

C *Economic & Market* o m m e n t a r y

Across a Clouded Valley

Looking across a valley between two mountains on a clear day gives you perspective as to the depth of the valley and the height of the mountains. On a cloudy day, one cannot make an accurate estimate of either – such is the case with the current market. As the clouds have moved in, we have seen an abrupt slowdown in capital spending, and a number of announced layoffs. As the ripple effect of this slowdown hits other sectors, experts are concerned about the lagging impact these events will have on consumer confidence. Since consumers account for almost two-thirds of our economic growth, this is a valid concern.

The recent monetary action and tax cut discussions have been in line with our expectations, but the movement in the markets has not. Some feel the Federal Reserve should have cut rates earlier, and some feel the cuts should have been larger. We have seen some encouraging (or less discouraging) signs from leading economic indicators that point to a bottoming in the economic downturn. While we believe that the current direction in fiscal and monetary policy will eventually provide the lift we need, the confidence levels of company officials and investors must be restored, and that may take some time.

Economic uncertainty causes firms to slowdown spending plans, and “just in time” inventory management causes inventory levels to correct quickly. Ripples throughout related industries occur faster than in the past, and while there is a capital spending slowdown, it has not yet caused the consumer to slam on the brakes. Nonetheless, these ripples have resulted in reductions to future earnings estimates for many companies. These reductions have pulled stock prices lower across the board. In short, there has been no place to hide.

I have mentioned the word “stagflation” and the “decade of the 70’s” from time to time, which represented a period of slowing economic growth, rising inflation, and P/E compression. Economic issues we had to contend with during that period were a weak currency and rising federal debt, just the opposite of our present situation. We still don’t believe stagflation is on the horizon, but the fear of it has captured the market.

Time will tell whether the current policy will be sufficient to clear the clouds out of the valley, or whether further action is required. Markets hate uncertainty, and participants have become impatient and have found more reasons to sell than to buy. As your portfolio managers, we have successfully used the tools of asset allocation and diversification in the financial markets to reduce the volatility associated with these periods. Further, we have made an effort to focus on companies with healthy recurring revenue streams. Ultimately, we believe companies and investors will look beyond the next two quarters and take a longer-term view of their investments. When they do, you will own a portfolio of investments that should reward you well over the longer term.