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"Predicting is hard, especially about the future."

— Yogi Berra

If Yogi were peering into an economic crystal ball today, he would doubtless be somewhat bewildered. Disturbing scenes would appear. Against a global backdrop of rising interest rates and soaring commodity prices, he would see geopolitical turmoil highlighted by a bellicose, nuclear wannabe Iran, leftist ascendancy in South America, and an Iraq reeling from insurgents and a flawed liberation effort.

Focusing on the U.S., the ball would reveal a crocodile-filled moat around the White House, with the Bush Administration seemingly careening from one misstep to the next, its domestic agenda emasculated in large part by the albatross of Iraq. The budget and trade deficits appear to grow larger with each passing day. The Federal Reserve, which has increased the federal funds rate 15 consecutive times, is set to notch number 16, and a 17th increase in June is not out of the question.

But other, brighter images would also float to the surface. An economic boom is sweeping across a large part of the globe. China and India continue to forge ahead, with the former carrying many other areas of Asia along for the ride. Japan, for years suffering from anemic economic growth, is experiencing renewed strength. Europe, despite its flirtations with government paternalism, is flexing its economic muscle as well, and business and consumer confidence have both moved up sharply. International trade continues to set new records, and new entrants to the world economy are fueling demand for raw materials, goods, and services.

In the U.S., production at factories, mines, and utilities is humming at its busiest pace in more than five years. Industrial capacity utilization reached 81.3% in February, the highest since September 2000. Greater capacity utilization is prompting manufacturers to build new factories and expand existing facilities. A recent survey indicates that chief information officers anticipate spending

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more on information technology over the next 12 months than they planned last quarter. More and more manufacturers are recording increased export sales as the global economy expands. The Institute for Supply Management reported

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that export demand in the first calendar quarter was the highest in almost three years.

Other figures of economic strength have surfaced. The unemployment rate dipped to 4.7% in March, and employers are reporting that it is becoming more difficult to find workers. Consumer sentiment has improved and retail sales remain strong. Housing has slowed but still reflects a high level of demand as employment is robust and interest rates are still low by historical standards. GDP growth continues to impress. First quarter GDP growth should come in at least at 4.5%. Corporate profits have mushroomed for several quarters. Fourth quarter, 2005, pretax National Income & Product Accounts (NIPA) profits rose 21.3% over the fourth quarter of 2004. Pretax NIPA profits for all of 2005 rose 16.4%, significantly higher than the strong 12.6% growth registered in 2004. Interestingly, during the last 20 years, there have been only three down years for pretax NIPA profits: 1989 (-1%), 1998 (-10%), and 2001 (-0.7%).

The strong GDP growth of the first quarter will lead yet again to strong profit growth. Profits for 2006 could register another double-digit increase. The profit growth of U.S. corporations over the past few years has simply been extraordinary, and it has continued to surprise a large number of both optimistic and pessimistic economists for some time. In fact, since 2000, NIPA profits are up 72%, while stocks, as measured by major domestic indices, are either down slightly or have barely kept pace.

Stock valuations were at record highs at the tail end of the technology-media-telecom bubble mania that culminated during 1999-2000. The prolonged bear market of 2000-2003 followed in the wake of the excess euphoria. The horror of 9/11 and the expansion of global terrorism also weighed heavily on investors' appetite for stocks. While markets have recovered since the spring of 2003, they have had to face the headwinds of geopolitical risks, rising interest rates, higher energy prices, and rapidly accelerating commodity prices.

Today, the dynamics of the world and U.S. economies present a dilemma for investors. Will economic growth continue or are there developing excesses that will precipitate a recession? The global economic boom has led to strong economic activity and profit growth around the world. Greater economic activity has led to increased demand for materials, goods, and services. This global boom has led central bankers to continue tapping the brakes of monetary restraint so that inflation will not get out of hand. The turmoil in the energy and other commodity markets has hampered their efforts. While inflation has generally been held

in check, concerns are growing that the tempo of economic activity combined with upward pressure on energy prices and commodities, along with lower unemployment and rising wage demands, will begin to be reflected in prices. The threat of inflation may lead the Fed and other bankers to press their brakes somewhat longer than investors had hoped only a few months ago. If the bankers exercise too much restraint, a recession and lower profits may well follow.

So here we are. Booming economies, low unemployment, and strong corporate profits are, in turn, counterbalanced by geopolitical turmoil, high energy prices, speculation in a broad range of commodities, and nervous central bankers. Bond prices have been going down, stock prices in most world markets are higher, and key commodities have been screaming upward. What might the next chapter hold for investors? In a very broad sense, economic and geopolitical globalization and technological change are two of the major factors shaping the world in which investment decisions are made. Their influence on economic activity and financial decision making has raised the stakes for investors, with the promise of both reward and often-unquantifiable risk.

Advances in technology and telecommunications, coupled with the growing interdependence fostered by globalization among all participants in the world economies have led to explosive growth in the vehicles available to capitalize on economic growth. Today, there exist mountains of readily available, macro and micro data on countries, industries and companies, consumers, bankers, and bond and equity markets. Traders in Tokyo, Hong Kong, Dubai, Rome, Paris, London, Buenos Aires, New York, and nearly every corner of the earth can receive market-impacting information on a vast array of economic variables within seconds of each other. The instruments available for investing today range from the very simple to the stunningly complex. The alternatives available in which to invest through equity, debt, derivatives, currencies, commodities, indices, ETFs, and a host of other vehicles are mind-boggling. And leverage on a scale never previously encountered has made the investment world one in which all the economic players are tied inextricably together.

We have moved into a world in which markets on a macro and micro level, while not perfectly efficient, are nevertheless very efficient in many respects. Achieving excess returns has become more difficult as globalization, technology, and a plethora of investment alternatives have leveled the electronic playing field of investments. These developments have to some degree made it possible to seemingly reduce risk through the utilization of complex and tradable financial instruments. Yet, the difficulty of achieving excess returns, and the ability to supposedly lower risk via instruments of sophisticated financial engineering have led some participants to seek even greater risk than they otherwise might have in an environment that would be perceived as more risky. There has been an almost counterintuitive development over the course of the past few years of markets becoming somewhat more complacent and less, not more, turbulent. This development is even more astounding when looking back at some events that, while unnerving, did not result in major shocks to the financial markets and the world economies. In the aftermath of the bursting of the Nasdaq-centered tech bubble, there have been a series of events that potentially could have resulted in major financial crises. Some recent examples would be $75 per barrel oil, the downgrade of GM and Ford debt, the Refco failure, the dramatic slide in the equity markets

in the Mideast, the move toward nationalizing the oil industry in Venezuela, the nuclear threats spewed out by Iran, and the dramatic escalation in commodity prices.

The longer we have what Paul McCulley of PIMCO called a "stable disequilibrium," the greater the liklihood that unstable financial arrangements will result. Market participants become comfortable with a trend, and are ever more willing to take on additional leverage or debt, postpone savings, or pursue other measures that assume a continuation of the seeming financial stability of the recent past. This willingness to take ever bigger bites of risk based on the assumption that risk can be managed through financial engineering in an environment perceived as relatively stable was and is a major concern of former Federal Reserve Chairman, Alan Greenspan, and is doubtless of concern to the new Chairman, Ben Bernanke, and other central bankers as well. Their fear is that the potential risk for greater financial instability is higher because market participants believe the "stable disequilibrium" will be maintained.

As investors and speculators continue to increase their leverage and exposure, the bar is raised for risk should the fragile disequilibrium develop a breakdown. At that time when market participants change their behavior based on a perception that stability cannot be maintained, subsequent actions of investors and speculators could well result in severe shocks to overleveraged participants and the markets in which they operate. Given the interdependence of a wide array of financial instruments utilized by market participants, whether technologically emboldened traders at Citigroup or Goldman Sachs or retirees in Santa Fe or Zurich, the concern regarding potential systemic risk is certainly not unwarranted.

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Perhaps the recent economic stress experienced by markets in New Zealand and Iceland offer a clue as to some of the negative fallout that can develop when a period of "risk free" stability succumbs to exogenous shocks. During the first quarter, there were dramatic sell-offs of the New Zealand dollar and Icelandic krona, the currencies of two countries that are a far cry from the stereotypical, unstable emerging markets. The current account deficits of New Zealand and Iceland are 8.9% and 15.5% of their GDP, a very high percentage for developed countries. (Many economists wince at the U.S. current account deficit of 7% of GDP.) These deficits have been funded in part by outside capital seeking higher returns. Through the offer of high interest rates, the currencies of both countries had attracted capital from foreign investors; especially hedge funds and other money pools utilizing the carry trade, i.e., borrowing money at lower rates to invest in instruments yielding higher rates. In order to buy these instruments, the underlying currencies of the countries were purchased to facilitate the trade. But with the prospect that the Bank of Japan, the European Central Bank, and the Federal Reserve would be engaged in further tightening, thus narrowing the interest rate spreads, carry traders have been unwinding their positions. As positions were liquidated,

the NZ dollar and krona were in turn liquidated as investors and speculators converted these currencies to those of other countries, creating a vicious cycle of liquidation of assets and currencies. As bonds, stocks, and currencies were liquidated, the underlying market values of held positions continued declining. Leveraged participants in many cases were forced to liquidate even more assets in order to pay off their debts, further feeding selling and exerting downward pricing pressure on the assets of the countries whose currencies and assets were being liquidated, including non-financial, tangible assets such as real estate. The fear of a shift in behavior is that the pressure brought to bear on the equity and liquidity of participants who are on the wrong side of these types of trades can easily spill over into other countries and their markets as leveraged players must also liquidate assets outside of the countries under initial attack.

Certainly the stress created by developments such as those which occurred in New Zealand and Iceland pose problems and the threat of financial loss, especially to many leveraged market participants as well as many banks. However, the possibility that similar destabilizing shocks could spill over into other countries in domino-like fashion may not be as great as doomsayers predict. Globalization is fostering counterbalancing developments that may well offset or lessen the potential for crises in the world's markets. The financial pressures with which investors, businesses, and central bankers are concerned will continue to be offset to a significant degree by the positive forces of globalization. While New Zealand and Iceland present a graphic picture of the risks of disequilibrium, emerging economies and growing economic powers, most notably China and India, have prospered as a consequence of globalization. Their national incomes are growing rapidly as the global boom drives demand from other countries for their industrial commodities and commoditized manufactured goods. One corollary development is that their incomes are growing more rapidly than their consumption. Unlike many modern, industrialized countries, they are experiencing trade surpluses and accumulating significant international reserves. It is these countries that are the source of what Ben Bernanke has labeled the global savings glut. Countries such as Brazil, Venezuela, Argentina, and Russia have repaid billions of dollars in debt that just ten or fifteen years ago was considered only slightly better than junk.

How large is the glut? Estimates vary, but one measure might give some idea of both the size and trend of growth. At the end of January, non-gold, international reserves held by central banks rose to a staggering world record of $4.3 trillion, of which emerging nations held a record $3.0 trillion and modern, industrial economies held $1.5 trillion, a slight decrease from recent highs. Worldwide international reserves were up 11% year-over-year, with emerging economies registering a 19% gain. It is this growing liquidity among former have-nots that, unlike the period of the Russian and Asian debt crisis of 1997-1998, is helping to provide built-in buffers against a widespread financial crisis that would have a domino effect. The savings glut is a source of demand for investment in those countries that are running deficits, and, as a result, also a factor in keeping global bond yields lower.

Globalization underlies the 2+2=6 nature of growing foreign trade. The economic boom fed by globalization has unleashed deflationary forces. It has enabled industrialized countries to buy cheap foreign imports, which have

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helped to keep inflation relatively low. The competitive forces of globalization drive corporations to continually seek to maintain productivity growth, which also helps to keep inflation low. As consumer-manufactured goods become commoditized, demand for them increases. In turn, the demand for the industrial commodities and the machinery and equipment needed to manufacture them increases as well. While the industrialized world imports goods from emerging economies, the growing profits of the latter are propelling demand for capital goods from the U.S., Germany, Sweden, Japan, South Korea, and Taiwan. Backlogs at U.S. factories are at or near record highs. The symbiotic relationship between emerging countries and the industrialized world has led to a global capital spending boom which is expanding capacity, increasing productivity, keeping inflation in check, and leading to job growth and higher incomes.

Profits are growing, not only in emerging economies, but in the industrialized world as well. With growing profits, increased employment and investments in plant and equipment have followed in their wake. Higher employment has led to increased liquidity among businesses and consumers. While many decry the lack of individual savings in the U.S., the reality is that the government inputs to calculating savings continually underestimate the level of real savings and wealth accumulation in the U.S. Despite a supposed zero personal savings rate, the liquid assets of Americans rose to $4.4 trillion at the end of March versus $2.6 trillion in consumer credit plus home equity loans. Liquidity is high throughout much of the industrialized world as well.

We are in uncharted waters today. Globalization has and is creating tremendous changes for nations, businesses, and consumers. It is the impetus behind the creation of great wealth as well as opportunity and often-unfathomable risk. The global liquidity glut among emerging economies underscores but one of the sweeping changes spurred by globalization, and it highlights the shifting balance of economic power between emerging nations and the industrialized world that has occurred over the past several years. The recent spike in commodity prices is also an outgrowth of globalization, and further illustrates some of the impact that global demand and supply, technology, and financial product explosion have had on the financial markets.

Alan Greenspan recently remarked that he regrets having used the term, "irrational exuberance," in describing the stock market action of the late 1990s. Yet it might be a term that is an apt description of the action in today's commodities markets. The exuberance and speculation in commodities provides an example of the impact that some of today's market participants can have on key sectors of economic activity. The global liquidity glut and the desire for above average returns in an environment in which returns are more difficult to achieve because of the efficiencies fostered by technology and telecommunications have led to a flood of new

participants, financial instruments, and capital into the world of commodities. Producers and end-users no longer primarily drive commodity pricing. There has developed an almost overwhelming financial demand for commodities from individuals, mutual funds, exchange-traded funds, pension plans, and hedge funds. The action in commodities today is, in some respects, reminiscent of the mania associated with the bubble in technology, media, and telecommunications stocks of the 1990s. Will there be an exogenous shock in the commodities market that will spill over to other areas? Certainly it is possible, and many would say probable. Yet it is difficult to measure what the effect of fallout in the commodities market would be. Will the cushions of global liquidity minimize a severe sell-off or can they only contain a correction in prices of minor magnitude?

The observation that for some questions there are no easy answers is certainly apropos of the investment world today. An economic crystal ball will rarely yield a vision that is not marred by potential pitfalls. Predictions of data points along an economic timeline are often imprecise because of the unpredictability of the variables that may determine their outcome. We can safely say that the future is uncertain. It always is in the investment world. Without question, there exist many factors on the world's economic and geopolitical stage that have created a sense of great unease. But there are just as many, if not more reasons to look favorably upon the future. And there is a cornucopia of potential investments that should bolster investors' appetites and outlook.

We believe the evolutionary impact of globalization holds great promise over the long run for investors who capitalize on the opportunities it will present. The nature of the global financial markets is such that they are both exciting in terms of their potential for reward and awe-inspiring in terms of their complexity. The basic tenets of successful investing have not changed. The power of compounding, the need for patience and a willingness to wait for your investments to develop, a focus on value with a growth overlay, eschewing the seemingly popular and "sure thing," and perhaps most important, maintaining an attitude of long-term optimism— all are keys to successful investing.

Another oft-quoted aphorism of Yogi Berra is, "When you come to a fork in the road, take it." There will be many forks in the road over the coming quarters and years. Over long periods of time, it is the optimist who usually prevails in making rewarding investments. We believe that rewards will come to those who pursue their goals along a path of optimism leavened with caution, judgment, and the discipline to avoid deviating from the basics of a fundamental approach to investing based on finding economic value.

Roger E. King, CFA
Chairman and President

"Grab some lederhosen, Sutfin. We're about to climb aboard the globalization bandwagon."

The year 2006 marks KING's Twenty-Fifth Anniversary. Our professional staff includes investment managers, security analysts, and other specialists qualified to meet the needs of our individual and institutional clients. We are committed to creating wealth for our clients in the long term.

Over the past twenty-five years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

SOURCES FOR THIS ISSUE

Barrington Associates; *BARRON'S*; Bloomberg, L.P.; Oak Associates, Ltd.; *Thoughts from the Frontline*

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