Rutherford Investment Management Newsletter: Period Ending 12-31-2005

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The "Jig" is up!

In conversations with clients at the beginning of this year, I said that I thought this year (2005) would be a difficult year for the markets; if the markets were up 3-5% we could count that as a win. Actually, for the year, the Dow was up 1.72% the S&P up 4.91%, and the NASDAQ up 1.37%. Fortunately we did better.

The reasons for the markets' disappointing results are well known. Rising interest rates, rising oil prices, lower money supply and the turmoil in Iraq are just a few of the reasons. The best performing sectors were gold, precious metals commodities, energy. Utilities and transports did surprisingly well. None of these sectors could be classified as classic growth stocks. Since we had energy, utilities and transports in our portfolio, along with health care and consumer stocks, we did well. As a result of the addition of energy stocks to our portfolio, we tended to migrate to larger cap stocks.

We have now beaten the market averages three years in a row, been rated among the top multi cap growth funds in the nation and we understand that in February, Barron's will list us as a Morningstar 4 star fund for the last three years, albeit as a mid cap growth fund. I think if we were rated in our proper peer group, multi-cap growth, we would have a higher rating given that other data bases have rated us as high as the top ten percent in the nation. We are proud of our results, but of course, they are all history and don't tell us at all how next year will go. We do have confidence in our process, however.

When I was a boy, I listened to detective stories on the radio, when the cops caught the perpetrators, they would often say: "the Jig is up!" The Jig, of course, was the misconduct the bad guys were engaged in. Today the "Jig is up", but it also means to me, "Just in time Greenspan".

After 19 years in office (what, no one else would hire him?) Alan Greenspan is retiring and leaving his successor a plate full of troubles. As Stephen Roach, Chief Economist of Morgan Stanley indicated almost a year ago, the problem won't be replacing Greenspan but it will be cleaning up his mess. On the day his successor was named, the market rallied 170 points.

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Supporters will say that the economy has grown for 14 quarters and that's a pretty good job. But most of that growth has come in the energy sector, driven by the high price of oil. Greenspan probably would not want to take credit for the high price of oil. The other driver has been low interest rates, which the Fed reluctantly granted after the Fed caused crash of 2000-02, where 2.5 million Americans lost their jobs and 8.5 trillion dollars in savings was wiped out. Americans' incomes declined two years in a row-something that had never happened before. Income disparities increased, and in 2005 Americans spent more than they earned, which has not happened since the great depression. The Fed decided to load the economic woes of the nation on the backs of American consumers whose job it was to spend our way out of recession. We did a good job! But we now have rising interest rates, rising oil prices, shrinking money supply, and a lack of political confidence.

The Fed is trying to staunch inflation. But if the Fed goes too far, the economy will weaken; indeed we have already seen evidence of that. Indicators show the economy softening. The yield curve has inverted. In the past three decades, the Federal Reserve has tightened eight times. In five of those eight times, the yield curve has inverted. In every one of the five cases, the economy has experienced a recession one year later.

Greenspan suggests this time is different. "The yield curve "is not a foolproof indicator of future economic weakness", he says. Of course, by the time we know the answer he will be gone--just in time Greenspan. Housing prices may fall. Never mind, says Greenspan, (in his what me worry mode) Americans can absorb that hit.

So if the Fed continues to raise interest rates, we probably fall into recession, especially if the price of oil continues to rise, and the money supply continues to shrink. The only way out is for the Fed to ease off on the interest rates, or take the brakes off the money supply, or both. These actions will of course have inflationary tendencies. So, the "jig" is up.

What will Bernanke do? To begin with, he has to show he is tough on inflation. But not too tough. Remember that Greenspan tried to follow Volker with get tough on inflation tactics, and the market plunged in 1987 with twice the biggest one-day drop since the Great Depression. Furthermore, any recession that appears from Fed missteps will arrive just in time for the mid-term elections. I don't think the party in power would like that. In addition four of the slots open on the FOMC for regional bank presidents changed on January 1, 2006; also, it seems likely that President Bush will get to fill two other Fed Governor slots. Thus I am inclined to think that Bernanke raises rates once or twice more, and then eases off. Indeed the recently released Fed minutes suggests that the Fed itself may be thinking that rates are high enough. Bernanke may begin by loosening the money supply too. We may well see a lowering of interest rates this year as the economy weakens. If that is the case, we could see a rise in both the equity and bond markets.

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Lower U.S. interest rates could affect the Dollar, as would rising U.S. inflation, so it is probably wise to diversify internationally.

Of course, as recent years have reminded us, there are many exogenous events that can disrupt any scenario, war, terrorist attacks, natural disasters, avian flu - the list literally goes on and on.

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