



# DAVID R. KERN

**ASSET MANAGEMENT**  
*Dynamic Asset Allocation Strategies*

[www.davidrkern.com](http://www.davidrkern.com)

## 2<sup>nd</sup> Quarter 2006 Newsletter

### The Investment Environment

The stock and bond market activity of the first half of the year was an illustration of the degree to which it is increasingly a one-world economy. Markets around the world were up in the early months of the year, in spite of increasing interest rates and inflationary trends, and peaked in early May. Subsequently they gave back all of their earlier gains in the subsequent decline, to reach a low for the year in mid-June.

So what caused the big sell-off when things were going so well? After all, the economy was strong, corporate earnings were growing in double digits, and the Fed was close to calling a halt to its interest rate hikes. The stock and bond markets look ahead to what is expected six months to a year in advance. This is referred to as discounting the future. The seasonal strong period when new money comes into retirement plans ended in the spring, and a decline or correction in the market occurred with more sellers than buyers.

### The Outlook for Investment Returns

Early in the year many of the stock markets, as well as the bond markets around the world showed good gains, but those gains were given back from mid-April through mid-June. Our management models are designed to avoid downside volatility, so investors did not take the roller coaster ride for the first half of the year in our managed programs, compared to the market itself.

Investors with a buy and hold portfolio often are under the illusion that gains made during certain periods will be kept and compounded, however, inevitable market corrections in all market-based asset classes have downside as well as upside exposure.

Once the Federal Reserve has a clearer picture that inflation is under control, and assuming modest damage to the economy from higher interest rates, the markets have a good chance of recovery. This is most likely to happen late in the year based on seasonal factors and profit cycles. In the meantime, investors in

our programs are in the safety of money market funds, or positioned with a small percentage in asset classes that have potential for short-term gains. Interestingly enough, government bonds may be an asset class to provide gains, especially if the Federal Reserve quits raising interest rates. Many investors already are anticipating a declining of rates if the economy shows continued signs of slowing. As rates decline, it can drive bond prices higher and cause us to increase our exposure to this asset class.

### Sector Watch - Technology

Most areas of technology have done poorly relative to the broader market this year. A wide range of technology stocks began the year moving up, but have been declining to post negative returns for the year. Most of these sectors including internet, semi-conductors, information technology and biotechnology have declined more than the general market as measured by the Standard & Poor 500 Index (S & P 500). Investment analysts anticipated that corporations would start another cycle of spending on improved technology, but investors have been disappointed with the degree this has happened. Big corporations are holding onto their cash and are focusing more on acquisitions of smaller companies as opposed to adopting new technologies.

In most multi-year cycles over the last 20 years, technology has provided leadership for the market at the beginning of new bull markets. The fact that broad technology categories are leading the market down is one of the many reasons to be concerned about the health of the overall market. If past cycles are any indication, these sectors may lead the market in the next up cycle, and provide better returns than the general market in the early stages of a new bull market.

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**David R. Kern, Registered Principal**

## **Sector Watch - Energy**

Energy stocks continue to be driven by supply issues along with the broad stock market direction. Daily news focused on political developments around the world have a strong short term impact on oil prices, but the energy companies stock sector corrected with the decline in the broad market from early May through mid June. A British publication, The Economist, reports that British Petroleum estimates that the proven amount of existing oil reserves in the world (1.2 trillion barrels) from 12/31/05 would last 25 more years if today's daily usage of 84 million barrels increases by +3% per year.

(source: BP, The Economist)

## **Corporate Taxes**

U.S. corporations pay a marginal tax rate of 35% on their highest level of taxable income and 39.3% when an estimate of state tax paid is added in. The 39.3% rate is higher than the marginal corporate income tax rate levied in any of the 12 nations that make up the Eurozone (i.e., countries that use the euro as their common currency) with Ireland having the lowest marginal tax rate within the group. Its top marginal rate for businesses is only 12.5% (source: OECD)

## **Big Business**

The U.S. economy grew by 5.6% in the 1<sup>st</sup> quarter 2006 (annualized growth rate), pushing the size of our economy to more than \$13 trillion. Only one other economy in the world (Japan) is greater than \$5 trillion in size. (source: Department of Commerce)

Please contact David R. Kern Asset Management if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account. Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.