Rutherford Investment Management, LLC
Newsletter: 1st Quarter 2004

April 8, 2004 Waiting and watching, watching and waiting

In the first quarter of this year, the markets took a breather in response to the torrid increase of last year. This was not surprising after the 29% run-up of last year, and the Federal Reserve's curtailment of the money supply even though they have maintained interest rates at a low level not seen since 1958. The Fed was no doubt reacting to a concern that they may be fueling a new bubble because of the low interest rates and the 4.5% growth in GDP of the fourth quarter of 2003. Concerned that job increases have not resumed in the recovering economy, the Fed wants to keep interest rates low. But concerned that they may fuel inflation, they curtailed the money supply to cool the economy. Once again the Fed had its way. Both the Dow and the NASDAQ lost ground in the first quarter, but the S&P 500 actually increased.

In their most recent meeting on March 16, the Fed decided to continue to keep rates low, but they are sending out conflicting messages, and with the last jobs report showing a strong rise in employment, we may well see an increase in interest rates soon—maybe by June. While the consumer price index (CPI) continues to show a low rate of inflation, commodity prices are forecasting a resumption of inflation. The government, after all, has strong institutional incentives to report low inflation numbers. The CPI is used by Social Security and Treasury-inflation protected bonds to increase the liabilities of the government. Naturally it is in their interest to keep the rate of inflation low. It is well known that inflation is a lagging indicator. This Fed, unlike the Fed of the early 2000s, which seemed to find inflation in every breeze, now wants confirmation before raising rates. I believe they will get it in the not too distant future.

The price of oil has been trading in the mid to upper thirties in dollars per barrel. This is itself inflationary. It also is a tax on Americans. Goldman Sachs estimates that if oil prices stay where they are, it will reduce personal disposable income by $30 Billion per year. This is in contrast to the $70 Billion Tax reduction passed last year.

Job creation remains stubbornly slow because of the rise in productivity. While it is not uncommon for productivity to rise in the early stages of an economic recovery, slow job growth has persisted in this recovery beyond what would be expected. Outsourcing of jobs to Asia gets much of the blame, but this is only a partial answer as productivity increases are the real reason. In the long term, productivity increases will raise our standard of living, but for the unemployed, the worry is about the present. The protectionist flag has been raised against outsourcing, but if one compares job creation in the United States to Europe, which has a protectionist bent, you will see that since 1984, the US has created 35 million jobs while Euroland has created only about 4 million. Furthermore, even with a job protection mentality, over three million jobs have disappeared in Germany in the last few years, and are continuing to disappear at the rate of 20,000 per month.

In my last letter, I offered a point of view about the presidential election. I said, that "at that time" Howard Dean "appeared" to be the front-runner. Of course I said that my opinions were based "on information believed to be accurate". As we all know, Howard Dean is gone and the race is now between John Kerry and George W. Bush. I also said that President Bush's approval rating on April 1, 2004, would be a good historical indicator of the outcome of the election. All incumbent presidents with an approval rating above 50% on April 1 of the election year have gone on to win the election. The only presidents to lose, Presidents Carter and the elder Bush, had approval ratings of 39% on April 1. President George W. Bush's approval rating has taken a dramatic drop since a high of 56% in mid January, to the current rating of 43%, the lowest of his presidency. In fact 47% of the electorate now disapprove of his performance. Only 35% approve of his handling of the economy. Of even more concern to the Bush camp, 48% of those polled said they do not believe what the President said, to 43% who do. These have to be discouraging numbers to a President who made integrity one of the touchstones of his administration. While these cannot be comforting numbers to the White House, the latest job growth numbers must be encouraging.

Looking forward I see the resumption of inflation, rising interest rates, and high oil prices. There will continue to be terrorist threats, but in spite of all, the recovery does appear to be on track. The strongest recovery is in the US and Asia, with Europe a laggard. As the economy continues its recovery, and the European Central Bank cuts interest rates--as they surely must--the dollar will recover some. Asia will likely still try to maintain a stronger dollar and a weaker local currency. This will mean purchase of dollars, and dollar-denominated assets by Asia economies. The strengthening of the economy of Japan is good news for the world, as they will stop exporting their many problems to the rest of the world.

I think industrial, technology, telecom, health care and consumer stocks will continue to provide opportunities. As the attached article shows, patience over the long term has paid off, and being in growth funds has been the best place to be over the last 14 years in spite of the recent market crash.

Very Truly Yours,

William D. Rutherford
Rutherford Investment Management, LLC.