

C *Economic & Market* Commentary

World Cup Fever

Every four years since 1930, except during WWII, soccer fans from around the world have rallied behind their favorite soccer team. In 1928, Italy, the Netherlands, Spain, Sweden and Uruguay formulated the idea of a world soccer competition, and two years later, the back-to-back Olympic soccer champions Uruguay hosted the first ever World Cup in 1930. Today, this month-long competition is a daily infatuation of many Europeans and is fast capturing the attention of many in the United States.

Much like rabid soccer fans, investors have been infatuated with comments (both on and off the record) of Federal Reserve (Fed) officials over the last three months. Questions about the timing and magnitude of Fed policy have kept many participants on edge, resulting in rather skittish markets. While the focus is on the non-stop Fed Fund increases, which are at 5-year highs, it is important to note that we are still near some of the lowest Fed Fund rate levels in the last 40 years. The most recent $\frac{1}{4}$ point increase has brought the Fed Funds rate to 5.25 percent, which is near the levels of the late 1990's. Recently there have been steep declines in the price of gold, silver, aluminum, lumber, and natural gas, and slightly lower prices or stabilization in the price of many other commodities. The recent downturn in commodities should be of keen interest in determining the "evolution of the outlook for both inflation and economic growth, as implied by incoming information" (quoted from the Federal Reserve's 6/29/06 meeting). So far, the Fed has been playing good defense, as higher energy costs have not yet had a meaningful impact on core inflation. Gauging when to stop tightening is difficult due to the 12-18 months it often takes to see the effect of a rate decision on the economy. If commodity prices stay contained, this could make decisions in that regard much easier.

While some of the indicators of economic growth support a slowdown from the breakneck pace of the past two years, the latest revision of first quarter Gross Domestic Product (GDP) came in at an annual rate of 5.6 percent. Granted, that figure contained pent-up business activity deferred from the fourth quarter of 2005, but the average rate of 3.65 percent annualized growth over the last two quarters remains well above the 20 and 30 year average growth rates. Supporting this growth are healthy gains in employment and income growth, but questions remain on what impact higher lending rates will have on mortgage equity withdrawals, which have fueled plenty of consumer spending over the last few years. Some argue that job and income growth will offset any decline in home equity based consumption, but none argue that a slowing housing market combined with any disappointment in job and income growth figures and persistently high energy prices will create a problem. That is one of the risks to continued, and above average, economic growth.

The markets have been mixed. After putting in a solid first quarter, the S&P 500 Index dropped for most of the second quarter although a strong finish left it down only 1.44 percent for the quarter and up 2.71

percent for the year. In the face of continued short-term interest rate increases, the Lehman Brothers Government/Credit Bond Index lost another .15 percent this quarter, leaving it down 1.24 percent for the year-to-date.

We have stated for quite some time that the business sector has much more capacity to invest than has been evidenced. Debt ratios are low, and many companies are loaded with cash, as their net cash flow to capital spending ratio continues to be at its highest level since the post-war era. Simply put, it seems to be a question of when, not if, businesses will begin investing their accumulated capital. During the last recession, the business sector was quiet while consumer and government spending kept the economy from falling into the abyss. It is time for businesses to step up to the plate!

Overall, economic growth is not the markets' problem at present; shrinking valuations for corporate earnings are. The price to earnings (P/E) ratio has declined steadily since the stock market began its recovery in mid 2003. While earnings have risen just as steadily as the P/E has declined, the combination of the two has led to a rather sporadic and lackluster broad stock market performance. Some of the decline in valuation metrics may be a result of peaking inflation pressures resulting in lowered estimates for "real" (after inflation) earnings growth rates. Economists are adept at calculating *real* GDP by deflating "nominal" (pre inflation adjustment) GDP growth, while equity analysts mostly forecast *nominal* company earnings and growth estimates (including inflation), so the markets are left to place a value on *real* earnings and growth rates. At present, the markets remain focused on inflation and the Federal Reserve. Should either reveal lower inflation expectations with continued economic growth, you may expect stock valuations to improve.

As pointed out by fellow economist Jim Paulson, every recession since 1960 has been associated with a Fed Funds rate above the rate of nominal GDP growth. Today, nominal GDP is about 2 percent above the Fed Funds rate. This would mean that despite the 17 straight rate increases, the Fed may have the ability to raise rates a bit more before choking off the economy.

For the World Cup fanatics, while the markets have perked up after the latest Fed meeting, they have still handed Fed Chairman Bernanke a yellow card* and are watching policy actions closely. We would hope that he avoids picking up the dreaded red card, and is able to communicate a sensible direction for Fed policy that is supportive of continued economic growth and price stability.

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**A yellow card is a warning issued from the referee to a player for a flagrant foul. A red card is issued when a second flagrant foul is committed by the same player, or a purposely flagrant foul is committed, the red card results in the ejection of the player from the match.*