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funds so they downplay the economic consequences of falling commodity prices plus other global influences.

Some marker observers, citing the recent spate of better than expected economic data on housing, production, retail sales and employment, argue that the momentum of the economy is more vigorous than previously thought. Besides a sell off in stocks due to the prospect of a less accommodative Fed, the federal funds market is now pricing in almost no chance of a rate cut in March, compared to almost a 100% expectation a month ago. Currently the futures markets are pricing in the chance of a June rate cut at less that 10%.. A few analysts even forecast that the next move from the Fed will be a rate hike.

Of course, the concern about the level of economic activity is fundamental to the Fed's outlook for inflation. The Fed is not anti-growth. Rather it wants to foster an environment where the economy can grow as fast as its potential (estimated at about 3% real growth) without triggering serious inflationary pressures. The Fed believes when real economic growth exceeds that threshold then upward price pressures on resources begin to manifest themselves. Furthermore, the Fed believes preventing an inflationary spiral from beginning is a lot easier than stopping one once it gets started.

Fed economists currently expect a continuation of the economy's below potential growth through the first half of 2007 due to the drag on growth from the low level of housing activity and automobile production cutbacks. As these effects wane in the second half, the Fed expects growth to accelerate towards the economy's potential growth rate of approximately 3%. The Fed is gambling that there will be sufficient slack in the economy over the next two quarters to return annual core inflation to the Fed's comfort zone of 1-2%. Recent monthly readings on core inflation have been rather benign and if that continues for several more months core inflation will be back within the comfort zone.

Not all members of the FOMC, however, are as optimistic as the Fed's economic staff. Jeffrey Lacker, the President of the Richmond Federal Reserve Bank, has dissented from the recent votes to hold rates steady because he believes further tightening would help ensure that core inflation declines to an acceptable rate. Since the world is becoming more economically intertwined it is interesting to note that the Bank of England, Britain's central bank, just increased its rates in a surprise more while noting that inflation risks "now appear more to the upside."

The next several months will be interesting, at least to Fed watchers, as the interaction of growth and inflation play out. Economic indicators have a tendency to ebb and flow. Perhaps the next batch of economic releases will be somewhat weaker than the strong ones recently released. Furthermore, the growing tendency of the Federal government to revise reported economic data by often significant amounts has made it more difficult for analysts to assess the true economic situation. Some clues to where interest rates are headed might be gleaned from the next FOMC meeting at the end of January and from Chairman Bernanke's "Semiannual Monetary Policy Report to Congress" in February. Stay tuned. ■

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INSIGHT AND OUTLOOK

A QUARTERLY MARKET COMMENTARY & NEWSLETTER PUBLISHED BY PATTON ALBERTSON & MILLER, LLC

"Ce qu'on voit et ce qu'on ne voit pas"

by Bill Miller
Patton Albertson & Miller, LLC

But for an accident of birth, Claude Frédéric Bastiat (1801-1850) might have been as well known as Adam Smith, Lord Keynes, or Milton Friedman. He was born in Bayonne, France and wrote dozens of brilliant economic essays—in French, of course. English speaking economists by and large have neglected his writings. In fact many of his works remain untranslated to this day. One of his best essays carries the title shown at the top of this column which reads in English "That which is seen, and that which is not seen." It is also known as the Parable of the Broken Window.

Bastiat recounts the story of a shopkeeper whose son has accidentally broken a windowpane in the shop. Repairing it will cost six francs and the shopkeeper understandably is annoyed. Passersby console him by pointing to the "silver lining"—the expense will be good for trade. They say,

> **Everyone must live, and what would become of the glaziers if panes of glass were never broken?**

So in due time

> **The glazier comes, performs his task, receives his six francs, rubs his hands, and, in his heart, blesses the careless child. *All this is that which is seen.***

But Bastiat goes on to observe sagely,

> ***It is not seen* that as our shopkeeper has spent six francs upon one thing, he cannot spend them upon another. *It is not seen* that if he had not had a window to replace, he would, perhaps, have replaced his old shoes, or added another book to his library.**

So the glazier's gain is some other tradesman's loss, for no net advantage to the economy as a whole. Furthermore, the shopkeeper clearly is worse off because he must spend six francs to repair his window and that merely restores him to his prior position (less the six francs). Bastiat concludes,

> **Society loses the value of things which are uselessly destroyed.**

We see there is no stimulation to the economy from the destruction caused by nature or by man once we properly extend our analysis from that which is seen to that which is unseen.

Bastiat's parable reveals the nonsense of some prominent mainstream economists such as Paul Krugman of the New York Times who wrote after 9/11, "Now, all of a sudden, we need some new office buildings. …rebuilding will generate at least some increase in business spending."

Sadly, similar fallacies surfaced after Hurricane Katrina, such as InvesTech Research's statement that "While loss of life and property can be horrific after natural disasters, they inevitably lead to rebuilding, and rebuilding can be very stimulative to the economy."

Too often in economics and investments we focus on the obvious, the immediate, "That which is seen." In the next few paragraphs we consider a few examples of "That which is not seen."

Office Update

As our firm has grown we have encountered the inevitable problem of too little office space in both Macon and Atlanta. By mid-2007 we anticipate moving to bigger quarters in both cities. In Macon, we will be moving about four blocks down the street to the old Ice House building at 231 Riverside Drive. This location is one block from Interstate 16 and will be very easy for both our in-town and out-of-town clients to find. It will also have ample off-street parking and we will occupy space on the first floor which eliminates the need for stairs or elevators. In Atlanta, we are currently looking for new office space but anticipate that we will remain in the Buckhead area. With the addition of John Healy (see page 3), we expect our Atlanta office to grow even faster than in the past.

Crude Oil vs Alternatives

The dramatic 26 % surge in crude oil prices during the first half of 2006 seized the world's attention. Consumers everywhere could see at the gasoline pump the consequences of $77 per barrel oil. Congressmen made predictable threats against "price gougers" and demanded a rollback in gasoline prices.

What was not seen, however, was the impact on other fuels. The growing recognition of Peak Oil led to a scramble for alternative energy sources. The price of uranium, the fuel source for the nuclear power industry, vaulted from $37.50 per pound to $72 per pound, a 92 % increase which received almost no coverage by the business media last year. It was an unseen bull market.

We think uranium companies and other alternative energy companies will prove worthwhile investment vehicles (at the right price, of course) in coming years.

Fed Funds vs the Money Supply

The Federal Open Market Committee (FOMC) uses the Federal Funds rate as its primary lever of monetary policy. Consequently, most economists and Wall Street strategists focus on the FOMC's interest rate decisions to evaluate whether monetary policy is restrictive or accommodative. The Fed Funds rate is that which is seen.

What is unseen is the FOMC's impact on the money supply. We believe change in the money supply best measures the state of monetary policy. Despite the measured increase in the Fed Funds rate from 1% in 2004 to 5.25% today, monetary policy as measured by growth in the money supply has remained accommodative. M2 has increased at an annualized rate of 4.5% since June 2004. It has accelerated to an 8.4% annual rate over the past three months. Borrowers find credit easily available as evidenced by the huge sums being raised weekly to finance the merger and acquisition boom.

The Federal Reserve is not alone among central banks. Contrary to their tough talk, in 2006 the European Central Bank accommodated a 9 % increase in the Euro money supply, the Peoples Bank of China permitted a 17% increase in the yuan money supply, and the Bank of England oversaw a 14 % increase in pounds sterling. No wonder the prices of financial assets are booming worldwide. The world is awash in liquidity.

We think precious metals and selected mining stocks should fare reasonably well in such a monetary environment.

Government vs GAAP Accounting

We can't resist highlighting the chasm separating the Federal government's reported 2006 deficit ($248.2 billion) from the U.S. Treasury's generally accepted accounting principles (GAAP) estimate of $4.6 TRILLION. Naturally, the politicians want us to see the smaller deficit which they proudly note was down $70.8 billion from 2005's $318.5 billion. Government accountants compile the government's books on a cash, as opposed to an accrual, basis and they use a variety of accounting gimmicks to make the Federal government's financial condition appear better than it really is.

As we've written before in this newsletter, if an American company used such misleading accounting, the SEC would indict management for securities fraud.

What is not seen, except by fiscal policy wonks, is the impact of the Federal government's immense unfunded commitments for Social Security, Medicare, and Federal employee pensions. Properly accounting for these obligations is what throws the Federal deficit hopelessly into the red. Each of this country's 300 million inhabitants would have needed to pay $15,300 over and above any taxes already paid in order for the Federal government to truly balance its fiscal 2006 budget.

We do not know how long such deficits can be sustained before drastic fiscal retrenchment becomes imperative. We do know such retrenchment is inevitable. We reluctantly predict that our younger clients will not receive the Federal benefits currently promised them. Our only advice - save!

The Minimum Wage vs Jobs

People from a wide spectrum of political views believe that raising the Federal minimum wage would benefit the working poor and the economy. They reason that workers must be better off taking home a wage of $7.25 per hour rather than $5.15 per hour. And consumption in the economy would rise, wouldn't it, if the 6.6 million workers currently making less than $7.25 per hour received a wage increase? Everyone understands the positive consequences for those workers receiving wage hikes. That much is seen.

What is unseen, however, is the impact on 1) jobs and 2) jobs creation. In the first case, if the higher wage rate makes it unprofitable for some businesses to remain at their prior staffing levels, they will eliminate some jobs. Those people newly unemployed clearly are worse off earning nothing rather than something. In the second case, some businesses which might have increased hiring at lower wage levels might decide against it at $7.25 per hour. We never see the jobs NOT created because of the higher minimum wage just as Bastiat's passersby never saw the business not generated for the shoemaker or the book vendor.

> "The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else."
> —Frédéric Bastiat (1801-1850)

The net economic impact from these two unseen negative consequences of a minimum wage increase is very difficult to unravel. Perhaps that explains why Congress will find it equally difficult to resist the readily seen effects of a higher minimum wage. The glazier's gain is so obvious.

Wal-Mart vs the Moms and Pops

In recent years more and more politicians and local activists have criticized Wal-Mart, the world's largest retailer, for its negative financial impact on local businesses, the proverbial "mom and pop" stores. Undoubtedly Wal-Mart's aggressive low-cost strategy has put enormous profit margin pressure on smaller retailers who lack Wal-Mart's great sourcing power and economies of scale in advertising and distribution. Many small retailers fail when Wal-Mart enters their market. Wal-Mart cannot deny that which is seen.

That which is not seen, however, is far more important to Wal-Mart's core customers. Wal-Mart's low prices enable them to stretch their spending dollars. Getting a bit more for less makes a huge difference when every penny counts.

Although the loss of some "mom and pop" jobs is highly visible while the small improvements to the pocketbooks of thousands of Wal-Mart customers are not, on balance Wal-Mart improves the economic life of the communities in which it competes.

We think low-cost producers should be applauded, not attacked, and we favor investing in companies which have sustainable cost advantages. Such advantages provide an "economic moat" around the value of the company. Warren Buffet likes that and so do we.

Conclusion

Frédéric Bastiat demonstrated the insights available to us from looking beyond the immediate and the obvious to "that which is not seen." How many unforeseen results, later excused as "unintended consequences", could be anticipated if analysts only extended their reasoning forward another step or two? Quite a few, we suspect.

We recognize that analytical myopia is a common shortcoming, especially among the denizens of Congress and Wall Street. We can't do anything about the politicians, but as investors in 2007 we will strive to remember the wisdom of Bastiat by looking beyond the broken windows and what becomes of the glaziers. ■

FED EASE IN 2007?

After increasing its federal funds target rate to 5.25% in late June 2006, the Federal Reserve's Federal Open Market Committee has been on hold. The Fed's decision to pause was based on its expectation that real GDP growth would decelerate below potential in the second half of 2006 and into early 2007. And sure enough, the economy did slow in the second half primarily due to the contraction in homebuilding and the step-down in motor vehicle output. By early December, market participants interest rate expectations were very bullish. The federal funds futures market reflected a 100% chance that the FOMC would reduce the target rate $^{1}/_{4}$% at its March 20-21 meeting. Looking out over the next 12 months, a Bloomberg survey reported that sixteen of the twenty-two "primary" dealers who trade directly with the Fed expected the FOMC to reduce rates by $^{1}/_{2}$%.

by Charlie McAnally
Patton Albertson & Miller, LLC

Bill Gross, the astute bond fund manager at PIMCO, recently forecasted that the Fed would cut the target rate by a full 1% over the course of 2007. The FOMC itself, according to the minutes of its December 12 meeting, acknowledged

"That growth in economic activity had slowed to a pace below that of the economy's long-run potential in the second half of 2006…that eeconomic activity… was probably a touch softer than had been expected at the time of the October meeting. Several members judged that…the downside risks to economic growth in the near term had increased a little…and were a bit more broadly based than previously thought."

Indeed, the recent declines in oil and other commodities have suggested to some that a slowdown in economic activity is already underway. In particular, copper is down over 25% since its December high. Due to its widespread use in production, copper is often used as a reliable economic indicator; so much so it is often referred to as "Dr. Copper". Others, however, suggest the downturn in oil and other commodities merely is due to the weather and profit taking by large hedge

continues…

Healy Joins Patton Albertson & Miller!

We are very pleased to announce that John Healy joined our firm on January 15, 2007 as a Senior Portfolio Manager and Director of Research. John has been theprincipal of Healy Capital Management in Atlanta for the past six years and before that was a portfolio manager with INVESCO Capital Management of Atlanta. He is a graduate of Vanderbilt University and holds a Masters Degree from The Wharton School of Business. He is a Chartered Financial Analyst and has over 16 years of investment management experience. He is a strong disciple of value style investing and will make a great addition to our investment management team. We enthusiastically welcome John, his wife, Kathy, their family and his clients to Patton Albertson & Miller. John will be located in our Atlanta office and will become a member of our investment committee.

John Healy
Patton Albertson & Miller, LLC