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Quarterly Investment Outlook

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The Fed's Cure for Inflation Requires a Balancing Act by Investors

In early August, the Fed announced that it would forego raising the Fed Funds rate, making their previous increase of June 29th the last of 17 interest rate hikes that began in June 2004. That period marked an increase in the Fed funds rate from 1% to its current 5.25% and, hopefully, the end of a series of open market operations designed to rein in inflation. Whether they've been successful won't be known for some time but the initial reaction in the stock market indicates that investors are optimistic. Lurking behind those headlines is the grim reality that the Fed has fashioned a slowdown in the economy and many question whether they've gone too far. Will the slowdown take the form of a soft landing or rather a recession, the type of which has followed the vast majority of Fed tightening over the past half century? This uncertainty surrounds an economic recovery and a mildly bullish market that are both long in the tooth. While cyclicality of the economy is quite normal, the continued rise in inflation and the deflating real estate bubble could add volatility to the downturn and negatively affect the equity markets. Making the transition from a late-cycle downturn to the next recovery should present some challenges for investors. And some opportunities.

The End of the Goldilocks Economy?

For some time, we have benefited from what economists refer to as the "Goldilocks Economy". By that they mean one growing at a healthy clip with just the right amount of inflation, not too little, not too much, just right. In recent years, inflationary pressures have become evident, prompting the Fed to take action to tighten credit and slow the economy. Historically, they've rarely slowed the economy without tipping it over into recession. Investors and market pundits breathed a collective sigh of relief last month when the Fed appeared to have completed their tightening mission. Many believe that Bernanke and crew should have stopped months ago and that the table is set for a "hard" landing, i.e. recession. They point to a slightly inverted yield curve as an indication of trouble ahead and look for the anticipated carnage in the real estate market to exacerbate the problem as consumers are motivated to cut back on their spending.

From our perspective, the Goldilocks Economy has for now given way to the "Test-Tube Economy", one that combines a number of variables from which no conclusive result can be accurately predicted. Only time will tell whether the Fed has concocted a cure for inflation that won't derail the economy at the same time the housing bubble deflates. Central banks around the world are now also drawing down liquidity by raising their interest rates. Whether that will be sufficient to arrest the rise of global inflation and let the Fed remain in neutral over the next year remains to be seen. Data released over the next couple of months will offer clues as to whether the Fed has successfully completed its work or whether they have to resume tightening and risk triggering a full-blown recession and severe correction in the stock market. As of today, investors are betting that the Fed will be successful in producing a "soft landing".

Bridging the Gap

The challenge for investors in 2006 is to position themselves to successfully navigate the gap between the end of the current economic cycle and the beginning of the next. Recent data indicates that the economy is slowing. The debate surrounds whether we will experience a "soft-landing" or a recession, triggered by any number of factors: A precipitous decline in housing prices, a drying up of global liquidity, uncontrolled inflation, or all of the above. What transpires over the remainder of the year will put the debate to rest and could significantly impact investors. What to do now? If only it were as simple as cashing in your chips and waiting for a green light to signal the start of the bull market. Market-timers may have done so on occasion but, despite their rosy advertising, they ultimately fail to match the performance of the benchmark indexes over a period spanning multiple cycles. Why? Because even though there may be strong indications of how a scenario is likely to unfold, the timing and amplitude of those events are often uncertain, rarely repeat themselves across cycles, and usually remain somewhat of a mystery until the last chapter in the cycle begins to play out. There will be no Green Light.

Some respected analysts we follow view recession as a foregone conclusion, triggered by precipitous declines in employment and wage growth as a result of a weak housing market. We disagree and believe the Fed has successfully addressed inflation and that the global and US economies remain on sure footing. It feels to us like we've begun the last chapter of this mature cycle and indications are that we will avoid a "hard" landing. We expect only a modest decline in national housing despite the implosion of some "hot", investor-driven, regional markets making headlines. Interest rates remain near the bottom of their historical range and energy prices are declining for a third straight week from what we believe to be their highs in this current cycle. Both factors go a long way toward easing the burden on the homeowner and consumer as well as reducing inflationary pressures. While confident in our view, we see uncertainty in the near future with regard to Iran and potential constraints on the global oil supply. Coincident rising energy prices and falling house values over a sustained period of time would prompt us to recalibrate our expectations.

A Balance of Defense and Offense

So, how should one invest in the short term to profit in the long-term? With a few notable exceptions, fervent bull Art Laffer being one of them, analysts are advising some degree of caution in investing in the months ahead. The trick is to be positioned defensively and at the same time, opportunistically, for the beginning of the next bull market. Remember, there will be no Green Light! In fact, looking back to October of '02, the beginning of the previous recent bull market, there were yellow and red lights flashing at the time. We advise exercising caution through both asset allocation and portfolio composition. This means retaining more cash than usual over the next few months with the intent to deploy it on any measured weakness. It also means maintaining market weights or better in equity sectors that are traditionally defensive in character. Groups favored in the current environment are Healthcare, Consumer Staples, and Financials (now that the Fed is finished raising rates).

Being positioned for the end of one **economic** cycle is only half the equation. Being positioned for the beginning of the next **market** cycle requires something more than just playing defense. The stock market typically discounts future events, meaning that it reflects expectations about the future that often differ from conditions in the present. Market valuations often diverge from economic expectations between cycles or immediately following significant geopolitical events. It's why bull markets launch from the ashes of economic or market downturns. For that reason, in addition to playing defense, it's important to maintain exposure to stocks that typically lead a new bull market and point to an economy where growth is once again accelerating. That means being positioned in sectors that may not look attractive now but that will be the first to reflect expectations for the next cycle of expansion. These typically include Technology, Capital goods, and Consumer Cyclical sectors and raises expectations for the long-awaited resurgence in large-cap growth stocks.

Today, stocks present a compelling value proposition relative to bonds and real estate. With the S & P trading at a P/E multiple of 15, the question must be asked: Is the market currently undervalued, failing to reflect next year's recovery? Or is it overvalued, failing to discount a decline in corporate earnings (the "E" in P/E) as a result of recession? One school of thought holds that the market is always fairly priced, reflecting the aggregate of investors' expectations for the future. Right now, we think the market is telling us to "flip a coin", meaning that for the next few months the risk/reward ratio is about equal. Longer-term, there's no question that the ratio improves and that higher stock prices are ahead, reflecting the continued expansion of the Global Economy. However, as we said earlier, the last chapter of the current cycle is before us and we believe the jury is still out as to how it will end. Until we get into the meat of that last chapter, balancing some defense with some offense is advisable.

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