

Buffalo Office

Frank Leonard

Bruce Kaz

William Gurney

Thomas Hanlon

Jery Chambers

Alan Abels

Jamestown Office

Randy Ordines

Kevin Morse

Market Review & Update

SPRING 2006

The 1st quarter of 2006 witnessed the best return for stocks since 1999. As in our last writing, it remains our belief that the strength of the economy and robust corporate health should manifest in improving stock prices and that interest rates would rise as confidence in this growth trajectory increases. Reflecting this strength, corporate balance sheets have improved markedly over the last three years. (Fig.1)

Figure 1: Improved corporate balance sheets

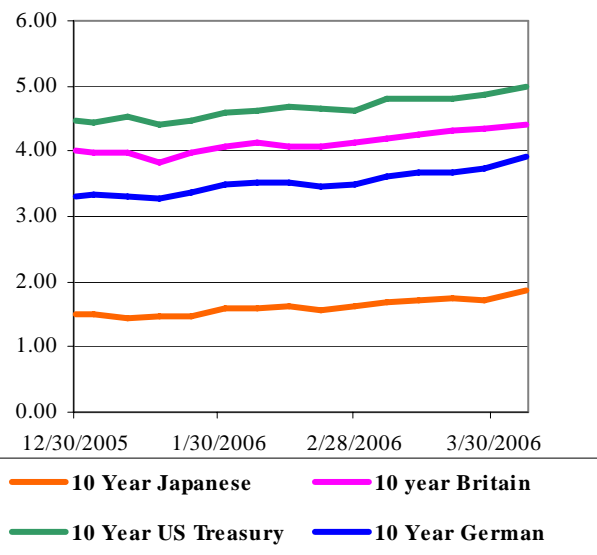


Source: FactSet and Citigroup Investment Research - U.S. Equity Strategy

While nearly finished, the Federal Reserve may hike rates a bit more as a reaction to this economic strength. Longer term interest rates rose this quarter, with the 10 year US Treasury note crossing 5% for the first time in four years.

Approximately 45% of all outstanding US government debt is held by foreign investors, and their purchases of US Treasury bonds have been helping to keep rates down in the United States. Without their continued interest, the concern is that rates will have to move higher in order to attract new buyers.

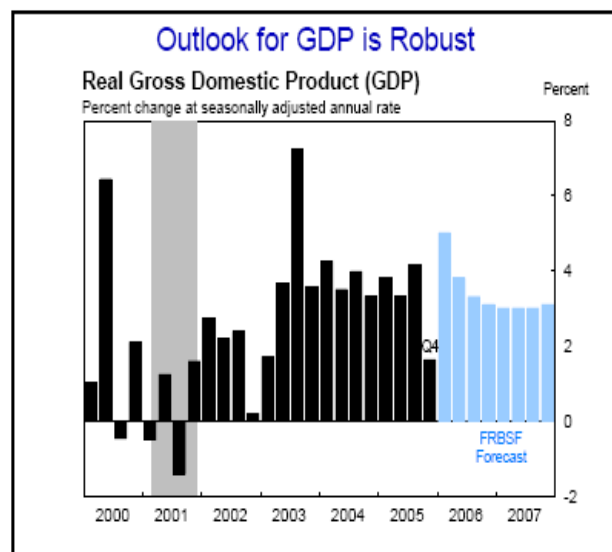
Figure 2. US Treasury rates still attractive



The higher yields available on US Treasury bonds versus foreign government bonds however is still very attractive. This should provide a continued draw for investment by the rest of the world. (Fig. 2)

While media outlets and politicians paint a bleak picture of the economy to capture viewers and voters, we continue to exist in a time of unprecedented global strength. Here in the US growth has been, and is projected to remain, above average. (Fig. 3)

Figure 3: Economic growth continues



The labor markets echo the robust US economy via an unemployment rate now at a 4½ year low. A coincidental 25% decline in layoffs for 1st quarter 2006 versus 1st quarter 2005 was noted in the recent Challenger, Gray, & Christmas survey. Historically, this would begin to spark inflation, but ample opportunity to find cheap labor and goods overseas has placed a glass ceiling on inflation, for the time being.

What drives the US and global acceleration? As we have seen so much press coverage of commodities that have been pushed higher by world growth: gold; water - the new gold; sugar - the newest gold, we forget that there are some commodities so critical that their presence or absence can drive or end even the strongest of momentums. First, technology. No surprise there, but the ease in movement of data around the globe made the migration of jobs even easier. They were going anyway, just think of cheap, fast technology as a really good lubricant. The real power commodity that spawned this unprecedented growth migration, and will continue for decades, is surprisingly short, disarmingly innocent, yet the key force to be reckoned with, babies. Over the last 30 years, babies have replaced atomic weapons, artificial borders/dictators, and natural disasters as the single most dominant architect of the new world order. Don't let the innocent little faces fool you.



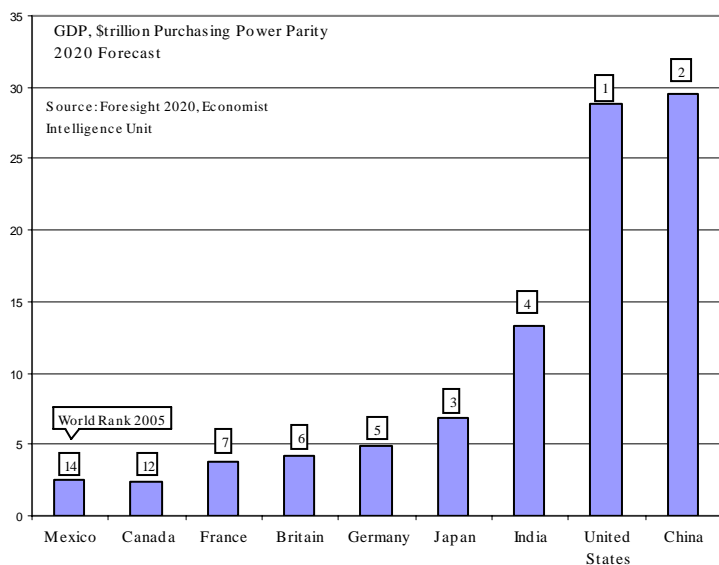
976 Delaware Avenue
Buffalo, NY 14209
Phone (716) 883-9595
Toll Free: 1-800-783-1083

214 West Fifth Street
Jamestown, NY 14701
Phone: (716) 484-2358
Toll Free: 1-877-484-2402

Let's look at this from a serious perspective. Beginning in the 1960's, we saw some of the early seeds of globalization being planted. Japan was in the early stages of becoming a dominant manufacturer and high cost union plants in the northern states here in the US began to migrate to the southern states. Why? Cheap labor. Cheap labor is available in ample supply in emerging economies. Why? Contrasted with the G-7 nations, birth rates are much higher (no cable tv?) and longevity is much lower (poorer health & nutrition). So, eventually, the factories that slid south, snuck over the border to Matamoros, Mexico. Lots of cheap labor, low ancillary costs & regulations, and babies. The enabling technologies arrive in a world of just-in-time delivery in the 1980's and WHAM, hundreds of millions of little pink hands waving a warm welcome to US companies that are struggling with the demands of higher relative worker costs, egregious increases in health care costs, and relatively punitive regulatory/taxation, and overseas we go. Technology met two countries that stood ready to offer more than Hong Kong, Japan, and their peers historically could muster. Hundreds of millions of little hands.

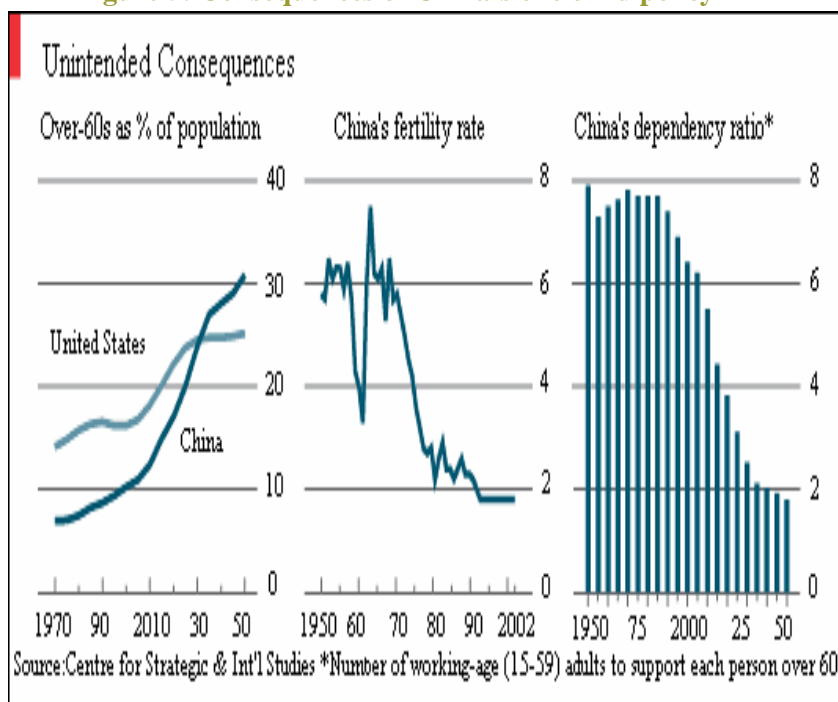
China and India have, and will have, a labor supply advantage for decades to come. It is driving growth rates around the world to above average levels, but particularly impressive within their borders. How long will this impact last? Quite a while. It will not be a completely smooth ride, as all growing youngsters experience, but grow they will. By 2020 it is estimated that China will be at parity with the US. (Fig. 4) But that will not be the

Figure 4: China/US parity 2020?



most impressive feat. At that point, China's "One Child" culture will have its unintended consequence, China will age quickly. China's more rapidly aging population will make it look more like Japan and the US sooner than most would anticipate – less youngsters, more oldsters, and the inherent obligations to service that demographic. (Fig 5.) India, by contrast, which now has 600 million folks under 21 will continue to grow and should overtake China before 2050. Global institutions will be reformed around this evolution/revolution. Think about the G-7 today or the United Nations Security Council. Think France will still be a player? And perhaps the biggest change we US-centric folks will

Figure 5: Consequences of China's one child policy



notice is that we will likely not be imposing our will on others as much as we have become accustomed to in the past. It will most certainly be different, and it will test and re-test our commitment to global trade.

And while we're on the topic of testing our commitment to global trade, this is a great time to interrupt with the topic of immigration. It has been such a political topic du jour with a lot of protectionism being marketed under a thin veil of national security. Security considerations aside, a properly constructed policy that encourages immigration is the last saving grace for the major developed nations. So you don't have a lot of children to supply cheap labor to grow your economy? Why not invite some folks over and let them stay. A few US cities with scant worker availability have taken the lead and actually advertised and offered incentives overseas for immigrants to locate in their region. We believe several Midwest cities are on the forefront of this effort.

Okay, back to the near future. Markets may stumble from time to time during these global changes, but the US economy is presently on solid footing showing good growth and low inflation. Interest rates should not get surprisingly high. The US consumer is still buying goods and services, and Corporate America is beginning to pick up steam with attractive valuations and more cash than they have had in decades. Earnings for large Blue Chip companies have risen nearly 35% in the past 5 years, but share prices have not. That makes large cap US stocks look increasingly cheap compared to their mid-cap and small-cap brethren.

While we will want to see attractive resolutions to Middle East volatility, oil prices, and some good fortune on the Avian Flu front, global growth appears to be on a persistent path for some time, perhaps decades. This trend has been tested by both man-made and natural disasters and has set records in spite of them. Babies aren't so benign after all, are they?

We'll talk to you soon...

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