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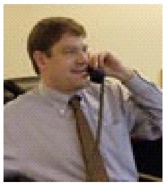

William A. Harris, CFA
Portfolio Manager

Third Quarter review

Look as this first table, and you'll see the stock and bond markets celebrating two things foremost: 1) the Fed's decision to "stand still" on interest rates at its August and September meetings, and 2) a significant drop in energy prices.

Total Return, Third Quarter 2006	
Allen Trust Equities	5.21%
S&P 500	*5.67%*
Allen Trust Bonds	2.24%
Lehman Agg Bond	*3.81%*

Investors on the whole believe that rookie Fed Chairman Ben Bernanke is pulling off a "soft landing," whereby a gentle, non-recessionary slowdown in GDP growth is enabling the Fed to relent on rate hikes without inviting inflation. After two years of federal funds rates ratcheting ever higher, from 1.00% to 5.25%, the markets are now daring to dream even of rate *cuts*, with a growing consensus that Bernanke et al will begin monetary stimulation early next year to keep the economy (read: US consumers) on its (their) feet.

Meanwhile, after brushing up against $80/barrel in August, oil prices have come down some 25%, and the end of summer's driving season has further helped lower prices at the gas pump. So though people's enthusiasm for paying ever higher housing prices on both coasts has slammed to a halt, nonetheless job growth continues, mortgage rates are easing and driving to the mall costs less. This is good for stocks. Good to bond bulls is the notion that a slowing economy and lower energy costs alike will take the wind out of inflation's sails, making fixed rate instruments more valuable, especially given the presumption that Fed rate cuts are imminent. Ain't life grand!

Well, yes, life is grand, but does that mean this dual stock-bond celebration will continue? Both markets' strength was initially catalyzed by the Fed's cessation of rate increases; given that the Fed has stopped, it can't stop again, and the only beneficial (from an asset price perspective) Fed action going forward will be rate cuts. Yet the language chosen by some regional Fed bank heads remains more hawkish than dovish on inflation, suggesting that the Fed funds rate may remain at 5.25% longer than either stock or bond market is pricing.

Also, the celebration's continuation is predicated on lower energy costs. In the very short run, that scenario seems a likelihood, as the North American hurricane season proved lamblike, Iran has toned down its rhetoric, and above-ground inventories are at all-time highs. Even $60/barrel oil reflects a substantial risk premium relative to the ample supply in storage; the question is whether that risk premium is warranted, i.e. whether something big and bad might happen to choke off the production and distribution of our modern economies' life blood. There is no "Big and Bad" Index, as such, but clearly apprehensions remain as to future supply shocks – not to mention dwindling below-ground reserves – and we think they are warranted.

In sum, both stock and bond investors are finding favor in the same set of indicators. This happy moment, we believe, won't be sustained for both. Either the economy and corporate profits will weaken to the point that stocks give up ground, or a stronger-than-expected economy and its attendant inflationary forces will put the bite on bond values. If the inflation is persistent enough, both asset classes could suffer. It doesn't always take "Big and Bad" to derail somebody's good times; just a failure of self-serving expectations.

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Firm News

Allen Trust Company welcomes a new member to its Board of Directors, John W. "Jack" Winter, Jr. In recent years, Jack's venture capital activities have involved him in the ownership, development and management of various entrepreneurial businesses, and he has served as Chairman of the Board for Legacy Health Systems. Prior to that, Jack was Managing Partner of Arthur Andersen's Pacific Northwest Audit and Business Advisory practice, with management responsibility for the firm's Portland, Seattle and Boise offices. We are fortunate indeed to be able to attract such talent to our leadership.