



Lighthouse Beacon

A Guide in the 21st Century

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Lighthouse Investment Commentary

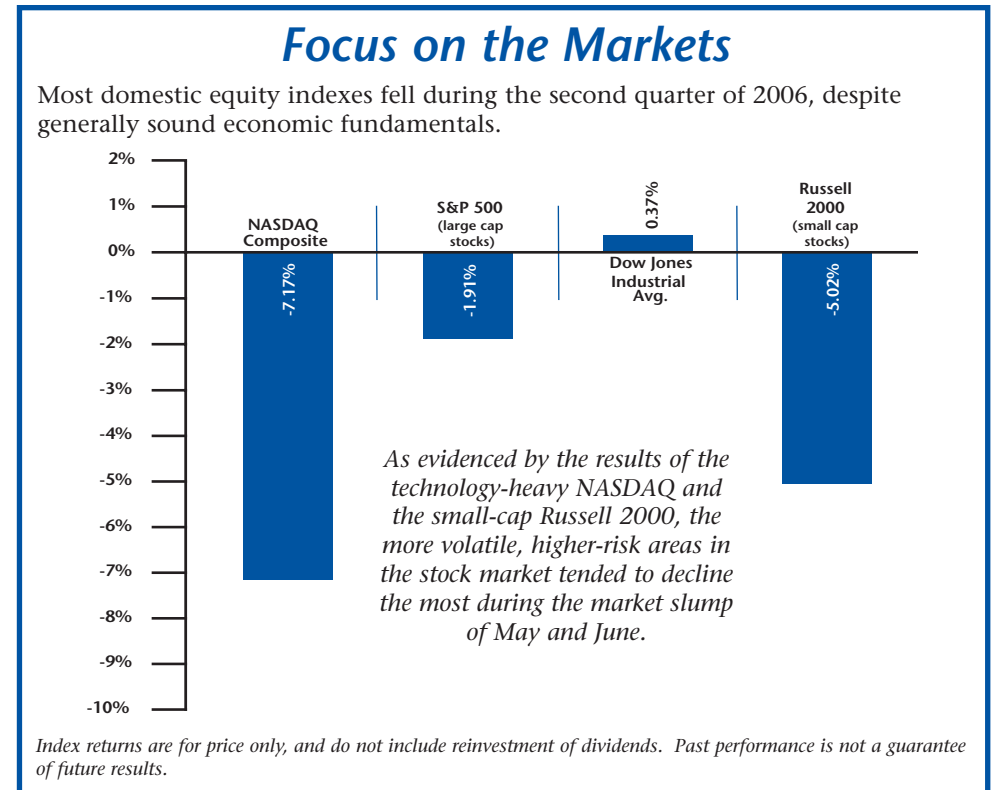
2nd Quarter Gave Investors a Roller Coaster Ride

After an encouraging start early in 2006, the world's stock markets abruptly shifted course in May and entered a correction phase that continued through June, eroding most of the gains recorded during the first four months.

From the peaks of early May, the stock markets declined by as much as 8-to-14% before suddenly reversing direction again and rising sharply on June 29.

A combination of factors led to the May-June decline, but it appeared that the major impetus for the slump was investor confusion over various comments by the new chairman of the Federal Reserve Board, Ben Bernanke. After taking office in February, Bernanke initially seemed to be reassuring investors that the Fed likely would soon take a pause in its cycle of interest-rate hikes. This gave investors optimism that the world's most influential central bank would not short-circuit the global economic recovery by raising short-term rates too far. However, in subsequent comments, he seemed to indicate he was becoming more concerned about inflationary pressures and that further rate increases might even be probable, depending on what message the Fed were to receive from subsequent economic data.

The apparent contradiction between Bernanke's early and later statements confused the markets, and fears grew that the Fed might act too aggressively to control growth and



inflation, running the risk of pulling the economy into recession.

While these fears were rising, a speculative bubble developed in commodity markets, especially in gold and copper, and international geopolitical tensions appeared to be worsening from Iran to North Korea --to say nothing of Iraq.

All these factors added to investor anxiety before June 29. On that day, the Fed, as universally expected, raised the key fed funds rate from 5.00% to 5.25%. However the nation's central bank also issued a

statement that once again hinted that it might soon take a pause in its rate-hike actions. The markets responded favorably to this news with a sharp rally that added about 2% to the major indexes in just one day. A relaxation in commodity prices and a new report indicating rising consumer confidence gave further encouragement to investors.

All this added up to a roller-coaster ride for investors in the second quarter. As we have pointed out before, while economic fundamentals determine the direction of the mar-

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kets over the long term, emotion can move stock prices in the short-term. This was never truer than in May and June, when there was nowhere to run and nowhere to hide. Emotion held sway over investor actions, overwhelming the still-encouraging news about economic growth and corporate profitability.

While stock markets were in decline, a great deal of good news still was coming out of the economy. A

series of economic reports provided fresh evidence that the economy was growing, assisted by steadily-increasing productivity, improvements in trade and budget deficits, and rising employment. All signs pointed to the high probability that U.S. corporations would register their 17th consecutive quarter of double-digit, year-over-year profit growth in the second quarter.

And yet, fear and emotion overshadowed all the good news—even

the reports that oil inventories were at an eight-year high. Investors who look at economic fundamentals could only scratch their heads as they saw the stock prices of sound companies, with excellent near- and long-term earnings prospects, decline by 10- to 20% for no apparent reason.

The biggest mistake an investor could make in such an environment is to overreact to the carnage and sell good stocks at exactly the wrong time—when the price has fallen for non-fundamental reasons.

At Lighthouse Asset Management, we believe that the pace of the economic expansion most likely will slow from the red-hot 5.3% annual growth rate seen in the year's initial quarter. However, we think any deceleration of the economy probably is good news, as it should moderate inflationary pressures in general, and commodity price increases in particular. It is becoming more evident that the economy is continuing to grow, but at a more moderate path. This would be an excellent backdrop for continued growth in corporate profitability, and corporate profits drive the direction of the stock market over the long run.

As we entered the second half of 2006, stocks in general were reasonably priced and offered good investment value.

While events such as we have seen in the last three months can be very frustrating, we should remember that there always will be short-term problems and challenges that will capture our attention as investors. The key to successful investing remains, however, in ignoring the short-term noise and remaining focused on your long-term goals.

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Q: Why have gasoline prices kept climbing when oil inventories are at eight-year highs?

A: Fear has kept pushing prices up.

Fear about geopolitical threats to energy supplies and fear that this year's hurricane season may damage our nation's production capacity once again.

Let's start with the geopolitical issues. Tensions over Iran, an oil-producing nation, and Iraq, which should be an oil-producing nation, have been escalating. At the same time civil unrest has threatened oil supplies from Nigeria, while leftist governments have threatened to cut off oil supplies from Venezuela and natural gas supplies from Bolivia. All these issues have contributed to a sense of insecurity in the energy markets and led energy traders to bid up the prices of commodities.

At the same time, the extensive damage to our production and refining capacity along the Gulf

Coast from last year's devastating hurricane season is fresh on everyone's minds.

While oil inventories indeed have been climbing, gasoline inventories have not kept pace, mainly because of the industry's conversion to greater use of ethanol as an additive.

Even with all these factors, there is a reasonable chance that retail gasoline prices may retreat somewhat from their recent highs. Unfortunately, we probably have entered a prolonged period of high energy costs. If any consolation can be taken, we can at least take comfort in the fact that the economy has thus far successfully absorbed the substantial increases in energy costs, thanks largely to productivity improvements and the effects of global economic competition to keep inflation in check.

Meanwhile, we can look forward to the day when energy traders will pay less attention to crises and more attention to supply and demand relationships.

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