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The Road Ahead (Under Construction)

It now appears that the economy grew at the rate of about 3% in the first half of the year. Not a bad showing. Retail sales are strong, non-manufacturing index shows growth, but job growth is weak.

But as of the end of May the Conference Board index of leading indicators had dropped five straight months. In the past this behavior has presaged a recession.

The road ahead is very murky. Weak fiscal and monetary policies provide no comfort.

The yield curve on U.S. Treasuries has been flattening which is another indicator of declining economic activity, perhaps a recession. Other factors leading to recessionary behavior are rising commodity prices, notably oil, weak growth in personal income and jobs, and high personal debt loads. Rising interest rates and a strengthening dollar are also negatives for the economy. Washington is running large deficits, $366 Billion over the last 12 months, or nearly 3.5% of the GDP, which is a lot of stimulus, but in spite of this, the rate of growth of the economy is slowing.

The Federal Reserve is committed to fighting inflation (about a year late to the fight). But with rising interest rates and money supply growth of slightly over 1%, the Fed is standing on the brakes. The risk is that the Fed will tighten too much and the economy will fall into a recession.

Fed chairman Alan Greenspan finds Treasury bond rates a conundrum. In spite of the fact that the Fed has raised rates nine times, bond rates have hardly moved. What is the bond market telling us? One explanation is that the Fed has been successful in convincing the markets that inflation is not a threat. Another explanation is that the economy is headed into a recession. The recent slump in manufacturing worldwide, particularly in Europe gives credence to both of these theories. If the bond market is right about weak growth, neither the equity markets nor the housing markets can find much to cheer about. Commodity prices should fall and bond yields should fall.

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If the Fed is right that inflation is the dominant risk, and they fail to contain inflation, then bond markets are in for a nasty surprise, bond yields should rise, mortgage rates should rise, and the housing market and equity markets should suffer.

A third alternative is that there is more demand for U.S. Treasuries. The U.S. trade imbalance has provided a savings "surplus" to many countries, which are believed to have recycled their funds into U.S. bonds. Recently however, more buying of U.S. Treasuries has been done out of the Caribbean, suggesting the private hedge funds are the buyers, not central governments. China is a notable "savings winner" with their huge trade imbalance with the U.S. Estimates are that China adds $250 Billion in dollar reserves each year. Recently China has tried to diversify their dollar holdings by buying Unocal, a U.S. oil company with reserves in SE Asia. Why shouldn't they want to diversify their dollar holdings? Washington has been negative to the Chinese bid, but we should welcome their investment in the U.S. and the closer ties it will bring. (We own Chevron the competing bidder). I discussed China's dollar holdings in more detail at a recent luncheon sponsored by Umpqua Bank.

The road ahead is obscure, and may well be difficult to navigate. The Fed must walk a very fine line between overreacting to inflationary pressures and therefore hurting the economy or failing to contain inflation and thereby hurting the economy. With the record of the Fed mixed at best, the markets have reason for concern.

At Rutherford Investment, we have found our best stocks in the consumer discretionary, healthcare, energy, outsourcing, and selected information technology stocks. Our performance has remained strong. Going forward, we continue to like healthcare, productivity enhancing stocks, and outsourcing. Energy is cyclical, and may suffer some as the economy slows, but longer-term energy demand is outstripping our supply so we are maintaining and even increasing our position in energy. If the economy slows markedly our consumer stocks are at risk, so we monitor them closely.

If the Federal Reserve pauses in its rate increases, or loosens its monetary policy, the markets could experience a rise, but we see the Fed continuing to tighten interest rates in a high stakes gamble to slow the economy without a recession. Given the record of the Fed the road ahead may be bumpy.

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