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The Fed is Back

The Fed Is Back In The Saddle

In June 2004 the Federal Reserve lowered the Federal funds rate to 1%, a 46-year low. In hindsight this rate was a huge overshoot. The excess liquidity created put the Fed in a difficult position; when they became concerned about too much growth and rising inflation expectations, there was a long way to raise rates to achieve what economists refer to as the equilibrium point -- a neutral (neither accommodative, nor restrictive) Fed Funds rate. That neutral rate is currently around 4%.[1] Put another way, after 11 increases over fifteen months of 25 basis points each, the Fed is only now approaching the equilibrium level where interest rates may begin to slow the economy, profit growth and ultimately the financial markets. Meanwhile, investors appear to be inured to the small incremental increases just as rates are reaching a point where they could really begin to bite.

The Fed may finally be back in the saddle; when its actions, large or small, will materially influence economic and financial outcomes. Particularly worrisome is that three regional Federal Reserve bankers have publicly warned that the Fed is very concerned about inflation, suggesting the inflation hawks are sharpening their talons. This Fed can't "let the inflation virus infect the blood supply and poison the system," said Dallas Fed President Richard Fisher.[2] The September 20th Fed minutes revealed concerns about increasing wage pressures, higher inflation expectations on the part of consumers and unchecked

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federal spending on rebuilding after Katrina that the Fed said "underscored the worrisome loss of fiscal discipline in recent years."[3] Analysts argue that the minutes provide evidence that Chairman Greenspan is intent on raising rates at his three final meetings before ending his 18-year career at the Federal Reserve in January.[4] If so, he will leave office with a 4.5% funds rate, on the restrictive side of the neutral threshold. Investors are already expressing their displeasure with this possibility. The issue of Alan Greenspan's successor has also moved to the front burner. Intensifying investor uncertainty, the choice of a new Fed chairman leaves Fed Watchers ringing their hands until a new Chairman is in place and his or her intentions are better understood. *Note: as we went to press, Ben Bernanke had just been named successor and the early responses are very positive.*

Current Economy

United States Economy

The U.S. economy is slowing as the inflation rate is increasing. This economy was losing momentum even before Hurricane's Katrina and Rita sent gasoline and natural gas prices sharply higher. The Conference board's leading economic indicator dropped in September for the third month in a row and both consumer and business confidence plummeted in September.[5] The effect of the fiscal stimulus from hurricane rebuilding that will begin early next year is also contributing to increased uncertainty. The ensuing distortion of economic data may keep the Fed tightening rates longer than they might have during a "normal" cycle.

Inflation is back in the headlines. High energy prices, a potential shift in public psychology toward accepting higher prices, signs that businesses are using up spare capacity and a steep, apparently uncontrollable, federal budget deficit combine for a troubling future inflation outlook. Looking 12 months ahead, the University of Michigan Consumer Sentiment Survey is expecting inflation to approach 4.5%.[6]

World Economy

Global economic growth is also slowing. The latest World Bank report forecasts growth of around 3% in 2005, down from 3.8% in 2004. They expect growth in 2006 to be between 2.5% and 3.0%.[7] Concurrently, European economic growth may be anemic at 1%. The bright spots are China and Japan. China's economy is expected to grow by 9% in 2005 and 7.5% in 2006. Japan could grow at a 2.3% rate in 2005 and 3.0% in 2006.[8] After years of economic gloom, Prime Minister Koizumi's recent election brings hope that Japan will climb out of the dark, deflationary rabbit hole that once obscured all avenues to growth. His landslide election effectively endorsed his plans to reform the postal service system and other hidebound institutions.[9] The $3.1 trillion privatization of the postal service will essentially create the world's largest bank and make the $1.75 trillion in savings deposits available for more efficient investment.

Investment Outlook - United States Equities

In our January 14, 2005 Q&A, (you can review this on our web site www.avaloncapital.com) we expressed our concern about U.S. equities. We outlined why 2005 would be a difficult year and recommended an under weight position. Among our strongest arguments was that since 1932, using the four year presidential cycle (2005 being year one), the first two years of those political cycles have produced down markets 67% of the time in real terms. Another that since 1897, if the Dow loses value in the first five sessions of the year, then 50% of the time it falls for the entire year. 2005 opened down four of the first five days. So here we are with most major indices down 4% to 6% year-to-date. Uncertainty has increased: the Fed is on the warpath; inflation and interest rates are increasing; the economy and profit growth are slowing; and President Bush is losing leadership rapidly. We began raising additional cash at the end of August and think it prudent at this time to continue to underweight the U.S. stock market. In our October 2002 piece: Why a Rally Now? (You can review this on our web site www.avaloncapital.com) we made the case that the stock market bottoms roughly every 4 years. The S&P500 is now in the third year since the last market low in October 2002. The pre-conditions for a low in 2006 are falling into place. Stated differently, the next several months are likely to be challenging, but things will begin to brighten after that. Why? Much of the Fed tightening will be behind us and market valuations, currently reasonable, should be even better. Based on 2007 S&P earnings projections, the S&P500 is now at 12X 2007 earnings. Any substantial sell off would create a "cheap" market and would eventually support another bull market that could last several years, near-term concerns notwithstanding. Such a material correction would set up an opportunity to put cash to work.

Asset Allocation

U.S. Stock and Bonds

Our overall asset allocation continues to favor cash, short-term bonds and selective equity themes. Since the major indices are down for the year the only way to achieve positive returns has been to overweight those sectors that did well and underweight those sectors that lost money. For example, for the year-to-date ending Sept 30, 2005, the energy sector was up 40%, biotechnology was up 16% and semiconductors were up 12%. On the other hand, consumer oriented sectors did poorly: home furnishings -29%, automobiles -28%, apparel retail -16% and leisure products -14%. Another heavily weighted group in the S&P to avoid was the financial arena: diversified financial services -8%, regional banks -8% and thrifts and mortgage finance -21%.[10] At this time we recommend sticking to big cap issues in consumer staples, high technology, biotech and health care. We also recommend large cap growth over small and mid-cap growth, a major shift in emphasis from the last five years. We recommend treasuries, corporate bonds or bond funds with maturities less than five years for fixed income portfolios.

International

Although 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 to benchmark weightings. However, we added to Japan, which could well prove to be one of the best markets over the next twelve months. The Nikkei peaked at 38,916 in 1989, well above its current level of 13,359. Richard Jerram, chief Japan economist at Macquarie Securities in Tokyo says, "You now have a functioning banking system, rising real estate prices, and a functioning domestic economy".[11] The Bank of Japan hints it will soon abandon its policy of keeping official rates at zero. Japan could show growth of 3.0% in 2006. The ROE (return on equity) is approaching 10%, a level not seen since the late 80's when the market was booming, a good sign that corporations are using their capital more efficiently and effectively.[12]

Natural Resources and Energy

Energy and natural resource stocks have done very well this year. The S&P Energy sector was up 40% through September 30th. Oil prices could retreat to under $50 over the next six to twelve months as demand slows down and supplies increase, so we have reduced our holdings, moving closer to our benchmark. We would add back to this asset class on a significant pullback.

Real Estate

We expect the Fed is serious about continuing to raise interest rates, so REITS are vulnerable to a significant price correction. We recommend that investors be at their lowest weighting relative to their benchmark for now.

Summary

Uncertainty in the economy and financial markets has increased. Downside risks are greater than upside potential at this time. By reducing smaller cap issues and overweighting large cap stocks, cash and short-term bonds, we remain defensive.

Dave Rahn **Clara Basile** **Bill Oberman**

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1 WSJ.com
2 Reuters.com
3 FederalReserve.gov
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5 BCAResearch.com
6 WSJ.com
7 WorldBank.org
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9 Barrons.com
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