

The Counter-Intuitive Rally Continues

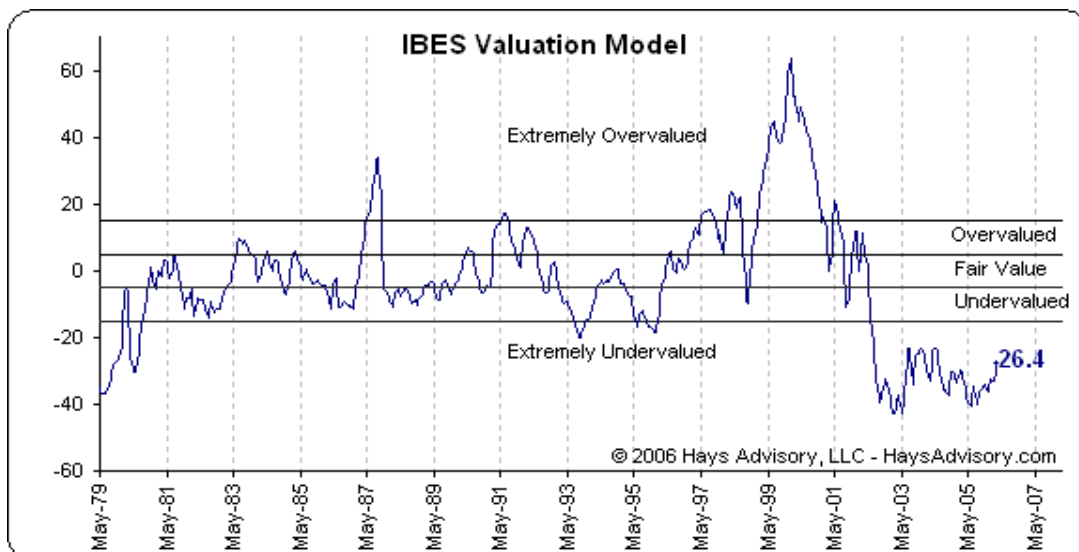
Summary: Despite rising commodity prices, plunging Presidential polls, high oil prices, potential nuclear threat in Iran, terrorist worries and the war in Iraq the U.S. stock market climbs the wall of worry at a steady pace which should be no surprise to us. It would appear that the staunch negative backdrop is causing investors to invest new money at a timid pace, which ironically prolongs the rally. So, steady upward we go and on track to meet our return estimates for 2006.

To reiterate our basic premise for 2006: The U.S. stock market senses that finally, the Federal Reserve will be halting raising rates soon, perhaps as soon as May 10th. With the end in sight for rate hikes, expect stocks to rally much the way they did in previous years (1984-85 and 1995) when the Fed finished raising rates.

Just as multiples for the market have compressed in the last few years, they will now expand. For example, in 2004 earnings growth was 23%, but the market only moved 10% higher. Now, I suspect if earnings growth is 11% (as estimated this quarter) we could see 16% or more in returns. In English, this means that investors going forward will now get paid in returns exponentially greater than the strength in the economy. This is just the inverse of the last few years when returns were paltry despite the rebounding economy.

The past three months has generated increased clarity on the interest rate issue: There is a chance the Fed will halt rising rates on the May 10th meeting. Consider Kansas City Fed President Hoenig's remark: "we are very close to where we need to be,"

Correspondingly, the European Central Bank and the Bank of Japan have embarked on a series of rate hikes. Iceland and the Arab stock markets have sold off dramatically, this selloff could spread to other emerging markets and those funds migrate to U.S. stocks. The potential migration into U.S. markets makes sense as our cycle of rising rates is near an end, whereas international markets are just embarking on their bearish rising interest rate cycle



Despite the move in the stock markets, U.S. stocks remain 26% undervalued relative to bonds. This 26% under-valuation means there is lots of room for great returns. When you take a look at the last page of your Portfolio Performance Summary you'll notice that the bond market is negative for the year. As I've stated since 2003, bonds were an accident waiting to happen while stocks were about to start a period of relative out-performance.

Years ago I received some very sage advice: "Never trust a rally where Nasdaq/Technology doesn't lead." That remains true to this day and you'll notice your portfolios have significant Tech holdings. My belief has been that where Energy and Alternative Energy stocks led in 2005, Technology will lead in 2006. For the time being, I believe the trade in Alternative Energy is largely over. However, these are not ordinary times and I don't think terrorist attacks on energy supplies or refineries will end anytime soon. If any oil producing countries go offline with production, \$100 oil could be a reality. Since Alternative Energy is dependent upon high fossil fuel prices to justify their use, any further spike higher in oil has a positive effect on shares of Alternative Energy stocks. Please see our RHHI Holdings list accompanying this letter for more details.

In the meantime, discouraging headlines are masking a very strong market, driven by strong economics and the anticipated end to the rate hike cycle. Time to be steady and let markets run their upward course.

Warmest Regards,
Brad Pappas

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