Rutherford Investment Management Newsletter: Period Ending 12-31-2004

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Bubble, Bubble Oil and Trouble

In my recent letters I have said that rising oil prices, and rising interest rates would make it difficult for the markets to make much progress. In addition to these known concerns, the Federal Reserve decided to shrink the money supply. The combination of rising oil prices, rising interest rates and shrinking money supply was the recipe for the disaster that the Fed cooked up in 2000. Once again, we find ourselves on the brink of an oil induced liquidity crisis.

At present, we have real inflationary pressures (not imagined as in 2000), a falling dollar and large budget deficits. A Witch's brew. A long period of low interest rates, which the Fed hoped, would keep the consumer spending to shore up lack of capital spending by business, has created massive debt loads for consumers, and perhaps a real estate bubble.

Criticism of Greenspan's handling of Fed monetary policy has increased. Recently, Stephen Roach, Chief Economist for Morgan Stanley wrote that the problem when Greenspan leaves office will not be finding his replacement, but cleaning up his mess. John Makin Chief Economist for the American Enterprise Institute wrote an article just days ago, with the self-explanatory title of "Greenspan's Second Bubble".

Corporate scandals reemerged and add to market woes with the Worldcom trial in the news, Enron still making headlines, and now the emerging troubles of AIG.

The markets have responded negatively to these problems. Recall that last July I noted the lag effect for the Fed interest rate increases was 6-9 months, which is where we are now. The Dow and the S&P are down 2.6% for the quarter with the NASDAQ down 8.1%, both near the year lows.

The Fed is now seeing inflation, which has been evident to the world for at least a year and a half. As fears mounted for accelerated interest rate increases, yields on bonds rose, and bonds and stocks suffered. But the jobs report, which came out on the first of April '05, showed slowing job growth. Consumer confidence also fell. While this took some pressure off interest rate increases, it did nothing to quell market fear.

We are now entering corporate earning season, which is always preceded by warning season. Earnings will be a key indicator for the markets going forward. Unless earnings are positive we will likely see further declines in the market.

As you will note in your portfolios, we have raised a significant amount of cash, and may raise more. This is defensive in light of the problems, which I have highlighted. We hope for better markets and an opportunity to redeploy this cash in growing companies.

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