CONWAY • JARVIS

Quarterly Investment Outlook

Volume 16 Issue 2 June 19, 2006

The New Fed Chair and the Markets: A Short Honeymoon Comes to an End

As stock market investors, we constantly evaluate the global economy, the policy decisions that determine its direction, and the success of the companies that comprise it. We monitor data indicating the condition of the economy, levels of business activity, relative currency values and lending rates, what governments spend (or save), and, of course, corporate profits or losses. It's where we apply the "science" of investing to take a look back, project trends for the future and look for clues as to market direction. Unfortunately, the stock market is also a less-than-precise emotional barometer, constantly measuring the level of optimism or pessimism about the future among the aggregate of investors. That explains why investor confidence in "the known" has been trumped by what the new Fed chairman is thinking and doing at a critical tipping point for the equities markets. Welcome to the first major crossroads for the markets in the post-Greenspan era of Monetary Policy.

Long-time readers of the Outlook are no doubt familiar with our oft-repeated rant against politically motivated Fiscal Policy crafted by legislators with questionable intent and, as evidenced more recently, even more questionable ethics. In contrast, we've been relatively positive about Monetary Policy. For the past two decades the Federal Reserve, led by Alan Greenspan, was by and large the least of our worries. Under his leadership, the Fed has guided the US economy through a period during which a powerful global economy has emerged to challenge the dominance we've enjoyed for the last century. Sure, there have been some moments when we've banged a guardrail or two, but for the most part the Fed has steered along the centerline, fostering growth while at the same time avoiding a case of the "flations". That's hyper-inflation, deflation, and the dreaded stagflation. Their success has been a critical component of the robust growth in the economy and its markets that we've enjoyed over the past two decades.

Now we find ourselves in the rare position of being fairly sanguine about the direction of fiscal policy this year. Of course, that's because it has no direction. Outside of retaining previously enacted tax cuts, Congress has shied away from any newly conceived initiatives, good or bad, in these days leading up to the mid-term elections. Instead, investors find themselves running in place in a stock market spooked by the direction of Monetary Policy, as articulated by the new Fed chairman, Ben Bernanke. History indicates that a change in Fed leadership can impact the markets and that it's not unusual for the "new guy" and the markets to struggle under the intense scrutiny and criticism that accompanies such a transition. We only have to look back to former chairman Greenspan's ascendancy to the post. Within months of his appointment in August of 1987 the bond market cratered and October's Black Monday kicked off a harrowing correction that, at the time, looked and felt like a crash. It seems that getting to know your new Fed chairman can be an unpleasant experience for investors….. or it can be an opportunity like it was in 1987. It all depends on one's outlook, risk tolerance, and investment horizon.

By all accounts, Ben Bernanke has got the smarts and the skills to succeed in the job. However, he employs a strategy and communication style that is currently much different from that of his predecessor. During his tenure, Greenspan sent clues to the markets through his statements before Congress and banking groups. Those comments were usually so convoluted as to defy literal translation and left many in the audience scratching their heads. Only on the rare occasion did he indulge in plain-speak saber-rattling, as in his famous "irrational exuberance" statement of 1996. Investors were forced to rely instead on published rate adjustments and transcripts of the FOMC meetings for indications of future actions. This lack of transparency afforded the Fed great flexibility in reacting to unforeseen changes in the economy. They would fight inflation at every turn but remain ready to adjust their strategy or add liquidity in the aftermath of an event or structural dislocation in the economy.

In contrast, nuance and subtlety are not part of the new Fed chair's repertoire of skills. He has stated in no uncertain terms that he is hawkish on inflation. He's also made it clear that the Fed will manage the domestic economy to a targeted rate of inflation, making future rate actions data-dependent. It's a strategy employed by other developed nations and, aside from Japan, most of our major trading partners. This is a departure from Greenspan's approach and that alone has raised the anxiety level of investors. Some have likened this strategy to driving while looking in the rear view mirror or looking only at the speedometer. It fails to account for changing road conditions and the terrain ahead . It's also thought to limit the flexibility the Fed might need to steer to a soft landing for the economy. However you look at it, the markets don't like it. Yet, it may turn out to work for us as it has for other countries in creating a stable growth environment, avoiding boom/bust cyclicality, and reducing the volatility of stock and bond markets. Getting there, however, may be a bumpy ride.

Aside from the data indicating a rise in inflation, the scorecard looks pretty decent for a late cycle contraction. Oil prices have leveled off and natural gas hovers just above recent multi-year lows. The geo-political situation has been fairly static, though with plenty of room for improvement. Net business profits remain at record highs while surging corporate tax revenues have stemmed the rise in the budget deficit. Consumer spending remains healthy in spite of a cooling real estate market. All the while, the greatest industrial expansion of our lifetime continues in Asia. This is why stock market analysis is a strange brew, combining an objective assessment of the present with a subjective prediction about the future. It's why we're seeing a wide divergence of opinion among respected experts as to whether the US economy pancakes on the runway as a result of the Fed's actions, or executes a delicate "touch and go", launching into the next cycle as the global economy continues to bloom. This divergence has placed the stock market at a tipping point.

While there is clarity of purpose on the part of the Fed, great uncertainty has arisen over the end result of their actions going forward. There is widespread fear that the Fed will continue to raise key rates until the data indicates otherwise, which by then will be too late to avoid a "hard landing". We have little doubt that a slowdown is ahead as interest rates rise across the globe, shrinking the world's capital base and reducing liquidity. It's the natural ebb and flow of a fully functioning economy. Forced to guess, we rate the possibility of a mild recession as a 50/50 proposition but view it as the lesser of two evils when compared to losing control of inflation as we did three decades ago. In our view, controlling inflation with higher interest rates is like being vaccinated. It's not pleasant but it's beneficial to one's health in the long run.

We believe, that in the wake of Bernanke's straight talk, stocks have already priced in the prospect of a mild recession. By our calculation, the market could decline another 5-7% from current levels if the Fed tightens into the 4th quarter. We also see upside potential of 5-10% if they complete their work before then. The challenge in the current market climate is positioning clients defensively and, at the same time, taking advantage of sell-offs to position for the beginning of the next cycle. In general, we favor companies that retain pricing power for their goods and services or have intellectual property they can defend. We are placing emphasis on Consumer Staples, Energy, and selected Industrials. We also expect foreign stocks to regain traction in the near future. We are reducing, not eliminating, exposure to Consumer Discretionary issues and are altering the composition of our Info Tech allocation. While we believe the bull market in industrial commodities remains intact, it will be some time before the current correction is complete and we'll reassess then. One thing we are sure of. When the news is its bleakest, the market will present a value proposition that will be hard to ignore. Much like October of 2002, investors who wait for the "All clear" will miss out on the significant advance that will constitute the first leg of the next bull market.

CONWAY • JARVIS LLC
3147 Fairview Avenue E. Suite 300
Seattle, WA 98102
206.324.9765 / 800.398.9765