

## E-Memo

**TO:** INVESTORS/MEMBERS AND FRIENDS  
**FROM:** Jon Bruss and Bob Ollech  
**Date:** June 13, 2006  
**Subject:** The answer is: Ben Bernanke and Abu Musab al-Zarqawi.

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"The Wrong Guy", "Greenspan's Inflation", "Facts don't fit despair, and despair cheats Iraqis", "Bernanke and Inflation: A Headache for Markets" and "Global Markets Plunge on Fed Worries" were just a few of the headlines we noted over the weekend and into the early part of this week. Carnak the Magnificent, the character created by Tonight Show host Johnny Carson, would have had a field day—a field day with the headlines and a field day with the subject of this month's **E-Memo**.

"What's wrong with this market?" is the question on the minds of every investor today. Commodities rocket to near all-time highs only to collapse as inflation news, first good news and then bad (if, in fact, it is possible to discern which is which). Last week we read about a fire in Brooklyn in historic buildings along its shoreline which took place on May 2, 2006. This fire, which resulted in more equipment and personnel being called out than any fire in the last ten years excepting the September 11, 2001 attack on the US at the World Trade Centers, was determined to be set by arsonists. The arsonists' objective? According to New York newspaper accounts, to burn the insulation off the copper electrical wire so that the wire could be salvaged and sold. The price of stripped copper wire is \$1.25 per pound compared to about 70 cents per pound for insulated wire. According to the brother of one of the accused arsonists, a homeless man, the man was trying to sell the wire to finance a heavy vodka habit—apparently the 55 cent per pound discrepancy was enough of a difference in ounces of vodka to make it worth his while to engage in the copper coating caper. And one of our investors told us last week that thieves have been removing copper gutters and down spouts from homes in the Aspen, Colorado area and selling them. So what is going on here? Copper is down, gold is down as are other precious metals and zinc is down and on and on. Hey, gold bugs, gold is down 20%! When a stock or commodity is down 20% or more it's called a bear market. What about the bond market? Have you noticed that the 10-year is trading to yield less than 5.00%? Is that what is supposed to happen when the market is concerned about inflation and the Fed is apparently committed to raising rates? And what's happening in the equity markets? The Dow moves to within less than 100 points of its all time high only to sputter and then fall by more than 1,000 points. And as of this writing, *all* the major indices we watch—except the bank indices—are negative for the year. The carnage has been significant. Take a look at this table:

### Performance of Major Equity Indices

January 3, 2006 to June 12, 2006

NASDAQ	S & P 500	DJ Industrials	S & P Small Cap	NASDAQ Banks	KBW Large Bks	Regional Bks
-6.79%	-2.55%	-0.51%	+0.34%	+2.75%	+2.93%	+3.55%

**NOTE:** *With dividends* the **Dow Jones Industrial Average** was actually **positive** through the 12<sup>th</sup> of June at +0.53%. *With dividends* the **NASDAQ Banks** added **104 bps** while the **KBW Large Bank Index** added **151 bps** and the **Regional Bank Index** (XRH) added **160 bps**.

Also, we failed to mention that the volatility index (VIX) has moved higher recently. In fact, it is has returned to the level it was at in mid-March of 2004. The VIX is the index of uncertainty. In other words, uncertainty in the market is higher than it has been in over two years.

The market consists of tens of thousands of humans and it is human nature which ultimately decides whether it is uncertain, whether it should buy or sell or hold and whether it needs to *attribute* its attitude to someone or something or some event. "Attribute" is a euphemism for "blame". And it is human nature to

"blame"—someone, something or some event. You'll recall at various times over the past several years investors have blamed moves in the market on interest rates, inflation, Iraq, Iran, hurricanes, oil, commodities, President Bush and the list goes on and on.

Playing the blame game is an inter-trade pastime of market participants, especially those positioned as talking heads, and that brings us back to Carnak the Magnificent. How would Carnak have responded to the statement "Ben Bernanke and Abu Musab al-Zarqawi"? One wag last week provided an answer (as quoted by *Barron's*, "They got the wrong guy." Typical of the blame game, right? But in the heart of hearts of many investors that is precisely what many felt. Not you or us, of course. But hasn't Bernanke become public equity markets Enemy Number One? Hasn't he replaced bin-Laden and al-Zarqawi in our minds at the person to blame for the state of the equity markets?

We were wrong in thinking as we came into the office last Thursday that the market would rally on the news that al-Zarqawi had "bought the ranch" with the assistance of the US Air Force (government assisted purchase?). We too, had become creatures of the market. We listened to and read the pundits' comments. As it turned out, we were wrong—really wrong most of the day. At the end of the day, the Dow and the S&P 500 were up only slightly while the NASDAQ declined. On Friday, the broader markets were back-sliding again.

Now maybe this wasn't a turning point in the war in Iraq but on the very same day, after the hand wringing of the past year or so, the Iraqis completed the formation of their government with what one commentator called a "triple ethnic compromise." Remember now as Pat McIlheran observed in the Sunday June 11, 2006 *Milwaukee Journal Sentinel*,

"Our troops will bog down, we heard, until they toppled the tyrant in three weeks. Yeah, but until you catch Saddam Hussein, it's meaningless, we heard—until our guys caught Hussein. At which point democracy was said to be a fool's dream, until Iraqis waved their purple fingers. But that would never lead to a government—until the Iraqis formed one."

And, we'd like to add that it took this nation from July 4, 1776 until 1789 to form its own government. But that was 200 years ago and isn't comparable—is it? Now let's see. The Coalition of the Willing invaded Iraq in March of 2003 and *three* years (not thirteen) later the Iraqis have engaged in nationwide elections, not once but twice, and the government is in place. The outcome may be in doubt, as some say but it sure seems as though events are going in the right direction. Remember, it wasn't until 1789, 13 years after we declared independence from England that we held our first nation-wide election in which George Washington was elected president. It was March of that year that the first Congress was assembled and declared the Constitution to be in effect. In April of 1789 the House of Representatives elected its first speaker and Washington was sworn in as president. It wasn't until July of 1789 that the first US agency, the Department of State was formed. It seems to us that the Iraqis are ahead of schedule—especially because such a civilized group as our founding fathers wasn't able to get their act together for more than 13 years! We are playing the blame game again. It's human nature. We can't blame what is or isn't happening in Iraq for what is going on in the market.

Is it Bernanke or the Fed or Greenspan that is causing the markets to swoon? Well one thing is sure; Bernanke was not at the helm when rates were slashed after the dot.com bubble burst or 9/11. Arguably he was a dove on *in*flation and a hawk on *de*flation as recently as three years ago. Having said all that, we think that the history of the '70s clearly shows the damage that elevated inflation can cause. While we are still concerned about over-kill, that the Fed will raise rates too high, we think it is of great importance that we move to neutral rates before inflationary expectations can take hold in the economy. The numbers the Fed watches are what they are and the Federal Open Market Committee will make its decision on rates on June 29 based upon the numbers. Whatever they are, they are. We can only hope that the Fed has not

gone too far with 16 increases—and there are those for whom we have a great deal of respect who say they have not.

Yes, inflation is the enemy of the equity markets but one last question remains. Who or what is to blame for the swoon in the S & P 500 and the NASDAQ Composite—and for that matter the Dow? Why have the Dow, the S&P 600 Small Cap Index and the aforementioned bank indices performed better than the broader market?

Remember the Walt Kelly cartoon “Pogo”? We recall one of its characters dressed in a kind of arcane battle uniform saying, “We have met the enemy and he is us.” We believe that the answer may reside in the performance of the treasury markets. And investors drive the treasury market. Yields are down from recent highs. The curve which seemed to be steepening has flattened. The ten year is below 5.00% and as of this writing is declining further.

We’ve all learned that in times of uncertainty, investors “fly to quality” so the blame game stops with investors. Investors are uncertain. That uncertainty can be seen in the mirror every day. Uncertainty is driving the rally in bonds and, we think, the on-going strength in those stocks which are thought to be of the highest quality—the Dow Jones 30 (which incidentally includes two money center banks and three other financials—we include GE in that group) and banks. The highest quality companies pay dividends and those dividends are increased frequently—annually in many cases. Further anecdotal evidence comes from *Investor’s Business Daily* where our favorite tables in the second section of the paper start on page 3. Here we have found banks listed as the top performing group for the past several weeks or so in terms of the number of 52 week highs as a percent of all NASDAQ highs. Banks hitting new highs have represented 30%-40% and more of all the 52 week highs in the NASDAQ. That is twice their representation in the NASDAQ Composite Index. Some of these highs are driven by acquisitions and rumors thereof, some by the recent discovery of good P & L results—some are even in our portfolios.

The Fed will continue to do what is has to do. The odds of another increase according to Fed funds futures are around 80%. That’s good enough for us to conclude that it will happen (at least that’s our view today). There is a fear that the Fed will go too far—and it could. It certainly has in the past. That could be quickly corrected by a policy reversal and reduction in rates to get it just right. In the meantime, we like where we are—investing in quality stocks—bank stocks. As prices decline (and yes, many banks have retreated from their earlier peaks this year or last) we are finding opportunities to grab some attractive bargains off the shelf. In this period of uncertainty it is easy to play the blame game. Bernanke or al-Zarqawi, Greenspan or Bush or . . .? Instead of playing the blame game, remember Pogo. We encourage you, too to seek quality in your portfolio by reducing volatility and uncertainty and adding banks.

It is not too early and it may be just in time.

# FORTRESS

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