



February '06 Newsletter – Oil, Commodities and the Markets

Stocks started 2006 with an excellent 1st week with the S&P 500 index* up 3.0%...the same % it was up for the entire year of 2005 (“up” by-the-way, was our one-year old son, Jake’s, 1st word last month...mom and dad were very proud). For 30 of the last 35 years, the stock market has followed the trend in the 1st week of January.** In the 4th quarter, positive earnings surprises from S&P 500 companies have outnumbered negative surprises by a 3-to-1 margin. Unemployment is 4.7% - the lowest it has been since July 2001, yet the markets have been struggling to make any headway due to rising oil prices surrounding the uncertainties with Iran’s pursuit of nuclear power and the Fed’s tightening of interest rates to 4.5% in response to an overheated economy and inflation fears.

Rising oil prices prompted me to look back at the price of oil and its impact on the stock market in recent years. Since early 2003, when we chart oil price and the S&P 500 index on the same chart, every time oil prices surged, the market pulled back and went lower...including what has happened in recent weeks.

As was shown in December’s newsletter, stocks are undervalued when compared to long-term interest rates. Housing prices are flat and interest rates on long-term bonds are likely to trend up from here. Bond prices move in an inverse direction to interest rates making bonds a less desirable investment. When the stock market went down in 2000-2002, there was a huge outflow of money from stocks to real estate and bonds – a flight to quality. With real estate possibly hitting a “bubble” and bond prices falling, there are fewer places for our investments other than undervalued companies.

Is it just me or each time there is a “surprise” in the oil markets, the price of oil goes up? In the past, new information could make the price of oil go up or down. With the supply and demand situation in such a delicate balance, it seems any time an event occurs environmentally or politically in the world, the price of oil goes up. If oil spikes above the all-time high of \$71/bbl, that would most likely be a drag on the markets and negatively affect the returns of our accounts. So what can we do to protect ourselves?

In an effort to hedge against these oil related “surprises”, it is my assessment, we should allocate 5-15% of our portfolios to oil and other commodities like precious metals, building materials, etc. In an effort to reduce volatility, the investments should have seasoned managers with a fund prospectus that allows sufficient leeway to the fund manager to move in and out of oil and other commodities at their discretion.

Have a great day,

Dave

* The S&P 500 is made up of 500 common stocks representing major US industry sectors.

** Past performance is not indicative of future results.

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