



EARL M. FOSTER ASSOCIATES

INVESTMENT MANAGEMENT

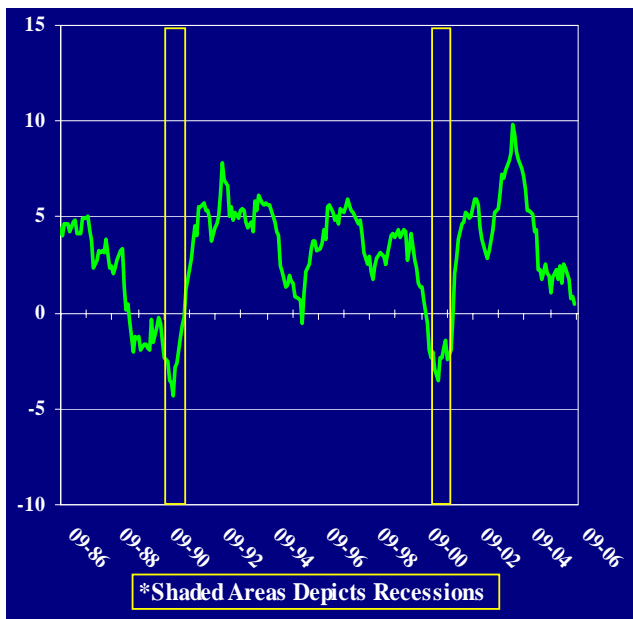
NEWSLETTER

October 2006

Economic Recession or Slowdown?

Even though there have been only two recessions since 1982, the current deceleration in the economy has prompted some to speculate that a downturn in business conditions is imminent. However, current economic trends point more towards a slowdown than a recession.

CHART I
Index of Leading Economic Indicators
(Year over Year Percent Change)



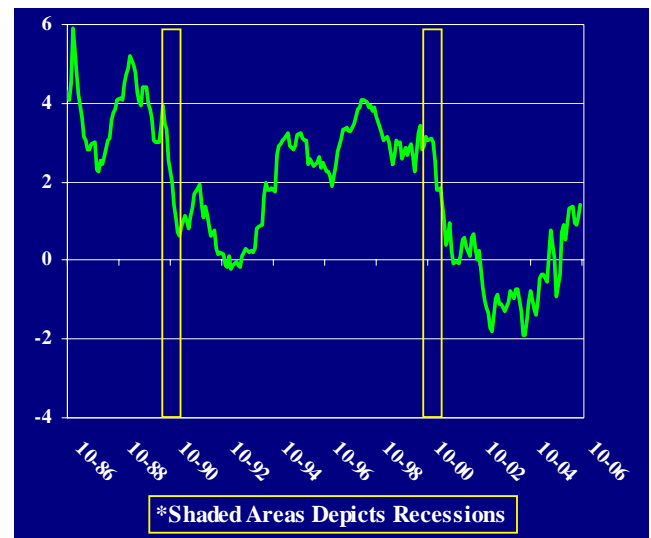
The Index of Leading Economic Indicators (Chart I) is a composite of 12 economic series that signals upcoming recessions when its year-over-year percent change falls into negative territory. It warned of the 1990-91 recession more than a year in advance and nearly a half of a year in advance of the 2001 recession. While the Index now indicates that a slowing in the economy is underway, it is premature to suggest that the Index is predicting a recession.

The economy is not as vulnerable to a downturn as it was prior to the past two recessions. The 1990-1991 recession, which lasted six months and caused the economy to decline 1.3%, was preceded by a Federal Funds rate in excess of 9%, money supply growth of less than 3%, and housing starts that

plummeted to less than a million units (annual rate). Still, the recession turned out to be relatively mild and relatively short.

The 2001 recession was longer, but not any deeper than its predecessor. That downturn could be attributed to the aftermath of an extraordinary boom in technology spending associated with the need to update computer systems at the turn of the century. Business capital spending (of which technology is a major component) declined 16%! However, the overall decline in the economy was cushioned by a stable housing sector, low interest rates, and accelerating money supply growth. The drop in capital spending did, however, lead to a two-year contraction in employment and a two-and-one-half year decline in stock prices.

CHART II
Federal Funds Rate – Adjusted for Inflation



By way of contrast, today's economy is not plagued by a restrictive monetary policy such as preceded the last two recessions. Chart II illustrates the inflation-adjusted Federal Funds interest rate, which is one of the better indicators of Federal Reserve policy. Prior to the 1990-91 recession, it ranged between 3% - 5%. Monetary restraint prior to the 2001 recession was not quite as restrictive, but the inflation-adjusted rate was still in the 2% - 3% range. For much of the last several years, the rate was in negative territory. More recently,

it rose to 1.4% last Spring; and now is about 1.0%. Its rise over the last several years has hardly impinged on economic activity.

Moreover, today's deteriorating residential construction sector should have less of an impact on the economy than capital spending did during the last recession. First and foremost, residential construction accounts for only 5% of the economy in contrast to 15% for capital spending in 2000. Second, the deterioration in the housing sector is not uniform throughout the country; instead, the decline is more pronounced along the east and west coasts, especially California, Florida, and the Northeast. There is more stability in the country's mid-section. Nationally, housing starts have declined to 1.6 million units, a level that is still satisfactory by historical standards.

Nevertheless, the recent deceleration in the economy is likely to continue. The downturn in the housing sector will have some "spill-over" effect on a wide range of other sectors related to new housing such as home furnishings and durables. Spending by existing homeowners is also likely to dampen. With home values no longer appreciating the way they were over the last several years, consumer enthusiasm to spend on discretionary items is likely to moderate. Moreover, consumers have been spending more than their income over the last year, resulting in a negative savings rate. This phenomenon is unsustainable and the re-alignment of consumer spending with their income should more than offset the benefits of lower energy costs. Thus, further deceleration in consumer spending can be expected.

The business sector is likely to fare better. First, energy prices are now lower than at the same time last year. Second, money supply growth has been accelerating for more than a year. Third, industrial production has been expanding at more than four percent, and inventories remain lean. Fourth, commercial construction remains strong.

On balance, this suggests a deceleration rather than deterioration into a recession. The economy is more likely to approach marginal growth similar to the 1995 slowdown, when it temporarily flirted with growth rates of less than 1%. For 1995 as a whole, though, the economy grew 2.5%. By way of comparison, consensus economic thinking has 2007's growth rate in the 2.0% - 3.0% range compared to 3.0% - 3.5% for 2006.

INVESTMENT STRATEGY

In this environment, one should expect corporate profit margins to contract next year from 2006 peak levels. Some of that narrowing will be cushioned by lower energy costs. Thus, corporate earnings are expected to increase in the 3% - 7% range in 2007. While that may seem disappointing compared to double-digit percent increases over the last four years, it is, nevertheless, sufficient to support higher stock price levels.

Unlike the prior two recessions, when the Standard & Poor's Index had a cumulative price decline of 20% and 44%, respectively, a further retrenchment in stock prices from that already experienced this year should be limited. The 1990 stock market decline was exacerbated by interest rates that were nearly double that of today. The 2000 - 2002 "bear market" was primarily related to the preceding extraordinary speculation in large capitalization growth stocks that prompted former Federal Reserve Chairman Alan Greenspan several years earlier to coin the phrase "irrational exuberance." At its 2000 peak, the price-earnings ratio for the Standard & Poor's Index was 28 times that year's earnings.

CHART III
Standard & Poor's Index
Year-to-Date



Today's stock market, even after the third quarter rebound, is only 15.8 times this year's earnings and 15 times projected earnings for 2007. By way of perspective, the average price-earnings ratio since 1990 (excluding the speculative valuations during 1998-2000) was 18.2. The average annual low price-earnings ratio over the last 15 years was 15.4.

It appears that investors are already discounting a recession, an event that may not materialize. Thus, the projected 1200 - 1450 trading range for the Standard & Poor's Index for 2006 remains unchanged. The Index closed the third quarter at the mid-point of this year's range.

TABLE I
Market Performance Comparison
(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	12/31/05	09/30/06	Return
Standard & Poor's 500	1248	1336	8.5%
Dow Jones Average	10,718	11,679	10.8%
NASDAQ	2,205	2,258	2.4%
EAFE Index (International)	1,684	1,882	11.8%
3 Mth U.S. Treasury Bill	4.1%	4.9%	3.5%
10-Yr U.S. Treasury Bond	4.4%	4.6%	1.7%
10-Yr AAA. Tax-Exempt	3.8%	3.8%	2.9%

*Estimate

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