



*“Illumination”*

The Annual Report to Advisory Clients which Sheds light on the Major Trends that can make you money in 2006

Part I

K&A Asset Management, LLC

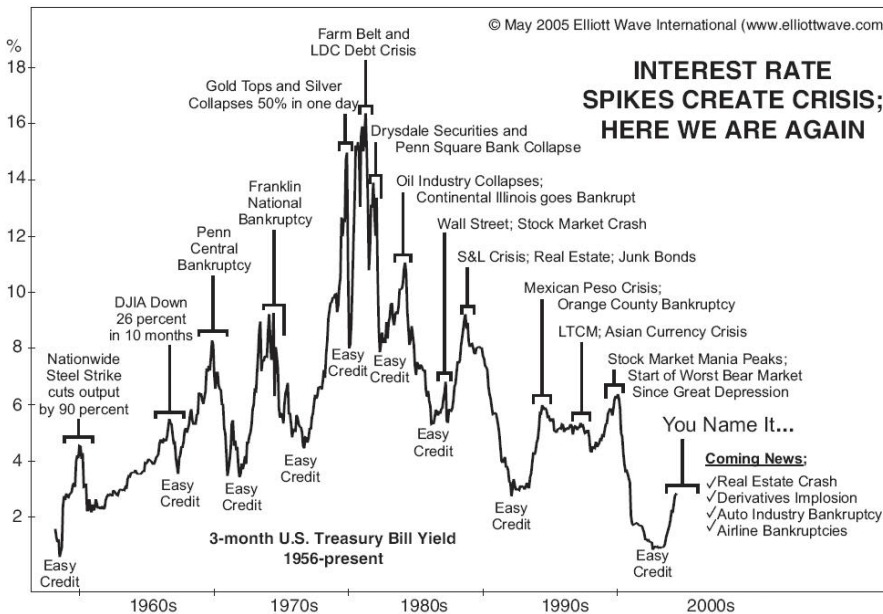
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*Introduction and Summary of Report*

Interest rates and rates of inflation are the wild cards for the financial markets going into 2006. Conventional wisdom is that the Fed is almost finished raising short term rates and that inflation in the U.S. is contained. In fact the yield curve just inverted, possibly indicating an economic slowdown in 2006.



We frankly aren't ready to assume the Fed is nearing the finish line. We do anticipate that the rate of economic growth in the U.S. will slow from 2005 but we are not sure by how much. We also know that past fed tightening cycles have often led to unwanted consequences that

have sometimes been very unpleasant. We hope that history doesn't repeat itself.

The U.S. economy has proven more resilient than many forecasters anticipated during 2005. Will that be the case in 2006? Only time will tell.

However, we believe that real rates of inflation are much higher than official CPI and PPI numbers indicate. We believe that these indexes have been sufficiently modified over the past several years that they no longer come anywhere close to measuring real rates of inflation. Both the CPI and the PPI have gone through revisions in their methods of calculation over the past decade, for the purpose of reducing the rate at which they measure inflation. The significant revisions started during the Clinton administration as a method of reducing cost of living increases in entitlement payments such as social security, which are tied to the rate of increase in the CPI. The lower the CPI increase the lower the benefit payment increase. It is just that simple—and therefore less federal spending.

The CPI can be manipulated easily by adding, subtracting or otherwise changing which factors get measured and also by how those factors are weighted in calculating the index. Change the components or change the weighting and you get a different CPI. That is exactly what the U.S. government has been doing over the past decade. They have changed the way we measure inflation to decrease the stated rate. Everyone seems to be happily ignoring that fact that today's CPI significantly understates the real rate of inflation.

So what you might ask? Well we have a good answer. Any darned fool can read that inflation is increasing at 3 percent per year. That same fool can find his or her home heating bill increasing at 25 percent per year, his car gas bill going up by 20 percent, and the price of his house appreciating 12 percent, and know that the 'official' statistics are wrong. It isn't a matter of what the statistics report. It is a matter of whether or not people can afford to pay for the goods and services they need. We think fewer and fewer people can do that.

In other words, there is currently a huge difference between the world as the keepers of statistics would like it to be and the world as it really is. The world as it really is happens to be getting more and more unaffordable for more and more people, and that will eventually become a serious problem. It is also becoming more and more unaffordable for government entities at every level including local, county, state and federal.

We also know that there will soon be a new Fed chief. The truth is that no one knows how he will conduct the business of the Fed. We believe his options are somewhat limited by the fact the neither the Fed, nor the Administration can afford to let the U.S. slip into recession. Therefore the brakes are on raising interest rates too much. We will also tell you that we believe the new Fed chief is inheriting a 'conundrum' related to what we believe to be the #1 investment theme of 2006. But even the new Fed chief is not talking about his conundrum right now.

**Here is our take on the #1 investment theme of 2006.**

Inflation is rampant and the official measures of inflation like CPI and PPI have been so manipulated over the past several years that no one seems to realize how much real inflation is in the economy. If the CPI were still calculated today using the same methods in the 1970's through the early 1990's the stated inflation rate would probably exceed 7 percent and we would all be panicking. We believe that the Fed is already quietly panicked. They are just not telling. Actually Dr. Greenspan is telling us; when he is away from the Federal Open Market Committee (FOMC) meetings.

While the FOMC is quietly going about raising interest rates 25 basis points per quarter, Greenspan is traveling the western world warning of the impending debacle our economy faces if we don't get our indebtedness, trade balances and entitlement expenses under control.

We believe that during 2006 the Fed is going to fool you by making you focus on what they do with interest rates while they flood the globe with an increased supply of U.S. dollars. They can't afford a recession and will "error" towards favoring inflation. Inflation is likely to go higher than the pundits currently expect, not related to the magnitude of movement of interest rates; but because the globe is being flooded with U.S. dollars.

Yet thanks to post-1990's inflation measures, "official" or "core" inflation still seems contained. That condition will remain static. The calculation of the "core rate of inflation" has been fixed to assure it. Before we continue lets get everyone on the same page with little "econ 101" reminders of what inflation is and what money supply has to do with it.

***The American Heritage® Dictionary of the English Language, Fourth Edition, Copyright © 2000 Published by Houghton Mifflin Company says:***

**Inflation:**

**2) A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services.**

You may not be aware, but the Fed is no longer going to report M3 money supply statistics starting in 2006. M3 is the broadest, most inclusive measure of U.S. money supply. We find that incredibly strange and have found no reasonable explanation for the change, other than our suspicion that they simply don't want the public to know how fast money supply is growing.

*Richard Russell, Dow Theory Letters recently reported, "For the week ended December 12, M-3, the broad money supply, rose \$27.3 billion. Do that every week, and you're talking about \$1.41 trillion added to the system. No wonder the "boys in charge" are getting rid of M-3. The statistics are too embarrassing."*

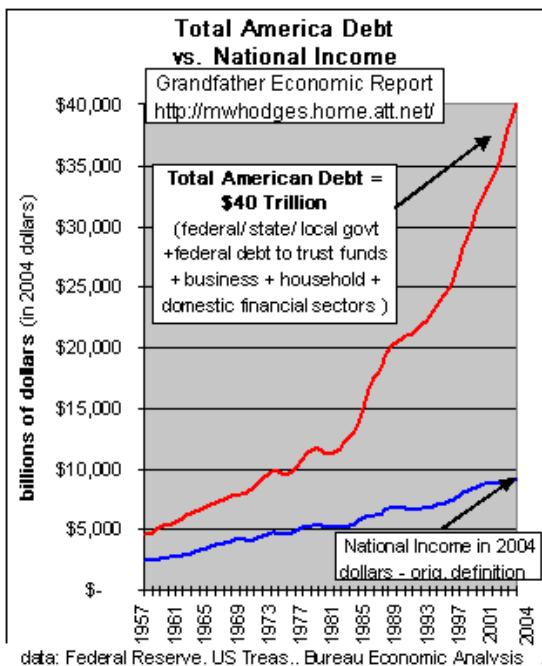
Most research services that we read, including those we like and trust, are counting on 2006 to be a year in which the "low inflation boom" continues. Even our favorite, Bank

Credit Analyst says, “Inflation will stay low everywhere. This is critical because it means that central banks will not need to become restrictive. The Fed will likely go on hold before rates reach 5 percent. Policy will stay accommodative in the other major economies, creating a bullish liquidity backdrop to financial markets.”

We believe the fed is literally playing a game, but a very crucial and intricate game. While acting modestly restrictive on interest rates, they are flooding the market with dollars. They are going to make sure that despite rising energy prices, and despite the huge personal and government debt loads, there is all the liquidity individuals and institutions need to keep buying all the goods and services they need and want.

The only problem with this policy is that we are not sure how this gaming by the Fed eventually corrects itself. We are not sure what the final chapter in this story will be. We think the Fed may be up to the same tricks that the Arthur Burns Fed pulled in the early 1970’s that led to the staggering inflation of the late 1970’s and early 1980’s.

This policy of rapidly increasing the supply of money to provide “all the liquidity individuals and institutions need to keep buying all the goods and services they need and want” is exactly what the Fed did in response to the oil price shock of 1973-74.



We obviously can't say definitively yet that this is the current Fed's policy, but that is what the situation looks like to us.

If you are a discerning reader you have to be asking why the fed would risk such a thing. The answer is simple. The U.S. is carrying a staggering debt load and can simply not afford a recession. The chart, at the left, depicts the growth of total American debt vs. the growth in national income through 2004. You can see the problem. We are essentially a debt financed society. The chart does not even include the unfunded entitlements for Social Security, Medicare, Medicaid, various state government and local government pensions, and unfunded private pensions.

**The U.S. simply does not have the economic flexibility to get through a mild recession. The next recession in this country is likely to be a hum dinger in which not only private entities will be declaring bankruptcy, but so might government entities. The Fed wants to avoid that scenario if at all possible.**

Therefore 'inflating' our way out of this dilemma is the more palatable choice. The irony is that this time the Fed has allies that the Burns Fed didn't have. Today the oil producing nations are loaded with cash and that cash needs to go somewhere. Much of it is being

recycled right back to the United States and is supplying our economy with much of the infusion of cash flow we need to keep the economy growing and to keep interest rates low. The same is true for China and India. They are selling us goods and essentially lending us back the money we need to keep buying from them. If only Arthur Burns had such friends; he would not have looked so bad in comparison to Paul Volker. And maybe Alan Greenspan would not be known as “the best Fed chief ever”.

On another note, U.S. consumers are increasingly broke, but they are not telling and they will just keep borrowing—until they can’t any more. That time is drawing much closer. However, the American consumer has proven much more resilient than we could ever have imagined. Debt loads are now staggering in many households. Rising real estate values have been the only thing keeping the American consumers balance sheets intact. If real estate does collapse we are in for a major recession. Real wages are simply not growing fast enough to fuel additional personal and family consumption.

Unfortunately, the U.S. government is also broke and so are all the state and local governments and they will be looking EVERYWHERE to solve their problems.

**The USA is in the same state today that it was during the “Roaring 1920’s” when Will Rogers said, “This country is not prosperous. It’s just got good credit. We live better and owe more money than anybody in the world.”**

So we go into 2006 believing that:

1) The four year stealth bull market in gold will finally go public. It had to break over \$500 to get the public’s and the media’s attention. Our minimum target for gold is \$720 and it could approach \$1000 per oz. before this cycle is over. That could take another 2 to 4 years. Gold is not going up as a predictor of ‘inflation’; it is going up as a defensive measure against a world flooded with paper money that is falling in value. (By the way, the British, Canadians, and Australians all have debt problems that are similar to ours.)

2) Oil and gas prices may bounce all over the map, but their inevitable path is upward. It would not surprise us to see another oil or gas shock in 2006 that will take prices back over \$70 per barrel for oil and \$18 per mcf for natural gas. The shock will most likely be political and not terrorist related. For example, there is a growing anti-American sentiment in countries like Venezuela, Bolivia and possibly even Mexico. If two or more of these countries decided to divert their oil sales from America to say, China, we could find ourselves in a supply crisis.

Even if they don’t, we are deeply suspicious that oil and gas supplies have reached their peak. Adding to supply in the face of increasing demand should prove more and more difficult for the major oil producers of the world. Shock or no shock we believe the long term pricing trend is upward. There may be plenty of oil and gas left in the ground but there are not enough infrastructures in place to deliver it to the right people at lower prices.

3) Commodity prices in general will remain high due to increasing global demand. Commodities and “hard assets” including precious metals, timber, water, oil and gas were a major investment theme at K&A in 2005 and will remain so into 2006. Currently as much as 30-35 percent of the positions in our model portfolios called Prudent Person Hedged Growth & Income and Prudent Person Growth & Income are allocated these to commodity related assets.

4) Water will enter the vernacular as the “next big thing” in investing. Globally there is simply not enough fresh water to go around. Companies that supply water and companies that supply technology to purify and deliver water should do extremely well over the next several years.

5) Corporate America is filthy rich and sitting on tons of cash they don’t know what to do with. If the U.S. economy is to stay healthy in 2006 it will be because corporations start spending some of that cash in productive ways that will make our economy grow, and in turn take up the slack created by a downturn in consumer spending. There is good reason to believe this actually might happen and therefore there is reason to be optimistic about U.S. economic growth rates at least through the first half of 2006. That could translate into modest gains in U.S. equity prices, at least during that period. We would be happy if the broad stock markets simply held their ground in 2006. We honestly can’t predict that they will go up. We think it could be another very long year for the U.S. stock markets. We favor large cap stocks in 2006 over mid-cap or small-cap. Industrials, energy, technology, health care and select consumer staples should lead the markets.

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We will approach the U.S. stock market the same way that we have for the past 5 years. We will own solid mutual funds that proved they outperformed even in the terrible bear market of 2000-2002; and we will buy individual stocks and ETF’s “opportunistically” when we believe they are likely to provide a positive rate of return in excess of a normal market return.

6) The Chinese are for real and so is their economy. Their torrid pace of growth may slow, but there will be no “hard landing” in China during 2006. We continue to believe that China is a place to invest for the long haul.

7) The Indians are for real and so is their economy. Their torrid pace of growth may slow, but there will be no “hard landing” in India during 2006. However, the Indian stock market has also been going up at a torrid pace and it may be ready for a breather.

8) Emerging markets will continue to emerge; particularly in Asia where all boats will continue to participate in the rising tide of emerging growth throughout the region.

9) Because of our uncertainty regarding interest rates we will be avoiding the purchases of most bonds for the time being. Shorter term municipal bonds may be the exception.

10) Our final, and maybe most important theme, is that we continue to be focused on the dramatic excesses and imbalances that threaten our national economy and that of the globe. But this is not new for us. We have been concerned for years and we have written extensively about our concerns. Wages are not going up fast enough. Debt loads are incredible. International trade balances are way out of whack, etc, etc.

We have also learned that just because these huge imbalances exist doesn't mean that they will have an immediate impact on the markets; or for that matter a negative impact. We have frankly been amazed that the financial markets have held together as well as they have in the face of these historically excessive imbalances in consumer debt, national debt, state and local government debt, negative trends in real wages in the U.S., high energy prices and dramatic global trade imbalances. The Fed has explained the resiliency of the economy, despite these structural problems, by the fact that foreigners continue to supply huge amounts of cheap capital to the U.S. Should that flow of capital be interrupted the economic music will surely stop.

The potential for these imbalances to unravel with very negative economic consequences keeps us nervous, watchful and alert; and ready to change course on a dime if the need arises.

However, as we enter 2006, despite all these imbalances we remain optimistic that we can generate positive real rates of return for our clients in their portfolios managed by K&A. It will be in consideration of all the themes previously mentioned in this report that we make investment decisions for 2006.

In summary we have more confidence in commodities and hard assets in 2006 than we do in paper assets such as stocks, bonds or even currencies. However we remain optimistic that stocks will outperform bonds in 2006. We suspect they will start the year weak, for technical reasons, if no other reason. And after "swooning" one more time, will start to track perceived economic growth rates and move upward. We would be happy if the major indexes finish 2006 no lower than they finished 2005.

We will manage money opportunistically and make profits where we can. We are not dogmatic. We are pragmatic and will accept opportunities for gains wherever we find them. We will be releasing Part II of this report in a few days. It elaborates on our techniques and provides more detailed insight to our money management style as well as providing more detailed support for our assumptions. We offer you our best regards and sincere best wishes for a prosperous 2006.

Paul Krsek  
For K&A Asset Management, LLC  
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