CONWAY • JARVIS

Quarterly Investment Outlook

Volume 16 Issue 4 January 15, 2007

Bigger and Better: The Old Economy Version 2.0

In 2006, the Bulls and Bears squared off over the question of whether the Goldilocks Economy would prevail over swelling deficits, aggressive inflation fighting by the Fed, political change at home, a declining real estate market, and an inverted yield curve foretelling recession. Despite these and other less obvious headwinds, the Bulls prevailed and the year proved to be a good one for stock market investors. This was viewed as confirmation that the Goldilocks Economy, where growth and inflation are "just right", has some legs. Meanwhile, the bond market's inverted yield curve pointed to a hard landing, if not a recession, in our future and the Bear camp points to conditions that, in the past, have spelled tough times ahead for the US economy and its markets. Has "Goldilocks" overstayed her welcome or are these perils simply normal growing pains of an economic expansion of epic proportions? One has to ask, "Is something different this time"?

The Eternal Question

For investors and economists, the eternal question is not about the meaning of life but whether "it's different this time". It's asked every time we see a wide divergence of opinion about the current state of the economy or stock market. In the past, a reversion to the mean has always given us our answer. Remember the "New Economy" of the 90's? Today, we are witness to an unparalleled global economic expansion which we view as uncharted territory for the US Economy. Fortunately, it's been one that has provided US business with healthy profits, the US consumer with cheap goods, and the US Treasury with capital to finance its deficits. While happy to reap the benefits of the Goldilocks Economy, we tend to believe it's also somewhat of a "Test-Tube Economy". That's where familiar economic conditions and data drive rational monetary and fiscal policy actions that may not bring about the same result or effect on the economy as in the past. From what we're seeing, we think it might be different this time…. at least for awhile.

The bull market in stocks has been fueled by record corporate profits and seems to reflect the likelihood that the global economic boom will provide the US economy with the capital to expand under conditions that, in the past, would have impaired growth. The bond market's inverted yield curve, often a reliable predictor of negative growth, is viewed by many analysts as an indication that a hard landing is ahead and that the Fed will have to lower key rates in 2007 to avoid a recession. So, which of these markets is correctly predicting the next phase of this cycle? Over the years, we've paid more attention to bond market investors for clues as to where the economy is going since the equities markets are sure to follow. Too often we've seen the stock market disconnect from economic reality and swing wildly on investors' attitudes or expectations. However, the current bull market, aside from some transient volatility in the energy and commodity sectors, has advanced in step with earnings and valuation measures that today, remain attractive. If we view the stock market as the better indicator, what could the bond market be telling us?

In our Test Tube Economy we think the bond market, rather than predicting recession, could be telling us that the world is simply awash in excess liquidity as a result of the global expansion. The inverted yield curve could be reflecting increased demand from abroad for our longer-term treasuries coincident with the Fed raising short-term rates to combat inflation. We're venturing a guess that global economic growth and the liquidity it produces is likely to preempt a hard landing or recession in the US. **This abundance of excess capital can finance our deficits, keep interest rates low and cushion any precipitous decline in the real estate market.** It also favors continued strong consumer and business spending, low unemployment, and moderate wage growth. Throw in benign inflation and you have a recipe for an economic expansion of extended duration that bodes well for the stock market.

Abundant Liquidity Driving Profit Growth

In spite of the bond market's enviable track record of predicting slowdowns in the economy, investors have been treading steadily into equities since Q4 2002. The stock market has scaled a wall of worry, marked with concerns over trade agreements, currency imbalances, threat of protectionist legislation, imprudent tax policies, and the interruption of energy supplies. Any one of these could quickly upset the delicate balance of factors that have combined to create and sustain the current global expansion. However these are known risks that we believe are already priced into this stock market.

Despite the fact that this bull market is characterized as being long in the tooth and that it has advanced, unabated, since its last correction in mid-2006, stocks still represent good value. The S & P 500 has averaged a return of almost 15% annually since the beginning of 2003, yet is still priced at an attractive 16 times projected 2007 earnings. During that same period, the Fed announced 17 rate hikes, oil spiked above $70/barrel, and real estate prices peaked and then declined for the first time in thirty years. Still, the US economy marches on wherein the past, it and the markets would have reacted poorly to such events. In search of an explanation, we've concluded that something new or different must be happening as a result of globalization.

The labor-cost arbitrage that exists between the US and the emerging markets has driven the much-discussed decline of the manufacturing base within the US. While politicians and labor unions complain, business has taken advantage by offloading their manufacturing capacity to Asia and Mexico, thereby reducing the need for higher-cost plants, equipment, and labor in the US. This has significantly shrunk costs structure for the big multinationals and small companies as well while reducing the inherent volatility of their business cycles. The shift to outsourcing capital and labor intensive functions abroad has combined with a tech-driven increase in productivity to boost profit growth for companies willing and able to take advantage of the emergence of the global economy. The Old Economy principle of businesses seeking lower cost capital, labor and resources has fostered investment and expansion overseas.

The result is an explosion of liquidity world-wide that is being invested in emerging markets, repatriated as profits to invest and shore up balance sheets here at home, and provide a source of cheap foreign capital to finance our trade and budget deficits. We believe this is why the US economy has remained healthy in the face of conditions that historically would have triggered a significant slowdown, or worse, and would spell trouble for the stock market. We're not equating the Test Tube Economy with the New Economy of the 90's. We believe it's just the Old Economy at full throttle, expanding on a scale unseen before in our lifetime. It's different. Enjoy it while it lasts. In our next issue, we'll discuss how long that might be and what factors could derail the boom.

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