DISCIPLINED GROWTH INVESTORS
The Way Wealth Is Built

ECONOMIC & MARKET *Update*

A NORMAL MONETARY TIGHTENING PROCESS

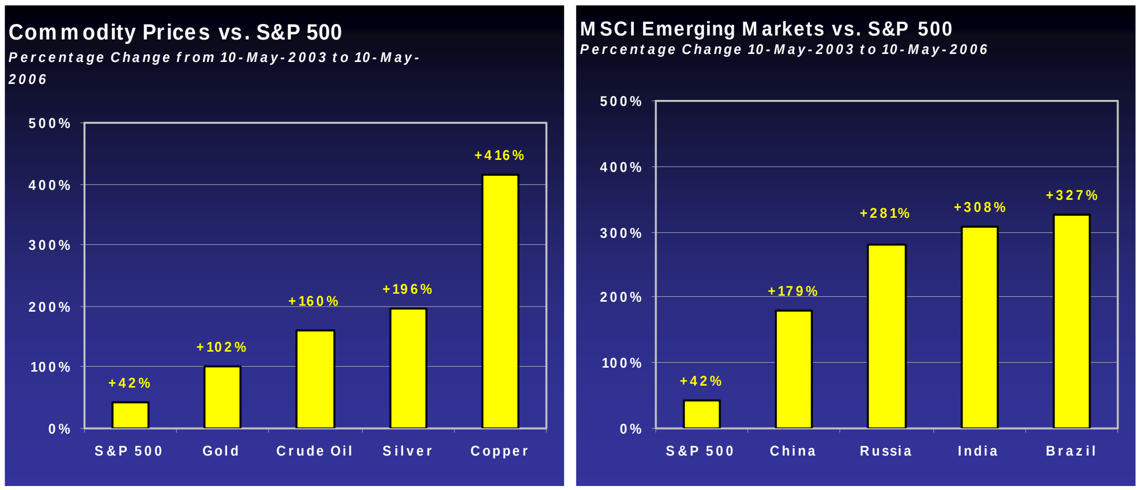
JULY 2006

During the past two years the Federal Reserve Board (FRB) has raised interest rates 17 times; the first 15 increases have had little effect on equity markets and commodities prices. The Federal Reserve Board raised short-term interest rates for the 16th time on May 10th to 5%, and again on June 29th to 5.25%.

There is a regular pattern to the FRB easing and tightening process. During the easing phase market excesses begin to build and inflation threatens to increase. During the tightening phase the FRB seeks to temper the speculative excesses and reduce the threat of inflation. Almost all markets involving risk capital eventually decline while the FRB is tightening. Those markets in which speculative excesses have developed often suffer severely. The late stages of FRB tightening can be chaotic.

The speculative excesses in this market cycle have occurred in commodities and in emerging markets. Chart A shows the appreciation enjoyed by some commodities and emerging stock markets for the trailing three years ended May 10th. It is clear that the U.S. stock market did not participate in the spectacular appreciation posted by commodities and emerging markets.

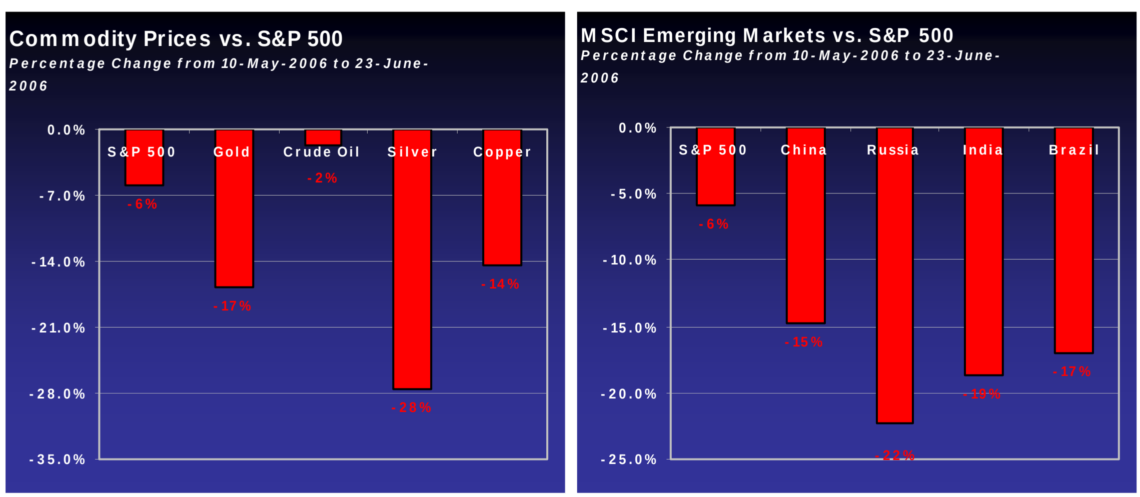
Chart A



Source: FactSet

The reaction of these extended markets since the May 10th Fed tightening has been sharp. Chart B shows the declines in the same markets during the last 1-1/2 months following the May 10th FRB tightening. The U.S. stock market has not experienced the magnitude of declines seen in other markets.

Chart B



Source: FactSet

Crude oil is a major commodity which has reacted only modestly in price to the May 10th tightening. The seeming lack of price response in the oil markets is likely based on two factors: 1) there is a significant Mideast-related risk premium in oil prices and 2) U.S. energy policy has been a political football for decades. Most knowledgeable observers of the oil markets agree that there is a risk premium in the current price of oil; the estimated premium is from $3-20 per barrel. After the terrorist attack of 9/11/01 President Bush changed U.S policy towards the Mideast by embracing the development of democratic governments in that region. This major policy change and the controversial War in Iraq have increased the risks to sustained oil production from countries such as Saudi Arabia. Despite the negative headlines about the Iraq War, it is becoming increasingly clear that the U.S. and the government of Iraq are making significant progress. The establishment of a full Iraqi government and the termination of the leading terrorist Zarqawi represent major victories. In addition, the U.S. and its European allies are beginning to jointly exert pressure on Iran. While it does not necessarily follow that progress in Iraq and negotiations with Iran will reduce the risk premium in oil prices, we believe it is reasonable to begin to imagine that the risk premium will decline. Unfortunately, we have little hope that a reasonable U.S energy policy will emerge anytime soon.

Even with the sharp market reaction after the May 10th Fed rate increase, it is not clear whether the FRB will suspend additional restrictive actions. We believe oil prices remain a major concern of the FRB because of the importance of energy to overall raw material costs. We expect the FRB will lean towards a restrictive policy until it is clear that commodity inflation has subsided.

If the FRB continues to tighten, we would expect the markets to remain unsettled. The sustained damage should occur in those markets where prior speculative activity has been most pronounced. Continued FRB tightening will foster an environment where one or more major financial players might get caught holding a plunging asset and fail. The likely market where this would occur is the oil market. Typically these types of crises are short-term events which clear the way for the FRB to shift to a policy of ease.

It is highly likely that the FRB will "win" the battle against commodity prices. The simplest way to view this is to understand that commodities such as gold produce no income. Short-term interest rates represent the cost of carrying, or holding these assets. Increasing interest rates inevitably force holders of assets like gold to succumb to the cost of carry. There is a silver lining in today's markets. In 1981 the FRB had to increase interest rates to over 20% to kill commodity inflation; today it appears the cost of carry is beginning to bite at the 5% level. The reaction of commodities prices over the last month makes it more likely that the FRB will subdue commodity inflation before causing a recession.

The willingness of the FRB to maintain a tight monetary policy in order to dampen commodity prices is a major long-term positive for capital markets, since inflation has a pronounced corrosive effect on economic activity and capital markets.

Once the FRB changes its monetary stance to neutral or ease, we expect the bull market in U.S. stocks to resume. The U.S. should experience an extended period of economic growth after the FRB changes its policy. The well-established trend towards globalization is spurring major productivity gains in the U.S and elsewhere; productivity gains are providing the basis for stable unit labor costs and rising corporate profits. Interest rates should pose little competition for stocks. Our valuation work continues to substantiate that our holdings should achieve excellent forward returns in the environment likely to unfold over the next several years.

To receive a complete list and description of Disciplined Growth Investors, Inc.'s composites and/or a presentation that adheres to the AIMR-PPS Standards, contact Robert Buss at:

DISCIPLINED GROWTH INVESTORS, INC.

Phone: 612.317.4100
Fax: 612.904.2546
E-mail: robertb@dginv.com

Address:
100 South Fifth Street, Suite 2100
Minneapolis, MN 55402