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Mid-Cycle Blues

April 27, 2005

The Blues

The economy and financial markets have the mid-cycle transition blues where everyone feels that economic and earnings growth will probably slow down but are hopeful for a "soft" landing instead of a severe recession. The last recession ended in November 2001. This economic upturn has lasted for over three years and is at an advanced age as economic cycles go.[1] The economic drivers of the last three years, rapid profit growth, low interest rates, low inflation and business and investor confidence, are showing signs of reversing. The Federal Reserve continues its campaign of increasing interest rates to defend against inflationary pressures.[2] While the Fed undoubtedly hopes for a soft landing, it probably knows that economic growth will have to slow enough to ensure that the inflation threat does not intensify. The Fed likely views the run-up in equity, corporate bond and housing prices that occurred in recent years as excessive, and they will not change course unless a significant financial accident occurs or sizable capital losses accrue. In any case, until the Fed stops raising interest rates, particularly in the face of an emerging slowdown, the environment remains troubling for financial assets and we continue to advise caution at this time.

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Current Economy

United States Economy

The U.S. economy is slowing as the inflation rate is increasing. Gross Domestic Product (GDP) grew at 4.4% in 2004.[3] We expect growth to slow to between 3.0% and 3.5% in 2005. Preliminary estimates of GDP for first quarter 2005 logged in at 3.1%.[4] In late April, the Labor Department reported that the Consumer Price Index (CPI) rose 0.6% in March, the biggest jump in several months. Core CPI (which excludes volatile food and energy prices) rose 0.4% (a 4.8% annualized rate), the largest increase in more than two years, a significant jump in an important indicator.[5] These numbers help reinforce the view that the Federal Reserve will continue hiking interest rates until inflation stabilizes.

World Economy - EU Focus

The latest World Bank report suggests that global economic growth is also declining. In 2005 the global growth rate is expected to be 3.1% down from 3.8% in 2005. Rising interest rates, high oil prices, U.S dollar weakness and rising trade imbalances are among the factors sited for the erosion in global economic growth.[6] The Euro Area is expected to show growth of only 1.6% in 2005 and it could be worse if the French vote NO on the EU constitution in May. A NO vote may weaken economic co-operation in Europe and force euro-zone interest rates even higher. Lorenzo Bini Smaghi, a European Central Bank Board Member, warned that if France, a founding EU member, turned its back on this vital treaty, the process of European integration that spurred the euro could be thrown into reverse and visibly shake the region's chances for growth in 2005.[7]

Investment Outlook - United States Equities

2005 has not been kind to investors. U.S. equities are down 6% to 14% for the year depending on the index cited. In 2003, 92% of all stocks were up. Last year, 76% were winners. So far in 2005, only 38% are in the black. This April alone, more than 60 stocks in the S&P 500 suffered losses of at least 10%.[8] Absent energy, basic materials and utilities, few industry sectors attracted much buying interest.

While an intermediate rally lasting two or three months could happen at any time, we think it will be muted in nature with limited upside potential. According to the March 22 meeting of the Federal Open Market Committee, the Fed is worried about U.S. inflation rising. They expressed concern that inflation pressures were mounting and wondered whether they would need to raise rates more than they originally thought in order to control it.[9] Economist Ed Hyman's ISI Group cautioned clients recently that, in prior cycles, the Fed has tightened until something "breaks". Whether it is the California municipal bond scandal in Orange County in 1994 or the near collapse of Long-Term Capital Management's hedge fund in 1998, these types of crises in the past have deeply shaken the market.[10] Until the Fed stops raising interest rates, the environment will be tough for equity investors. In addition, earnings gains are decelerating rapidly. Profits rose over 20% in 2004. While earnings for the S&P 500 could increase more than 10% in the first quarter versus a year earlier, if you exclude energy, the growth rate drops to 5.2%.[11] Without strong earnings growth it will be difficult for stocks to achieve meaningful price appreciation.

Asset Allocation

U.S. Stock and Bonds

Our overall asset allocation favors cash and short-term bonds. We continue to underweight equities. We may commit some funds if we think that an intermediate rally is tradeable but would still remain at or below benchmark weightings. For purchases we would emphasize the pharmaceuticals, biotech, semiconductors and industrials. For fixed-income we are sticking to treasuries, corporate bonds or bond funds with maturities less than five years.

International

We scaled back our international exposure to around our benchmark for this area. Even though we prefer international stocks to U.S. stocks on a very long-term basis, global growth and earnings are slowing and we feel it is prudent to scale back on holdings at this time.

Natural Resources and Energy

We are also reducing this area to around our benchmark. Except for cash, this is the only asset class that is showing positive returns so far this year. Though we think that oil and commodities could continue to increase in price over the next five to ten years, we also believe that the peak in prices for this economic cycle is at or near recent highs. We would add back to this asset class on a significant pullback.

Real Estate

REITS have declined about 10% from high to low during the last five months and have since begun to rebound. This decline is not enough to create an under valuation. However, now that some of the excess has been taken out of prices, and given the jittery state of the overall market, investors may once again be drawn to the relatively attractive dividend yields and treat some of the segments, particularly apartment REITS, as a defensive holding. This would support prices near the recent lows. We may add to such issues selectively while maintaining our under weight position overall.

Summary

We believe that investors are viewing the global economy as slowing down and that further interest rate hikes are on the way, neither of which would be positive for financial markets. We believe that downside risks are greater than upside potential at this time and remain cautious in our outlook by overweighing cash and short-term bonds. As always, please contact us if you wish to discuss your portfolio or how our outlook might impact it.

Dave Clara Bill

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Past performance is no guarantee of future results.
A risk of loss is involved with investing in financial markets.
Other than the footnotes below, the research underlying this piece represents Avalon Capital Management's proprietary research activities.

Footnotes

1 Macroadvisors.com
2 FederalReserve.gov
3 NABE.com
4 Commerce.gov
5 Dol.gov
6 WorldBank.org
7 FT.com
8 Barrons.com
9 FederalReserve.gov
10 Barrons.com
11 Thompsoninvest.net

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