Rutherford Investment Management Newsletter: Period Ending 06-30-2007

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You can't blame Paris

Proving that crime pays, Paris Hilton was recently released from jail after serving a truncated sentence because of time off for good behavior (a first!). Well coiffed and turned out, she left the jail house, doing a reverse perp walk, into the arms of her family and publicists who delivered her to Larry King and other shows reportedly for cash. But you can't blame Paris because she was in jail when all this happened. And you can't blame Paris for the sub prime mortgage lending woes that have bedeviled the markets.

As the broad market returned to levels last seen in 2000 (the NASDAQ is still a long way from its top), we are reminded what a brutal market decline that occurred in 2000-2002. It took seven years to recover. Because of the concerns over deflation at that time the Federal Reserve, under the leadership of now Sir Dr. Alan Greenspan, lowered interest rates to near one percent. The plan was that consumers would load up with cheap money in the form of debt and spend the money, reflating the economy. The cheap money also had the effect of reflating the sub prime mortgage lending business. All this cheap money was very good news for Greenspan as the economy slowly recovered, and very good news for Wall Street which made a lot of money bundling the mortgages into securities which, with the help of the bond rating agencies, could be sold as quality goods.

Greenspan was cautioned about the sub prime loans by at least one of his own Fed Governors, according to Edward Gramlich in his recent book regarding his term as a Fed Governor, but Greenspan rebuffed Gramlich, and any regulation. Now of course the loans have come a cropper and no less than the SEC is investigating the process and the firms that sold the loans. Many of the loan originators have gone out of business. Only a pulse and a pencil was required to obtain the loans and now tens of thousands of "homeowners" stand to be evicted from their homes, and perhaps two trillion dollars will be lost as foreclosures hit records. Even Bear Stearns, one of the firms that sponsored funds for loans that were sold to investors, said they would pony up $3.2 Billion of their own money to bail out the funds, but then Bear reneged when it became obvious that $3.2 Billion was not enough. Now the markets, both bonds and equities, are left to wonder how big this problem is going to get. And, Ben Bernanke has yet another headache to deal with as the ghost of Greenspan past has left another mess for Bernanke to clean up.

Bernanke will need a large aspirin for this headache as the economy fizzled last winter growing at only a 0.7% annual rate last quarter, dangerously close to recession. This was the slowest rate of growth in years. Most analysts think the worst is behind us and that the economy will resume a more normal growth rate of 3.0-3.5% by the fourth quarter, unless of course the housing problems spread, as they seem to be doing. But with the Kansas City Fed announcing that their index of manufacturing activity fell to minus 2.0 in June from a plus 20 in May, one wonders about the strength of the analysts' projections.

If this was not enough to worry about, inflation remains stubborn and both food and energy costs are rising putting pressure on consumers everywhere. With oil topping $70.00 per barrel and wheat, corn, meat and milk prices rising; scarcities have begun to appear.

What is the Fed to do? With the obvious fix for housing and a slowing economy being lower interest rates, and the obvious fix for inflation being higher interest rates, the Fed will likely do nothing and hope for the best.

Our portfolios last quarter reflected this indecision of the markets and the Fed. Volatility was elevated and portfolios whipsawed. Normally conservative stocks like Utilities and Banks suffered because of the changed expectations on interest rates. Fixed income suffered for the same reason. Healthcare was surprisingly weak. Energy suffered because of the expectation that prices were as high as they could get and would come down because the economy would cool.

We expect the next few quarters to be difficult, but we may see a mild upturn in the fourth quarter if the housing problems are contained. Probably most of the money that is going to be made this year has been made already. We plan to continue on our cautious path, even though that has penalized us to some extent in performance. Until the resolution of the problems I have mentioned get sorted out, we will remain cautious believing that is in the best interest of long term investors.

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