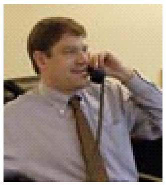
INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

NOVEMBER 2007



William A. Harris, CFA
Portfolio Manager

Fire, Ice, and Slogging Through

No, this month's title has nothing to do with blazes in Southern California or melting polar ice caps. Rather it describes some of what may await US investors in the next few years. I will define briefly (and unfortunately, will thus oversimplify) some competing visions of the future.

First, we have the Fire scenario: deficit spending continues apace in America's public and private sectors, hot-running economies abroad push resource prices ever higher, and disenchantment with dollar-denominated financial instruments causes our foreign funders to forsake us. The outcome? A searing inflation rouses from its quarter-century slumber, fixed income assets fall to the flames, and even a fitfully rising stock market loses economic relevance after the dollar's decline in purchasing power is taken into account.

Then there's the Ice scenario, where a deflationary spiral brought on by the housing slump and credit crunch chills economic activity to the point of recession or depression. The American dream of homeownership gives way to a vicious cycle of mortgage rate resets begetting delinquencies, begetting foreclosures, begetting an oversupply of homes for sale, begetting lower prices begetting further delinquencies begetting foreclosures, etc. Meanwhile the dematerialization of so much homeowner equity deprives American consumers of their erstwhile "ATM, Sweet ATM" such that aggregate demand suffers, begetting job losses, begetting mortgage delinquencies and… well, look above to see what all gets begot. The housing and credit manias having detonated, the economic equivalent of a nuclear winter sets in.

Or will Fire and Ice come at us in a tag team, combining credit crisis with monetary crisis such that Americans find their budgets strained both in real terms (each dollar earned buys less and less) and in nominal terms (aggregate wages fall as the economy ices up)? If so, we'll all be getting reacquainted with the term "stagflation."

Yet don't despair, there's another scenario I'll call Slogging Through (now have I cheered you up?) whereby repeated Fed interest rate cuts sustain the capital markets, a weak dollar entices foreigners to buy more goods from us so that exports rise and the domestic economy escapes recession. A fine outcome, this nonetheless will feel like a slog due to ongoing bad news in housing and credit, and periodic price spikes in food and energy – dynamics which will constitute the "wall of worry" bull markets are conventionally said to climb – and our good fortune will only be recognized in retrospect. Here, the forces that make the Fire and Ice scenarios so scary actually serve to *keep each other in check*, and we skirt through perhaps astonished that we've not just survived, but prospered. This is a rosy scenario (if not quite as pretty as Goldilocks), and has something of the air of fairytale, just as the prior scenarios give off more than a whiff of apocalyptic determinism.

Are these predictions? No! Contemplating various scenarios does not lead to our choosing among them – the future will unspool without regard for the tidy boxes we prepare for it – but rather frames the issues from two perspectives, risk management and opportunism. In other words, what might hurt us, and where can we find advantage? We always start with risk control in mind, but abiding this sensibility alone could lead to a static portfolio comprising, say, equal parts cash, gold, long-dated zero-coupon Treasuries, Treasury Inflation Protected Securities (TIPS), energy-related master limited partnerships, and a global equity index; but having thus hedged against most every potentiality, we may deprive ourselves what history foretells as being the most likely outcome, namely that the US economy will prove resilient, a capitalizing globe will do likewise, and those who own equity in the system will ultimately benefit, though it may hurt along the way. Opportunism demands participation.

I will hazard a single prediction: In a newly volatile environment, adaptive rather than static strategies are going to serve best. Buckle up.