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# THE RAY REPORT

September 21, 2006

## Transition

This is a time of transition and paradox. The Federal Reserve, under new chairman Ben Bernanke, has chosen not to raise rates in August and will likely skip September, as well.

Oil remains over \$60 a barrel, as supply constraints and world events put pressure on production. Yet, inventory remains historically high and consumer demand for gasoline, especially in the United States, is restrained.

Housing starts have slowed dramatically, showing a 6% reduction in August, and the pricing of homes will surely follow. Inflation remains a worry to many, although prices, both at the consumer and wholesale level, have been relatively tame over the last 2 months.

These are the types of things we see at the end of an interest rate cycle. There is uncertainty and the need for confirmation. Even the Federal Reserve continues to state that future moves involving interest rates remain "data dependent." Many investors are frozen and are skeptical that things have changed in the economic cycle. There is often a reluctance to deploy capital quickly. Despite a rally early in the year and an improvement over the last month or so, the stock market has remained quiet so far this year. Technology and more speculative stocks have fared worse as

represented by a relative flat NASDAQ. This period of drifting has led to a lot of anxiety by investors and clients, despite the fact that 12 month equity returns are reasonable.

Investors often fail to understand that markets are much like a football game. It is virtually impossible to sustain momentum for long periods of time. There are times to be aggressive and times to be cautious. There are situations when you have your offense on the field and can go for the big play. There are other times, when defense is warranted, or a conservative play call is appropriate.

The current market likely will continue to be somewhat restrained by an uncertain slowing economic period and its perceived effect on corporate profits. While the Federal Reserve is likely done for this

### Market Performance For The August 2006 Quarterly Period

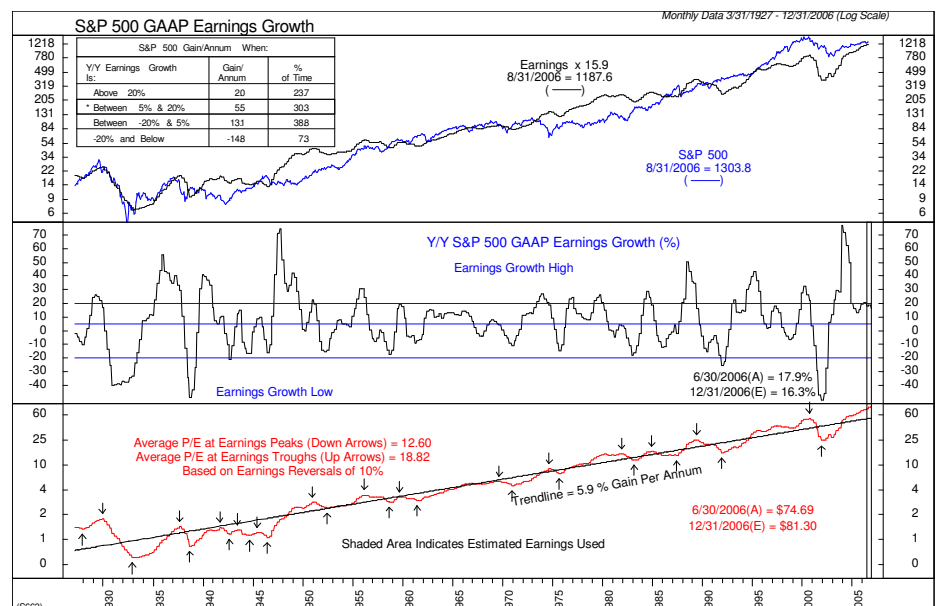
<i>Dow Jones Industrials</i>	<b>2.52%</b>
<i>Standard &amp; Poor's 500</i>	<b>3.13%</b>
<i>Russell 1000 Growth</i>	<b>0.45%</b>

cycle, in my opinion, it will take time for investors to come around to that opinion and Bernanke's inexperience will elongate this process. Mid-term elections and the potential that Republicans could lose one, or both, houses of Congress will create additional uncertainty as we drift into autumn.

While markets could rebound nicely in the short-term given the Fed and relatively high levels of pessimism, I would suspect a quiet fall is also a good possibility with a stronger rally toward year-end.

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## Earnings Growth Remains Strong

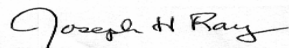


Courtesy of: Ned Davis Research, Inc.

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Investors should understand that it is all part of the game and there will be more excitement as the game goes on. The fourth quarter traditionally represents the best quarter of the year for the market and the potential remains for 2006 to be a very solid year for equities.

Regards,



Joseph H. Ray,  
President

### What if the Fed is Done?

The market generally performs poorly at the end of the tightening cycle. In fact, the market is generally down from the last Fed rate hike until the first time they lower rates. As we talked earlier about being defensive, here are a few facts exhibited during the past cycles.

- Value, financial and defensive stocks tend to outperform.
- The NASDAQ, technology and small-cap stocks underperform.
- Large-cap outperforms small-cap.
- Cash, initially performs well, due to the higher interest rates available in most money markets.

1995 was an exception to the rule, as markets broke out to new highs as the Fed stopped raising rates.

The breadth and liquidity picture in 1995 was more favorable than now, however.

It is important to note that the time between the last rate hike and the first time the Fed lowers rates is relatively short, with an average of six months. Once rates are lowered, stocks outperform greatly.

Thanks to **Ned Davis Research** for much of the statistical heavy lifting, which allowed me to pass on this interesting information.

### The Debate on Rates

Economists and pundits remain split as to whether we are done raising rates for this cycle. I believe we are. Former Fed governor Bob McTeer and TV pundit/economist Larry Kudlow also believe that the Federal Reserve is and should be done. Bear Stearns economist John Ryding still worries about imbedded inflation in the system and calls for a resumption of rate increases beginning in October. Given recent economic data, this viewpoint may be increasingly hard to justify.

### Cisco and Oil Spark Rally

Early in the quarter, the stock market continued to be dogged by high oil prices and political unrest. The Hezbollah-Israeli conflict and its potential broader implications made it virtually impossible for a rally to be sustained. In addition, early earnings reports provided little catalyst for stocks. General Electric, often an economic bell-

wether, showed that sales growth will be difficult to come by as the economy slows. Citigroup's earnings showed the challenges banks will face with the current flat yield curve, as well as, the slowing mortgage market.

As the quarter progressed, however, stocks began to turn more positive. There are a number of reasons. First, Cisco had an excellent quarter and suggested corporate technology spending is sound. The Federal Reserve then appropriately refused to raise rates. Microsoft's tender for shares of its stock also seemed to provide a floor to this technology bellwether. Lastly, oil has retreated to the low sixties.

Stocks have remained solid in September generally a time of seasonal weakness. Should third quarter earnings remain strong, I anticipate we could have a nice close to the year if oil and the Fed remain contained.

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### NOTICE:

### CHANGES TO CLIENT INFORMATION

It is important for us to be aware of any changes in our clients' information. Please notify us in writing, and as soon as possible, of any changes in your personal information name, address, phone numbers and when there are any changes to your financial circumstances or investment objectives.