

C *Economic & Market* Commentary

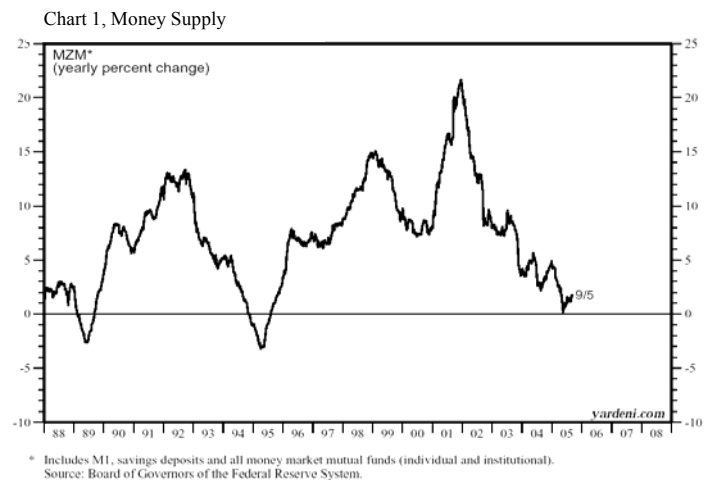
Riding the Storm Out

Recent headlines have centered on Hurricanes Katrina and Rita, the price of oil, and the Federal Reserve's interest rate policy. These issues have also dominated discussions regarding economic forecasts, leading some to conclude that they will slow economic growth to near zero in 2006. Others conclude that while the natural disasters will have a negative impact through the end of this year, 2006 should benefit from rebuilding efforts.

Damage incurred by the recent hurricanes will be paid for by a combination of private insurance companies, the federal government's flood insurance program, the federal disaster relief program, charitable giving, and funds from the pockets of those choosing to live in harm's way. These events have stalled economic activity in the region, and have impacted the supply chain for many industries.

Oil prices remain high as global demand remains at high levels and interruptions caused by the hurricanes have reduced domestic production. As indicated in Chart 1, the Federal Reserve Board has been tightening the money supply, and continues to push short-term interest rates higher, reversing the accommodative moves made during the last recession. This strategy is intended to limit the spread of commodity-based, demand-driven inflation by forcing price increases in one area of the economy to be offset by price decreases in another. The combination of these issues has presented a challenge for consumers, as unchecked spending trends have led to the first negative reading in the personal saving rate in many years, as well as a recent, rather steep drop in consumer confidence.

Healthy spending by consumers and the government pulled our economy out of the last recession. This time around, consumers are not expected to be the economic catalyst, as we expect continued measured spending and investment by businesses, combined with a government injection to rebuild areas affected by natural disasters, to lead the way. Currently, businesses have begun to carry their own weight, but if consumers beat a fast retreat, something will have to fill the void just as quickly. Capital investment by businesses is growing, companies are borrowing, banks are lending, jobs are being created, and there is more room to grow.



While the equity markets have traded in a fairly narrow range this year, energy related issues have led most every other sector in performance. We expect this leadership to change, as a continuation of rising oil prices and rising short-term rates should slow global economic growth, reduce to some extent global demand for oil, and thereby reduce the excess profits attributed to this commodity. However, it is a challenge to hold this conviction, in the wake of Katrina and Rita.

The stock markets have been essentially flat for the last eight years, despite record profits for the S&P 500 companies. Stocks have encountered intense competition for investment capital from real estate, battled persistent doubts about future economic growth, and faced a series of distractions ranging from typical global relations, lingering Middle East issues, and good old Mother Nature. As mentioned in previous commentaries, flat periods in the stock market happen, and historically have always created a good opportunity to own decent businesses at decent prices. Currently, the stock markets are acting more like a measure of current sentiment than a measure of future expectations.

Over in the bond market, the 10-year Treasury bond yield has not strayed far from 4.25 percent, despite 11 straight increases in the Federal Funds rate and ongoing concerns about inflation. Global trade related issues have created demand for US Treasury bonds, which in turn has kept a lid on interest rates, but ultimately, longer-term interest rates should move a bit higher to reflect a proper risk/reward level for a fixed income investments.

These imbalances in the stock and bond market should sort themselves out over time unless we have a Federal Reserve induced recession. Having fought so hard to coordinate economic, fiscal and monetary policies to pull the economy out of the last recession, it seems unlikely that the Fed would allow that work to be undone so quickly. One issue that will need to be sorted out in the coming months is how the disaster relief efforts will be paid for. The options we see: higher Federal revenues (preferably from increased growth, not increased tax rates), reallocating the Federal budget, or more deficit spending. Of the three, we think reallocating the current budget may be the most political savvy move...stay tuned.

Steve Taddie
Managing Member
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