A.R.Schmeidler & Co., Inc.

The Outlook

January 3, 2006

As of December 30, 2005		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	-0.6%	10,717.50
S&P 500	+3.0%	1,248.29
Nasdaq Composite	+1.4%	2,205.32

When 2005 began, the expectation of many strategists and investors was that it was going to be another good year in spite of the large structural imbalances that exist in our economic system. However **the increase in energy and raw material costs as well as the continuing quarter point interest rate increases by the Federal Reserve were a significant element in the disappointing returns for the year**. Not only has 2005 been more difficult than many expected, but if one goes back to January 2000, it should be noted that **the Dow Jones Industrial Average is down 1.4%, and the S&P 500 is down 10% over the five year period**. Without doubt, many companies in 2000 were overvalued. And this included great ones as well as not so great ones. The fact is that the more a business earns, the more it will be worth. But it should not be forgotten that to generate positive returns, investors must be careful not to overpay for securities.

While many of our clients' equity returns have far outpaced the major averages, the successes were not based on any market predictions; quite the contrary, we make it a point of avoiding predicting the stock market, but instead focus on the positive dynamics driving the U.S. and global economy and the companies that benefit from these forces.

Interest Rates and Federal Reserve Policy

As of this writing, the Federal Reserve is set to raise interest rates another quarter of a point in January, at which time U.S. monetary policy will not be nearly as accommodative as it had been. The yield curve has now inverted which means that short-term interest rates are higher than long-term interest rates. To many economists the significance of this is that an economic slowdown or recession will follow. This is based on past business cycle experience. However at this juncture we have a different view.

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The United States is running large fiscal and trade deficits. The liquidity being created by these deficits is flowing overseas and being used to create low-cost production. In addition, the excess dollars being created are flowing back to the United States in the form of foreign purchases of US Treasuries and fostering a lower long-term interest rate environment in combination with lower inflation brought about by excess productive capacity, particularly out of Asia. As long as our deficits continue to be successfully financed by foreigners, the U.S. economy should continue to expand. **Consequently, the fact that short-term rates are higher than long-term rates should not be interpreted as necessarily forecasting a recession**. Furthermore should Congress enact pension reform in 2006, this will tend to put further downward pressure on long-term interest rates as pension funds purchase more long-term fixed income securities.

The Coal Industry's Favorable Prospects

Among the sectors that we favor, domestic coal is notable as use will continue to rise as electricity demand and the cost of competing fuels remains high. **The U.S. uses coal to generate more than 50% of all electric power; the cost per megawatt hour is about $20.00 compared to more than $55.00 for oil and gas. As more generating capacity comes online and more environmentally friendly technology is used, we expect demand for both low sulfur and high sulfur coal to increase.** The continuing growth of the U.S. economy has also resulted in our overall electric power generation needs increasing about 4% in 2005. The primary fuel used to generate our increasing electric power needs is likely to continue to be coal. With low coal inventories at major utility plants, 2006 should be another strong year for the coal industry. A variety of coal grades have had price increases of 100%, particularly benefiting the Powder River Basin low sulfur coal region in Wyoming.

U.S. Electric Power Generation Continues To Grow

The utility companies have announced their intention to build more than 100 new coal-fired power plants over the next 10-15 years. The obsolete coal-fired power plants built in the 50’s and 60’s need to be replaced. **The energy bill Congress recently passed contains tax incentives and subsidies to produce electricity using the new clean coal burning technologies.** Integrated Gasification Combined Cycle (IGCC) technology produces far fewer pollutants than conventional plants and can capture carbon dioxide gas before it enters the atmosphere. Moreover the existing IGCC plants can easily be adapted to capture carbon dioxide. Florida’s new Tampa electric power facility produces a fraction of the sulfur dioxide, nitrogen oxides, particulates and other pollutants compared to older facilities. As far as carbon dioxide removal is concerned, it could be piped and sent deep below the earth’s surface for storage.

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This is a proven carbon dioxide storage process called carbon capture sequestration. Cinergy and American Electric Power, both large users of coal, have announced plans to build modern IGCC power plants. Businesses that supply utility companies with equipment have been putting pressure on the industry to build IGCC plants. As a final point, coal gasification technology is now coming into its own. Coal gasification breaks coal down into its chemical constituents. Coal gasification creates a synthetic gas that yields valuable byproducts- ammonia for fertilizers, chemicals for resin for wood products, and carbon dioxide itself, which can be used to enhance oil field recovery.

Energy Industry Consolidation Is Likely To Continue

The recently announced purchase of Burlington Resources by Conoco-Phillips is a reminder that the energy industry consolidation we have discussed in past Outlooks is continuing, and we expect 2006 to witness more of the same. Around the world, governments are changing the terms of their profit-sharing agreements with the oil industry, shifting profitability from the industry to various respective governments. In addition, the UK's Chancellor of the Exchequer (Finance Minister), Gordon Brown, announced a tax increase for oil companies that is likely to discourage North Sea investment. The British did this back in 1980 and the results were to discourage investment. Now that North Sea oil production is in decline, it is particularly poor policy to discourage investment and production. One consequence of this policy is to encourage further industry consolidation as **companies find it more economic to acquire reserves by buying companies than by exploring for reserves with reduced profitability in hostile areas**. Of the various investment opportunities in the energy sector, in order of preference we favor coal, natural gas, and oil.

Dividend Payouts Are On The Rise

The recent rise in dividend payouts by companies marks a significant transformation in the way companies allocate their cash flow. Overall, in the first nine months of this year, S&P500 companies paid out $147 billion in dividends and spent $231 billion on share repurchases. Companies are sharing more of their profits and free cash flow with investors instead of plowing most of the available cash back into their businesses. If the trend persists, this would mark a return to the historic norm when investors relied on dividends to make up a significant portion of their total equity return. Dividends have been on the rise since the U.S. Congress succeeded in passing legislation that cut the tax rate on dividend income to 15% in 2003 as opposed to taxing dividends as ordinary income. **Even after a recent rebound in dividend payments, the average S&P500 stock has a dividend yield of just 1.8%, which is about half the historical average rate.** Currently, U.S. companies are holding near-record levels of cash. Companies are starting to bring their dividend payouts to

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shareholders closer to historical norms because of the pressure for more shareholder friendly corporate governance in the wake of persistent faulty business practices, bad acquisitions, and accounting scandals. For years share repurchases had been preferred over dividends because they were viewed as more tax efficient. That argument has now been weakened somewhat by the 2003 dividend tax rate cut. **We expect dividend payouts and share repurchases for S&P500 companies to top $500 billion for the full year, and we continue to favor investments in companies that pay sizeable and growing dividends.**

Conclusion

For 2006 we do not expect any relief from the structural imbalances existing in our economic system; the U.S. trade and fiscal deficits will continue to be a feature of the U.S. economy. Moreover the U.S. economy should decelerate as a result of both a slowdown in the housing market and reduction in consumer home loan equity extraction that has bolstered consumer spending. **We also expect inflation to remain low as the transfer of production from high-cost nations to low-cost nations continues.**

As a consequence of Asian central banks' ongoing purchases of U.S. treasuries, the global monetary environment should remain accommodative with excess liquidity continuing to build through our deficits resulting in relatively low long-term U.S. interest rates. The global economy should continue to grow as Asian economies expand. A growing Asia will also put upward pressure on commodity prices reflecting greater demand than supply. Moreover should the dollar weaken, exporting nations will be under pressure to devalue their currencies to remain competitive thereby further increasing global liquidity and tending to raise the prices of tangible assets.

While many consumer balance sheets remain stressed, corporate balance sheets are very strong, and we should expect continued dividend increases by companies generating significant earnings and earnings growth. Moreover in making our investment decisions, we put a higher premium on companies that are willing to share their good fortune with their shareholders. **As discussed in our September 2005 Outlook, we believe that particularly good values can be found in the oil, natural gas, coal, railroad, insurance, defense, precious metals, machinery, and the industrial company sectors. As 2006 begins, we expect these sectors to continue to be among the most notable areas for investment in the coming year.**

We wish our readers a Happy, Healthy and Prosperous New Year!

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