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RESEARCH NOTES

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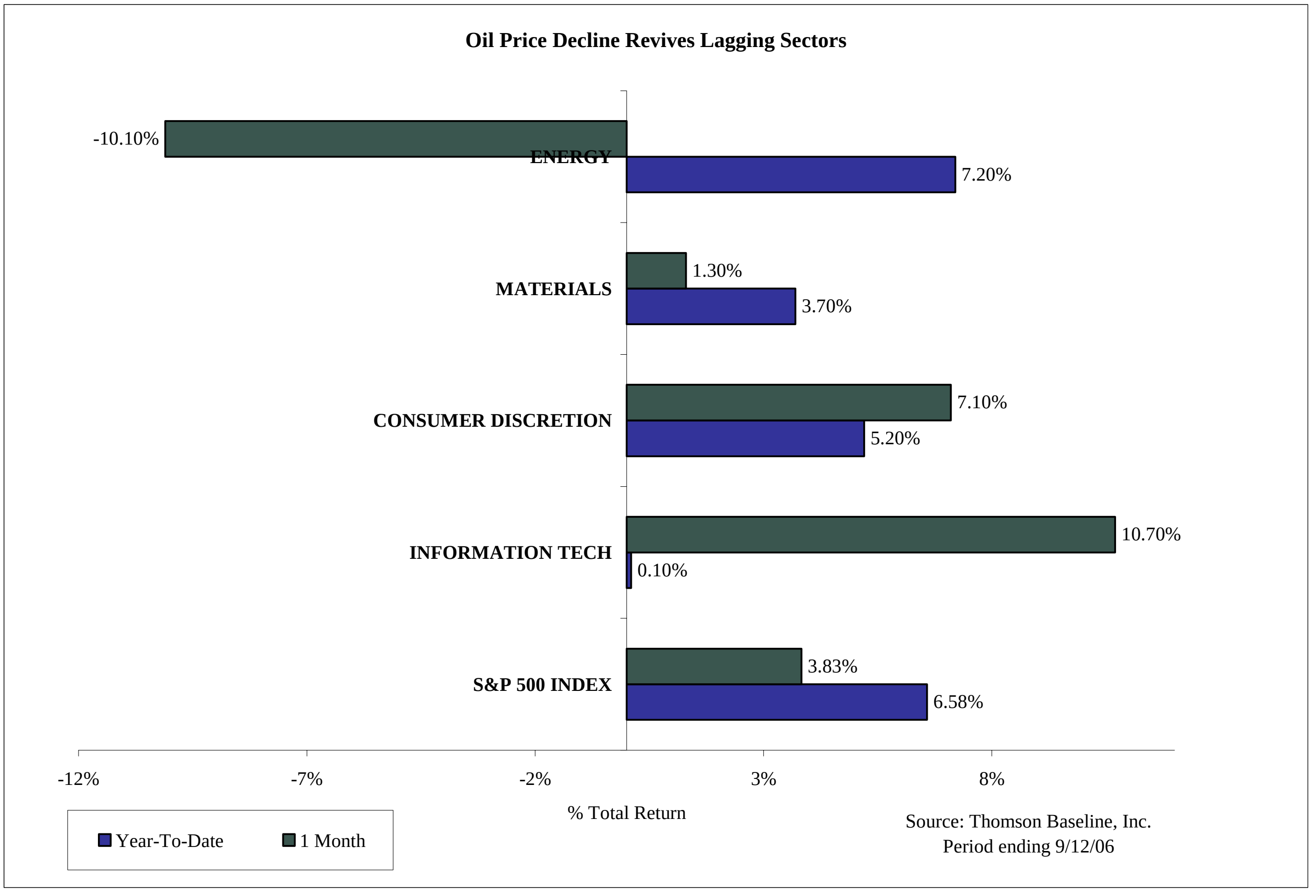
Since early August, the price of crude oil has declined by more than 12%. Although $64 oil and $2.60 gasoline would have been viewed as disastrous for the economy just a year ago, the decline has provided instant relief for the market in general, and consumer-related stocks in particular.

For the past year or so, predictions of $100 oil had become commonplace, and the theory of "peak production" was gaining wide acceptance. Further, the global economic boom had put significant pressure on commodity prices, fueling inflation fears and broad gains in natural resource stocks. Conversely, as the housing market and economy showed signs of cooling, it appeared certain that the double whammy of declining home equity liquidity and rising oil prices would force the U.S. consumer to reduce spending. Consumer discretionary and technology stocks (increasingly tied to consumer spending) plummeted. Predictably, speculative forces and a herd mentality drove valuations to extremes at both ends, paving the way for disappointment – and opportunity.

The problem with the $100 oil view was that it failed to consider what might happen if the demand side of the equation were to soften. High gasoline prices will cause consumers to drive less and buy more fuel efficient cars, and a slowing economy will reduce demand in general. As a result, inventories of crude oil and refined products have steadily increased, helping to bring prices down. Further, an easing of some global concerns (perhaps temporary) has reduced the "speculation premium" that had recently become such a significant component of the price of oil. So, supplies are steady, demand is reduced, and the price comes down.

This shift has had a swift and visible change in the sentiment driving the markets. As the accompanying graph shows, energy stocks have experienced considerable declines, while the lagging sectors have suddenly come to life. In particular, consumer discretionary and technology shares have enjoyed the largest rebounds. This reversal of fortunes is partly due to the rapid shift in sentiment about energy, but also attributable to the fact that many high quality companies in the consumer and technology sectors had become so out of favor that their valuations were too compelling to be overlooked. They remain very attractive, and momentum could continue to build.



"Sector rotation" is often evident at certain points in market cycles, but the timing and magnitude of these shifts are completely unpredictable. Even if one could predict them consistently, the implications for portfolio turnover are simply unacceptable for most investors, especially taxable accounts. Thus, our approach has always been to maintain a diversified approach to sector allocation. While it would have been nice to be over-weighted in the energy and basic materials stocks on the way up, we are pleased to have a market weighting in technology and consumer discretionary sectors today. In the long run, valuations – which are at the center of our work - will have the largest influence on returns.

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