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Quarterly Investment Outlook

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Beyond Sub-Prime: Resuscitating the US Economy

Almost forgotten in the furor surrounding the sub-prime meltdown is the great US economic experiment: "Borrowing Your Way to Prosperity". Deficit spending by government, coupled with rising productivity and domestic investment, allowed us to enjoy lower taxes and higher growth in a low-inflation environment during what has been an eventful 8 years. While mounting an admirable recovery effort from the "Perfect Storm" of the Tech Bubble, 9/11, the '02 recession, and the Iraq war, the US began spending more and investing less as it continued to pile up debt in record amounts. Many consumers also did some serious deficit spending, using easy credit and their home equity to dig a hole they couldn't climb out of when the housing market collapsed. This set the stage for the second "Perfect Storm" of the decade, occasioned by the Housing Bubble, the credit crisis, and record high oil prices. The economy appears to be drifting toward a 70's style of recession where weak domestic growth and a resurgence of inflation combine to threaten the return of an old enemy, stagflation. Whether that occurs or a normal recession persists is the subject of intense debate. What is agreed upon is that the "Great De-leveraging" of the US financial system is at hand, that it will be painful, and that it will take time, patience, and a steady hand by the Fed to navigate our way through it.

Swapping Prosperity for Inflation

The verdict is in: the financial strategy of “”Borrowing Your Way to Prosperity” has hit a snag. Deficit spending, a handy tool for stimulating investment and growth in bad times, can be a risky strategy in good times, especially in a world where inflation is always lurking in the wings. After flirting with a budget surplus at the close of the 90's, the US went on a spending spree that has taken the dollar lower and ballooned the budget deficit to record levels. Of course, some of that money was well spent. So far this decade, the US economy has absorbed the bursting of the Tech Bubble, the resulting collapse of the stock market, a terrorist attack, the recession of 2002, a budget-busting war, the disintegration of the credit markets, and the deflating of the housing bubble. Oh, and lest we forget, a spike in oil prices of epic proportion. Financing our way through those trials and tribulations was necessary. Unfortunately, policy-makers employed the strategy beyond shoring up the domestic economy to continuously finance personal consumption. In addition, leverage created through the miracle of financial engineering spawned a Liquidity Bubble that, with the help of bonehead banking practices, created an imbalance in the US housing market that has negatively impacted financial institutions around the world.

For a number of years the US was able to borrow its way out of trouble. In the wake of the 2002 recession, the US economy rebounded sharply as global growth, led by Asia and Latin America, exploded. Still, the US borrowed and spent to further fuel the fires at home. The Goldilocks Economy became part of the investment community's vernacular, signifying a robustly growing economy with just the right amount of inflation. Needless to say, Goldilocks has left the house. **The structural impairment of the banking system, the resulting credit crisis, and an already weak dollar severely limits the Fed's ability to now finance the growth needed for recovery without reigniting inflation.** The Fed is left with little choice other than to re-inflate the US economy toward recovery by printing money to recapitalize the banks. Re-inflating our way to recovery leaves the central banks of the world little choice but to combat the increased threat of inflation by raising key rates and slowing their economies as well. In turn, the Fed will likely be compelled to act in concert to arrest a further fall of the dollar, making it almost a certainty that the next move for US interest rates will be higher.

While it's not a pretty picture, we're confident it's unlikely to derail the Global Industrial Revolution and look for the benefits of global growth to continue to be channeled to the US economy through our multinational corporations. That should cushion the fall for business but the consumer remains at risk from inflation. Some optimists diminish the threat and point to a low Core Inflation Rate that excludes Food and Energy and, under normal conditions, best reflects long-term CPI growth. However, where Food and Energy prices rise in a persistent trend, headline inflation becomes synonymous with core inflation and that's where we are today.

We view inflationary pressures and high oil prices as being inextricably linked. We also view the current price of oil as being unsustainable. We think restoring confidence and stability to the dollar through fiscal discipline will go a long way toward ending speculation in the oil markets and at the same time ease inflation pressures. That big first step toward righting the ship can be accomplished with the Fed and Treasury's commitment to a return of fiscal discipline to monetary and fiscal policy initiatives. Absent that, the US, as the world's largest debtor, could lose a measure of its financial autonomy and drop a notch or two further down the ladder in the global hierarchy of developed economies.

The Market's View of the Fed's Balancing Act

It has become axiomatic that the stock market hates uncertainty. The only thing it hates more is inflation. And it really, really hates stagflation, a term coined in the early 70's to describe the worst of both worlds: Low (or no growth) coupled with inflation. Unfortunately, the US economy presently finds itself policy-dependent and treading in dangerous waters. Investors are focused on the Fed's attempt to engineer a desirable balance between growth and inflation as it steers the economy out of recession and away from stagflation. And for better or worse, Congress appears to be waiting for the election results before it suits up and gets into the game. Our hope is that they and any new Administration let the Fed do its work and resist the temptation to craft a quick-fix solution that, if history is any indication, is likely do more harm than good.

Investors are wary and rightfully so. While we see improvement in the condition of the credit markets, the ending to the sub-prime story hasn't been written yet. We believe the worst is ahead for real estate, both residential and commercial, and expect some financial institutions to find themselves on the rocks as a result. A number of them will be unable to recapitalize or find a brokered bail-out through the Fed, a la the purchase of Bear Stearns by J.P. Morgan. That transaction set a precedent where the Fed now finds itself in the uncomfortable position of deciding who fails and who doesn't. We know that all the banks can't be saved without crashing the dollar so future Fed decisions as to who survives and who doesn't will almost certainly have a dramatic effect on the Financials and the broader markets in the short term. **The longer-term outlook for the markets should improve once the marketplace determines which banks survive, we see a return of stability to the dollar, and speculation in oil comes to an end.**

During the most recent earnings season and the period that followed, the market has reacted predictably to news, both good and bad. The beginning of June saw the indices clinging tenaciously to support levels representing a 50% retracement of the rally that was launched in March. However, the June 6th report of the spike in unemployment to 5.5% erased that support and since then the market has churned slowly toward those March lows. We think the odds favor a test of those levels, 11740 for the DOW and 1273 for the S & P, before the next earnings season hits full stride in July. We view that as a healthy step toward establishing a base from which this market can rally. As for our current strategy, we are treading lightly back into the Financials, anticipating a recovery for that sector in '09. We are opportunistically positioning global industrial and technology issues, believing that infrastructure growth outside the US will remain strong. We anticipate an end to speculation in oil before year's end and are reducing our exposure there while remaining in natural gas and alternative energy issues. We remain underweighted in US consumer-related issues and instead are positioning portfolios to take advantage of rapidly growing consumer markets abroad.

We have no illusions about seeing a sustained broad market advance like that of 2003 in our immediate future. For that, we'll have to see lower oil prices and benign inflation, foreclosures down, home sales and housing starts up, a stable employment and wage base, and improving GDP growth. In other words, we'll have to see expectations for the return of the Goldilocks Economy. That won't happen overnight and it will require some nimble moves by the Fed and restraint by Congress in taxation and spending over the next few years. Until then, we expect specific sectors to perform well on a relative basis with the net effect of seeing the broad market advance modestly through the end of 2008. The outlook beyond that is unclear since our projections will be based on the outcome of the election that we will discuss in our next issue. Stay tuned.

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