

# C *Economic & Market* Commentary

## Is the glass half empty or half full?

Opinions change from day to day; one guru says the sky is falling while another claims it is time to buy. This divergence, we believe, is caused by a basic disagreement regarding economic issues. Some believe that we are headed into an inflationary period, others believe we are headed into a Federal Reserve induced recession, and still others are predicting a repeat of the stagflation experienced during the 1970's. This wide spectrum of opinions results in wide ranging investment markets.

The recent market volatility simply reflects the changing opinions of the market participants based on the latest piece of economic news. A general understanding of the implications certain economic conditions have on the markets should lead to a higher comfort level with the recent market action.

If we are headed into **rising inflation**, generally, one should avoid bonds, as interest rates will be expected to rise, and focus on what we call inflation resistant investments. These types of investments would be oil stocks, real estate and other industries where price increases can easily be passed on to consumers. There are two keys; focus on firms which grow sales and earnings independent of inflation, and those that are attractively priced based on the discounted value of future earnings at higher inflation rates.

If we are headed into **recession**, generally, one should own longer-term, high-quality bonds, as interest rates will be expected to fall, and focus on what we call recession resistant investments. These types of investments would be consumer staples, healthcare related firms, and other industries and companies whose earnings are not as dependent on economic growth. The key is to focus on quality and stability, as investors will pay a premium for these qualities during a recession.

If we are headed into a period of **stagflation**, a condition which combines price inflation with a stagnating economy, it is the worst of both worlds. In this environment, one should generally avoid long-term bonds, as interest rates could rise, and focus on what we call all weather investments. Drawing reference from the 1970's, these types of investments would be oil stocks, basic material and capital goods type companies, selected real estate, and other industries where sales growth is not dependent on economic growth or hampered by inflation. Money markets, while not typically considered an investment, perform quite well during this type of economic environment, and help investors preserve capital to invest at better prices.

Technology has improved the access to information and quickened its analysis so that investors are able to react faster than ever before. This shortened reaction time has been partly responsible for the increased volatility of the financial markets. This results in the traditional 50 and 200 day moving average

benchmarks being violated more often, without disrupting the true trend of the markets or a company's stock price. If one widens the normal trading range and lengthens the moving average periods, things look a little calmer.

Without getting into an economic dissertation, many economic forecasts are tied to what Federal Reserve Chairman Allan Greenspan will, or will not do, in the future. Our view is that he should ultimately realize that economic growth in and of itself is not inflationary, and that the risks of overtightening are greater than the risk of running modest inflation. In turn, as the consensus view regarding the future of the economy narrows, the financial markets should become less volatile. The United States could have one of the best economic opportunities in the last 50 years ahead of it. Just as we believed the stakes were too high for world leaders to stand idly by in October 1998, we believe cooler heads will prevail at the Federal Reserve, bringing an end to the inflation witch-hunt, and preventing long-term damage to the U.S. and world economies.

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