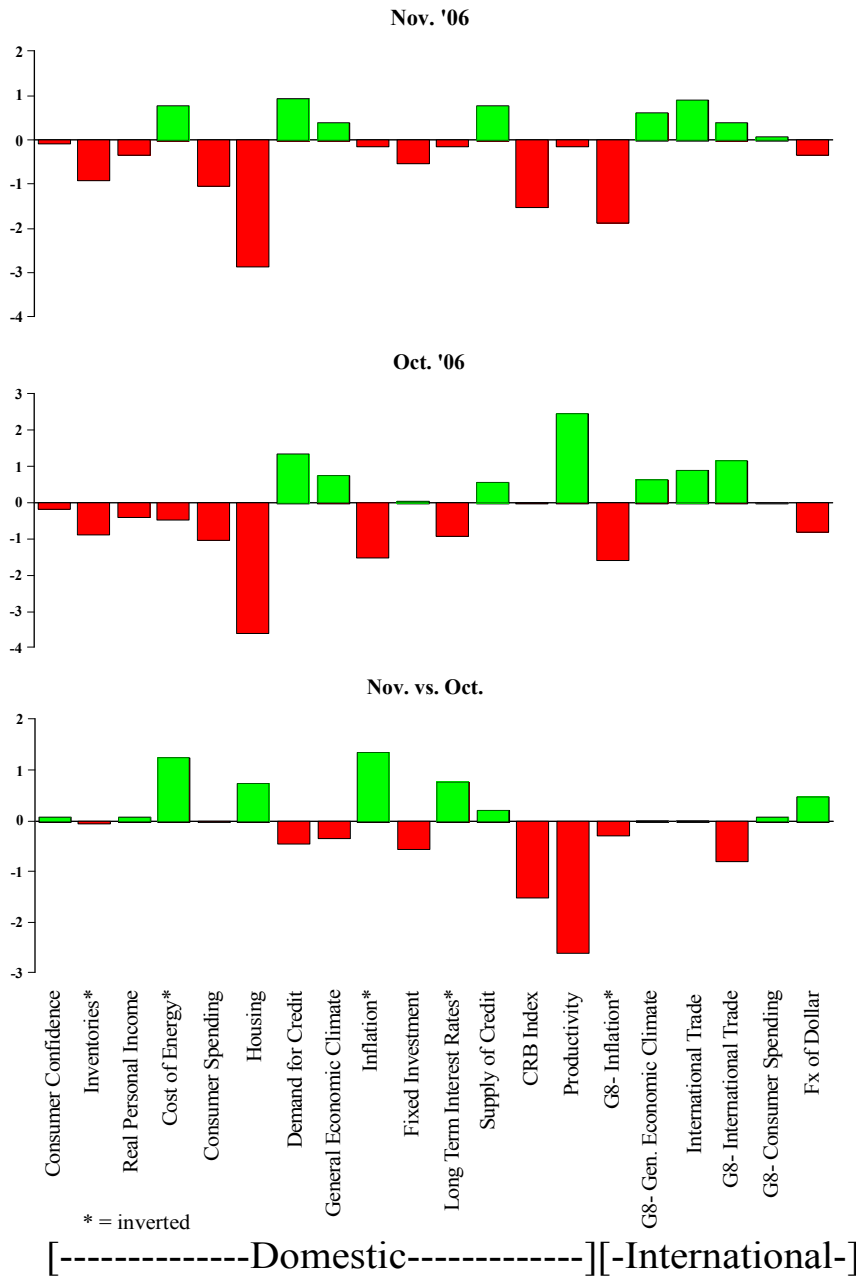


Signs of Weakening Emerge

November 20, 2006

The following charts show fact based trends in ASC Economic factors as of November 2006 as compared to October 2006 and changes expressed in standard deviations around the norm, hereinafter referred to as “units.”



ASC Factor indicators of future activity show that the economy weakened last month. Following are significant changes in trends last month expressed in standard deviations around the average rate of change or "units." Cost of Energy fell by 1.23 units. Consumption was unchanged, staying weak at 1.03 units below normal. Housing had what might be considered a dead cat bounce increasing by .73 units. Inflation fell by 1.35 units. Fixed Investment fell by .54 units. Long Rates fell by .77 units. The CRB Index fell by 1.49 units. US exports fell by 2.59 units. G8 Exports fell by .78 units. The summation index is currently at 95.2 as compared to 96.7 in October 2006. Even though the summation index was fairly stable, it is safe to conclude that the US economy weakened last month because there was significant weakness in areas representing real economic activity such as fixed investment, exports, CRB Index and consumption that were offset by favorable showings in "soft" macroeconomic factors such as Inflation and Long Rates.

Many economic services have dismissed the weakness in retail sales as being caused by lower gasoline prices, in that, were it not for declines in sales at gas stations because of lower prices, overall retail sales would not have been so weak. Since the ASC model is fact based, it does not make excuses for the data; whatever is reported is used. In some respects, making allowances for the role of lower gasoline prices on reported results may be self-deceiving because of other adjustments that may be taking place because of the effects deflation has on consumption. When prices are rising, consumers tend to buy more than they would normally need, to avoid paying higher prices subsequently. When prices are falling, such has been the case recently, consumers may defer buying, hoping prices

will decline more and allow them to buy later at lower prices. With Wal-Mart already cutting prices for Christmas merchandise, we may see extensive discounting for the remainder of 2006. The question is will it stimulate activity or will consumers wait until the last minute to take advantage of lower prices.

Economists that have been warning of an overextended consumer who was about to fold his tent have been wrong for a long time. In fact, the American consumer has been overextended to a certain degree since the middle 90's. Normally, recessions bring about a period in which consumers are able to cut back and replenish their liquidity. Since the recession of 2000-2001, which was an investment led downturn in which the consumer continued to spend, the typical reliquification did not take place. In this cycle, the consumer upped the ante by using his home ownership equity as a source of financing. A correction by the consumer is long overdue. This onset of deflation may be the trigger that sets it off, if the experience in Japan is any guide.

Although lagging indicators such as employment are still showing continued strength in the economy, leading indicators such as consumption, housing, high inventories and real income are pointing toward weakness. It does not appear that there is enough strength in fixed investment or progress on trade to offset weak consumption.

If the economic weakness that the ASC model is discerning sets in, one has to be prepared for a "Bad News is Good News" interpretation. Bad news may be deemed good news for equities as it may usher in rare cuts and an eventual strengthening of the economy without disrupting corporate earnings. However, if the Fed is slow to respond to economic weakness, the econ-

omy could get away from the Fed and weakness might not be preventable. In recent history this has not been the case, but one should always be on the alert for the possibility. It appears that Fed Chairman Ben Bernanke has a bias toward being more fearful of deflation than inflation, so the odds are favorable that the Fed could act in a timely basis.

ASC's recession proxy, the foods group, rose sharply from 34th to 14th. Commodity groups such as metals and energy fell sharply from 25th and 6th to 35th and 43rd respectively. Electronics slipped from 13th to 34th. The ASC model is suggesting that the US economy is on the verge of a significant slowdown.

Investment Strategy

Equities:

Assuming bad news is bad news, the industries that are well positioned are health care and consumer staples. Over weights in S&P groups are advised in Health Care and Consumer Staples. Market weights are advised in Consumer Discretionary, Industrials, Financials, and Basics. Underweighted are Information Technology, Energy and Utilities. Of course in the interim, if bad news is good news, one should hang on to information technology and industrials for a while. If we were ask to make the call, it appears that perverse psychology is likely in the near term, but is likely to give way to reality in early 2007 unless the Fed starts signaling an easier policy.

Fixed Income:

Based on current macroeconomic trends, our view on long bonds is more positive. Over the intermediate term, the yield on the long bond should be fairly sta-

ble. Regarding the issue of duration, on a scale of 1 to 10, with 10 representing a maximum position in shorter term debt and 1 representing a maximum position in Long Treasuries, we would rate the current environment as a 5, down from 8 last month.

Hedge Funds:

We are long Health Care and Consumer Staples. The spread of emerging market debt over Treasuries appears to be getting too wide. With greater economic uncertainty brought about by a slowing US economy, one should get serious about reducing exposure to emerging market debt.

As for Global macro bets, we would pull back on Asia ex-Japan and ex-Korea.

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Analytic Systems Corp. 740 Broad Cove Rd. Hopkinton, NH 03229 603/746-6443

