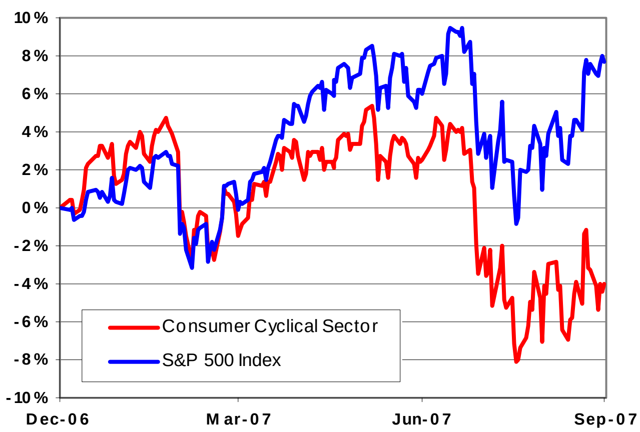
Robshaw & Julian Associates, Inc.
Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended September 30, 2007

The Market is Betting Against the Consumer?

So Far this year, the Standard & Poors 500 Index has risen nearly 8% but consumer cyclical stocks have fallen 4%. Consumer cyclical stocks include the auto, housing, leisure, media, household durable and retail industries. Familiar names include General Motors, Whirlpool, Disney, Hilton, Time-Warner, Target, Home Depot and Best Buy.



Consumer Cyclical Stocks are Down 4% in 2007

The common denominator for these stocks is that they all depend on discretionary consumer spending, which fluctuates with the economy. As the economy strengthens and job growth improves, consumers feel more confident about the future and commit to major purchases such as cars, houses, appliances and travel. When the economy slows, confidence wanes and these purchases are deferred to a later time.

The biggest losers among the consumer cyclical stocks are the home builders. This group, which includes K B Home, Centex and D. R. Horton, went down 25% last year then declined another 52% in the first nine months of this year. Interestingly, after a two year decline in the stocks, home builders are just now beginning to report negative earnings. Clearly, the stock market anticipated our current weak housing market.

But home builders represent less than one quarter of 1% of the S&P 500. Recent steep declines in the much larger retail and media groups suggest that the economic repercussions of the housing decline could be spreading, and possibly leading to a consumer led recession. The continuing decline of the dollar and the stubbornly high price of oil are also big negatives for the consumer. But the positives still outnumber the negatives. The economy continues to grow and few forecasters see it turning negative. The Federal Reserve is lowering interest rates. Inflation is low. Unemployment claims are not rising. The industrial and export side of the economy is strong. Worldwide liquidity remains high. And it's worth remembering that the stock market has forecast past recessions which never arrived.

At some point, downtrodden consumer discretionary stocks will be a good buy. If actions by the Fed reignite economic growth, that time is soon. If the economy slips into recession it could be somewhat later.

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"The Most Powerful Force in the Universe"

Albert Einstein is said to have declared that compound interest is, "the most powerful force in the universe". No wonder. If the Indians who supposedly sold Manhattan Island for $16 in beads and trinkets in 1626 had invested the money at 8% interest compounded annually, they could now buy back the entire island and still have a few hundred million dollars left over. The secret to this phenomenal growth is interest-on-interest, a trivial factor when time is short, a giant over long periods of time.

Whether Einstein actually said this or not, compound interest is vastly under-rated by most investors. Consider a more practical example:

Over the last 40 years the stock market has returned, on average, about 10.5% per year. Starting with $10,000, an investor earning 10.5% will have $11,050 after the first year. In the second year, with the extra benefit of interest-on-interest, our hypothetical investor will earn $1,160, which brings the total investment to $12,210. Not very exciting so far. But see what happens when time is allowed to work

Continued on page 2.

Powerful Force: continued

it's magic. After 10 years the investors original $10,000 has grown 171%, and is now worth $27,140. After 40 years, about the time most people spend working, the investors original $10,000 has grown to $542,614, or more than 54 times the starting value. The fact that purchasing power was substantially diminished by inflation does not alter the fact that compounding is the investors best friend, but only if the acquaintance is made early in life.

A recent study by the World Bank concluded that intangibles such as property rights, the rule of law and a good educational system are far more important than natural resources or capital assets in producing prosperity for a country.

Is the Price of Oil Due for a Fall?

Most people believe the price of oil is going higher. First, the trend in oil prices is up. In 2000, a barrel of oil went for about $25; today's price is over $80. Second, many believe that the world is running out of oil or at least that discovering new oil deposits will be increasingly difficult. Supply disruptions in Venezuela, Nigeria and the Middle East and unprecedented high demand from China, India and other developing economies are predicted to continue. A continued decline in the dollar feeds the trend.

But not everyone is a believer. Michael Rothman, an oil analyst with the ISI Group, thinks that the price of oil is due for a fall. His target price is $45/bbl. This is the same Mike Rothman who, in his former position as chief energy strategist at Merrill Lynch in 2000, was described as a "foaming at the mouth" bull on oil prices when everyone else was negative. Although the price stayed in the mid-20's until 2003, it subsequently went up more than 25% a year to its current high level. Mike's only error was in being too early.

Mike's prediction for an oil price decline is based on his careful count of barrels produced, barrels stored and barrels used. He sees a large gap between perception and reality. First, as predicted by basic economic theory, the high price of oil is stimulating additional supply. Non-OPEC production is running at twice the expected growth rate. Saudi Arabia, the swing producer in OPEC, recently announced increases in production. They will be bringing on a major new field later this year and three more in the next few years. Supply is also increasing via the substitution effect. Ethanol, bio-diesel and natural gas liquids, ready substitutes for oil, are experiencing dramatic increases in production.

Demand growth is also not what it seems. In developed nations, oil demand grows slowly and is unlikely to accelerate. The demand story is in developing nations. There growth may be solid but is not likely to match expectations. Data for oil use and storage in developing nations is sketchy at best. Estimates for China are based on recent double digit growth in purchases of oil, not on actual consumption. Mike estimates that much of the oil purchased by China and India went into storage for meeting future demand. If this is correct future demand growth may be less than half of current estimates and a significant price decline should result.

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The Bottom Line: 9/30/2007

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1527	+16.4%
Small company stocks *(S&P Small Cap Index)*	423	+14.9%
Short term interest rates *(3 Month T-Bill Yield)*	3.7%	From 4.8%
Long term interest rates *(10 Year T-Bond Yield)*	4.6%	No Change
Inflation *(Consumer Price Index)*	207.7	+2.0%
Energy *(West Texas Intermediate Crude Oil)*	$81.66/bbl.	+30%
The economy *(Inflation adjusted GDP)*	$13.8trillion	+2.7%

QUOTABLE

"The tax on capital gains directly affects investment decisions...and thereby the strength and potential for growth in the economy."

John F. Kennedy

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