Rutherford Investment Management Newsletter: Period Ending 06-30-2006

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Headwinds Strike with Vengeance

At the end of January, 2006 our portfolios were up nicely and I commented off handedly that we should probably take what we had and call it a year, because I didn't think we would do any better for the year than we had already done. Indeed, the market continued to reward us up to May 10, 2006. Those of you who read my quarterly letters know that I have been warning of the headwinds caused by rising commodity prices, the falling dollar, the Federal Reserve interest rate increases and tightening of the money supply, serious budgetary deficits and geo-political/terrorist events.

The Federal Reserve was giving reassuring guidance up to and including testimony that Fed chairman Ben Bernanke gave to congress in early May. The market had some very positive up days. But that all changed when, at a lunch with Maria Bartiromo, Bernanke confided to her that the markets had gotten his testimony wrong. Apparently Bernanke forgot that he was talking to a reporter, and soon his casual aside was the top news story. The markets reacted with a vengeance, dropping sharply and continuing to drop all through May and, with little interruption, through June also. The Fed speakers in the meantime took to the luncheon circuit telling everyone that inflation was a serious matter and the Fed took it seriously and would take steps accordingly. This meant all chances of a rate increase pause raised by Bernanke in his congressional testimony were gone, and a rate increase was certain. It even raised the prospects of further rate increases. Soon, most of the market's gains for the year were gone - ours too.

During this decline we were actively selling and tactically raised a substantial amount of cash. We have reinvested some of this cash, but still carry what are for us substantial cash balances. Some stocks that we sold continued to decline. Some turned around and rose. While cash provides an anchor in a declining market, it also is an anchor in a rising market. A manager that looks good with cash in a declining market can look bad with cash in a rising market. But that is the kind of market we are in: increased volatility, increasing risk. So while I believe we are making some prudent investments, we likely will carry more cash than usual. When the market moves up, we run the risk of underperformance as well.

So now that the problems I have been forecasting have come to pass, what next? It seems to me the economy is slowing. That is probably not news. The questions are how deep and how long

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and these are much harder to answer. Two factors that will provide the answer are: Inflation and interest rate increases. Ben Bernanke did not invent this problem, he inherited it. Strong evidence of inflation goes back at least to 2004. During that time Fed chair Greenspan pooh-poohed inflation, until his reappointment was secure at which time he became an inflation hawk. Beginning from a base of a very accommodative monetary and rate policy, he began tightening, but the horse was out of the barn. As he left office, he handed the mess off to Bernanke and went off to gather speaking fees at $250,000 a pop. A falling dollar exacerbated the pace of inflation, since commodities are priced in dollars.

Bernanke inherited inflation and a slowing economy. He is hoping to tame inflation by slowing the economy with rate increases, without a hard landing. He is receiving no help from the price of oil and geo political events. Furthermore, when the secret minutes of the Fed meeting of March 2000 were revealed, we found out that one of the key staffers at the Fed was warning Greenspan that whenever the Fed had tried a soft landing, it usually resulted in a train wreck. (The minutes indicate that Greenspan dismissed this advice)

So, I see rough times ahead for the economy and consumers under pressure from rising oil prices and interest rate increases. I also see the markets under a lot of pressure. To counter this, we are maintaining a broadly diversified, defensive portfolio while trying to find opportunistic purchases. We will carry cash tactically and bonds opportunistically, where our instructions permit.

The Fed may continue to increase rates, but will be forced to cut them, probably within the next six months, as the economy slows. (The fear is that they overdo tightening.) Bonds will be more attractive then, and equities should also benefit. While the price of oil is skyrocketing because of supply-demand issues and events in the Middle East, I believe our new Treasury Secretary understands the importance of a strong dollar, and to the extent he has influence with the administration, may be able carry out a strong dollar policy. This would surely benefit us with respect to commodity prices and inflation. It should also benefit the markets. A continued weak dollar will not be good for this nation, our economy, or the markets. The sooner this is realized in Washington, the better we will all be.

As I have mentioned before, central banks all over the world are in a giant struggle with oil prices. They have been raising interest rates to slow the world economy. While they are slowing the economy they are not having much effect on oil prices. A notable example of rising interest rates is the central bank of Japan, which recently raised their interest rate from 0% to 25 bp. They have also been draining liquidity. Japan's problems go far beyond the scope of this letter, but suffice it to say that this increase will slightly deter the "carry trade" where big investors (not you and me) borrow money in Japan and invest it elsewhere. This will have some marginal effect on the U.S., but a larger effect on emerging markets.

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The next three to six months will require patience. It will not be nearly as much fun as the last three years. But once this work is done we should get back to better times. Of course there is the continuing risk of geopolitical and terrorist activities. A "financial accident" cannot be ruled out.

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