venus is the only planet that rotates clockwise.



Michael L. Dana  
Chairman of the Board



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.*

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