Rutherford Investment Management, LLC
Newsletter: 2nd Quarter 2004

June 30, 2004 Geopolitical risks weigh on market

Since the beginning of this year the markets have traded essentially sideways. The S&P and NASDAQ are both up just over 2%, and the Blue chip Dow average in negative territory. The explanation for this sideways movement in the face of the rosy economic data out of the government can be found in several factors.

First, the markets had a big run-up last year in anticipation of the economic recovery. The recovery, coming off very low numbers, was strong, but in some cases the data had to be revised down. The governement has a vested interest in producing rosy data, so downward revisions should be no surprise. Rosy forecasts should be taken with a grain of salt. Also, since the market over reacts on both the upside and the downside, the market simply got ahead of itself and had to digest its gains.

Additionally, there were many things to worry about: terrorism, the war in Iraq, oil prices, the threat of inflation, rising interest rates, a jobless recovery and an election.

Terrorism, the war in Iraq and oil prices are all interrelated. There is no doubt that the markets now factors in terrorist risk, and this keeps the markets nervous. Weekends, holidays and special occasions all become times of increased concern. The risk factor for terrorism will not go away soon. It will be with us for years.

The war in Iraq has been dispiriting. Daily news of more deaths, some in a gruesome manner have taken their toll on the American psyche. Certainly the occupation has not gone as planned. However, the occupation took a step forward with the handover of the country to an Iraqi government, no matter how weak. This was seen as a step toward disengagement, but there is still a long road ahead.

Oil reached $40 a barrel and still hovers in the mid to upper 30s. Part of the increase in price was due to terrorist activities, and part to supply constraints. OPEC agreed to slightly increase supplies, but terrorist disruptions continue. Oil prices; of course act as a retardant to economic growth.

Although oil and food are not factored into the consumer prices that the Federal Reserve watches, American families and business felt the effects of both. Fuel surcharges became common, and prices at the grocery story were affected by transportation costs. In testimony before congress about two months ago, Alan Greenspan registered "surprise" about inflation even though it has been obvious to nearly everyone for some time. Worldwide, commodity prices have been on the increase for over a year. In addition to oil, such items as steel, aluminum, paper, copper and food have shown a rapid increase. A large contributing factor to the increase in commodity prices has been the surging Chinese economy. China has been busy buying everything they can to grow their infrastructure. China has also seen a rapid increase in inflation.

The Federal Reserve has been telling everyone for months that they are going to raise interest rates. The unknown factors were by how much and how rapidly. These factors also led to uncertainty in the markets, so while the markets were re rating equities and bonds, it had many unknowns to deal with. Many thought the Fed had been too slow to raise interest rates in light of increased inflationary pressures. Still others thought that President Bush and Alan Greenspan had struck a bargain:

Greenspan would keep rates low in an effort to secure Bush's reelection and Bush would reappoint Greenspan. With his appointment secure, Greenspan became much more vocal on interest rate increases, and indeed at the end of the quarter the Fed raised interest rates by 25 basis points, the first rise in four years. It remains to be seen if the Fed once again, acted too little too late. Bond markets have done much of the heavy lifting for the Fed as markets have already factored in rates of 3.5 to 4% by the end of 2005. This will allow the Fed to be more "measured" in their rate increases. Meanwhile Bonds suffered their worst quarter in 24 years. (We previously warned our bond investors in a special letter.)

A note about the election: The election is still very close. President Bush's approval rating continues to decline, although that may change with the handover in Iraq and an improving economy. At the same time the race remains deadlocked, primarily because John Kerry has not excited the electorate. Furthermore, millions of dollars of attack ads by the Bush campaign have sown the seeds of doubts about Kerry. However, it is still early in the election and as the election approaches and the few remaining undecided voters realize they have to make a choice, we can expect more volatility in the polling numbers. A late breaking news event could spell the difference in the election. Most of our clients live in states that are barely aware there is an election, but if we lived in a swing state we would see lots of ads, even now. Keep an eye on such states as Ohio, Missouri, New Mexico, Pennsylvania and Florida.

Last quarter our portfolios benefited from our commitments to health and industrial stocks. Health care is growing because of the aging population and at the same time is defensive, while industrials are a play on the recovering economy. Other parts of our portfolio were slightly up or slightly down mirroring the market. The net result was that we again outperformed the broad market for the year to date.

Looking forward, taking into account the risks enumerated above, the market is sure to encounter headwinds. The global and U.S. economies are recovering, but very large uncertainties, still remain. Economic growth in the U.S. seems to be slowing even as interest rates increase. Inflation is rising too. Both the equity and bond markets are sure to encounter headwinds in this environment.

Our emphasis will likely continue to be on health care and industrials with representation from other sectors based on our desire for a diversified portfolio.

Very Truly Yours,

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