

C *Economic & Market* Commentary

Mr. Toad's Wild Ride

Whether the last time you visited Disneyland was as a kid, a parent or a grandparent, you probably didn't escape without a visit to Mr. Toad's Wild Ride, one of the few original attractions remaining from the park's grand opening in 1955. Based on the 1949 adaptation of the 1909 story, "The Wind in the Willows," the manic, two-minute spin through foggy London Town tells the tale of how Mr. Toad's insatiable thirst for motor cars disrupts life along the riverbank and in the Wild Wood.

In any environment there are disruptions to the status quo that cause you to continually re-evaluate where things are going -- the financial markets are one such environment. The disruption making headlines during the last part of the quarter was the rapid rise in long term interest rates, which took the yield on the 10-year Treasury from 4.5% in March to a 5-year high of over 5.25%. Notwithstanding the wild ride that long-term interest rates have had in the last few quarters, our view has not changed. We still think that the Federal Reserve Board (Fed) "got it right," that long-term interest rates should trend up, and the Fed's next move may not be a rate cut. The Fed has shown tremendous patience over the last 12 months waiting to see the impact of prior rate increases, which slowed the economy and moderated inflation, while long-term yields continue their trek higher.

On the labor front, we are fast approaching the low levels of unemployment that we experienced in 1999, which were the lowest rates of the last 25 years. Looking forward, low unemployment levels will be a persistent problem for the U.S. economy, as demand for qualified workers is outpacing domestic supply. While that may sound absurd, without both immigration and outsourcing, unemployment rates would be even lower, causing labor costs to rise faster than they already have, resulting in higher inflation rates. This shrinking pool of qualified workers is also keeping a lid on domestic job creation, as firms evaluate the long-term risks and costs associated with creating domestic jobs versus outsourcing the same jobs to a lower cost region.

Inflationary "hot spots" such as food and gasoline, combined with persistently higher prices for many base commodity materials and rising labor costs cause concern for many economists. One of the worries is whether "stagflation" will stage a comeback this decade. Concerns about such a combination of inflation and slow growth spill over into the financial markets as both affect growth and valuation estimates of stocks and bonds. Typically, productivity increases can offset cost increases, but when economic growth slows, gains in productivity shrink, and cost increases flow through to the rest of the economy in the form of either reduced profits or increased selling prices. As the financial markets digest this issue, expect more sharp turns in both the bond and stock markets.

Bad news on housing and real estate will continue to be with us for at least the rest of this year. Expect more ugly stories about falling prices, rising inventory of unsold homes, foreclosures, and earnings disappointments from firms involved in these markets. With the amount of debt used to finance real estate transactions, rising interest rates will further exacerbate the problem. As the real estate related markets continue to contract, labor demand in these industries will fall, and the displaced workers will filter into other industries expanding their workforce, neutralizing, to some extent, the negative effects on employment. As we have stated in previous Commentaries, the combination of sub-prime lending woes and lack of appreciation in home prices creates a negative impact on retail spending, leaving job growth as the sole driver of domestic consumption. The revenue growth of consumer cyclical companies is certainly coming from a much narrower base than it has been in the past, making it more difficult for many companies to show favorable earnings growth rates and comparisons to prior years.

It has been a long road back from the turn of the decade “Nightmare on Wall Street.” Stock prices (excluding NASDAQ) have regained all of their losses, but corporate earnings are roughly 50% higher as measured by the S&P 500 index, and the yield on the 10-year Treasury bond is still almost a full percentage point below the 1999 high of over 6.50%. Based on present data, the markets offer a better value now than at the turn of the century. While we don’t think that all roads lead to a collision with a speeding locomotive, in a pitch-black tunnel, in London Town, we do think careful consideration should be given to the impact rising global interest rates and a falling U.S. dollar will have on portfolio performance.

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