Rutherford Investment Management Newsletter: Period Ending 09-30-2005

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Dislocation, Dislocation, Dislocation

At the start of this year I advised clients that I did not think this would be a very good year for the markets. That prophecy has proven correct with the S&P up only 2.8% YTD and the Dow and NASDAQ both down for the year.

Fortunately we have had a better year than the market. In fact, after reviewing our results year to date, I wondered if we ought to put our money in cash and call the year over, as I doubt we will improve our performance over the balance of the year. Nor, quite honestly do I see 2006 improving very much for the market. (We of course, are optimistic that we will outperform the market).

Why this apparent pessimism? Just yesterday, I had a well-known businessman who buys his groceries where I do, stop me and ask, "Does anyone know what is going on"? And that, I think, is the nub of the problem: so many conflicting signals make it difficult to know what is going on with the economy, hence the title of this quarter's letter.

Long before Alan Greenspan rediscovered inflation, there was ample evidence that inflation was showing its muscle. Nations such as China, India, Russia and Brazil were enjoying robust economies and bidding up the price of commodities throughout the world. Everyone, except Alan Greenspan seemed to know that inflation was on its way. Greenspan kept reassuring us that inflation was well contained even though it was not. He kept interest rates at an all time low in an effort to compensate for the Fed debacle of 2000-2002. Certain areas of the economy, construction and retail benefited from this policy, but for the most part it was a jobless recovery that put the reelection of George W. Bush in jeopardy. Low interest rates also had the side benefit of keeping the dollar weak and exporting our unemployment.

However, the Federal Reserve Chairman rediscovered his old nemesis, inflation, shortly after his reappointment as Chairman and he began a series of rate increases that have continued. He has also shrunk the money supply as the price of oil has skyrocketed. If this sounds familiar, it is because it is precisely this approach that led to the debacle of 2000-2002. Once again, Greenspan having botched his job brings a solution that creates yet more problems. His strategy now seems clear, slow the economy to control the inflation that his policies have helped to create but which he formerly said did not exist.

The result is that the Fed now sees what has been obvious to every housewife for some time: prices are going up! The Fed wants to raise interest rates to control inflation and reach a neutral rate of interest (something around 3% more than the rate of inflation). If this is true, and I believe it is, then hints that the Fed will stop raising interest rates anytime soon are unfounded. At the current inflation rate, 3.6% in August year over year, interest rates would have to exceed 6% before the Fed reached a "neutral rate". If that is the case, then I don't see how the markets make much headway.

The economy is sending confusing signals, the price of real estate remains high-but maybe slowing. Construction remains strong-but maybe slowing. Economies, ex-U.S., seem strong-but maybe slowing. Manufacturing seems to be slowing but the services sector seems to be stronger than expected. Katrina deals a powerful blow, but oil prices drop and unemployment claims are not as high as expected. Retailing takes a hit, then rebounds.

The Fed could use Katrina as a reason to pause in their rate hikes, but apparently unaware of the problems of ordinary people, keeps raising rates. (It should be noted that there was a dissenting vote on the Federal Reserve to the last rate hikes, and most of the Federal Reserve Banking Presidents were opposed. The rule on the Fed is that you don't vote against Greenspan if you disagree, only if you can't live with the vote. The last dissent was years ago. The sole dissenting vote was cast by the sole businessman on the Board, everyone else being an economist). Since Katrina, the Fed has allowed the money supply to grow, showing once again that it takes a climatic event to get them to respond to the economy. (The last time was 9/11 when they finally got serious about rate cuts).

S&P Profits for the 4th quarter are expected to be high but much of that is from oil profits; indeed the markets would be down much more for the year were it not for the rise in energy, primarily oil, stocks. It is hard to see what high oil prices and profits do for most of the economy, although there is evidence that some of these profits are being recycled into bonds, which have helped keep bond yields down.

I have heard it said that this is a stock pickers' market. I think that is an oversimplification. Getting good results in this market is much more complicated. We are doing our best, and so far we have met with success, but there are many risks still in the market and the future road is far from clear

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