STELLAR CAPITAL MANAGEMENT, LLC

Economic & Market Commentary

Inflection Point?

The question on many minds is whether we have witnessed an inflection point in inflation, interest rates, and stock market valuations. It's a good question since the Federal Reserve ("the Fed") has not felt the need to continue raising interest rates, taking no action in the last two meetings, after 17 consecutive increases. In their capacity as manager of the nation's monetary policy, their goal is to maintain maximum employment, stable prices and moderate long-term interest rates. Their inaction in the last two meetings indicates that they see a potential inflection point, and current economic data support this view. If this view changes, we should expect Fed action to resume, accompanied with a meaningful change in the language of the minutes of the Fed meetings.

The year-over-year Producer Price Index (PPI) growth of 6.9 percent in September 2005 represented a 15-year high, but it has since fallen off to 3.7 percent in August. The "core" PPI rate (excluding food and energy) posted a decade high of 2.8 percent in July 2005, but has fallen to just 0.9 percent in August. The directional trends have turned toward lower for intermediate and finished goods while core crude goods prices (mostly metals) reached a multi-decade high in July. The year-over-year rate of the Consumer Price Index (CPI) reached a 14-year high of 4.7 percent in September 2005 as well, but has fallen to 3.8 percent in August. However, the Fed's favored inflation measure, the core Personal Consumption Expenditures (core PCE) price index rose to a new cyclical and 11 year high of 2.5 percent year-over-year in August. While these figures are well above the theoretical targets of the Federal Reserve, if the price trends of crude goods (which have driven inflation higher) continue to recede, these price indexes should fall.

Since the most recent peak, the price of many of the commodities known as the building blocks for economic growth have dropped substantially: crude oil is down 20 percent, gold is down 14 percent, copper is down 17 percent, and natural gas is down 40 percent. Analysts at many Wall Street firms are lowering profit expectations for many commodity-based companies. With this in mind, we believe that if current trends continue, reported inflation should drop over the next few quarters. The extent of the drop will depend on how much permanent inflation has been built into the system over the last few years. The market reaction to these events has been to send interest rates on the 10-year Treasury bond from 5.3 percent to 4.6 percent and the S&P 500 from 1240 to almost 1340, creating good times for both bond and stock investors.

As we have discussed in previous *Commentaries*, the markets have remained focused on Fed action and inflation. As commodity price advances have remained contained, inflation expectations have been lowered, and the Fed has stopped tightening. The markets have noticed, and reacted accordingly. The nagging problem for the markets over the past few years was the valuation of future earnings. Companies logged decent revenue and earnings gains, but fears of continued increases in inflation reduced the value assigned to those future earnings, keeping a lid on stock price appreciation. A return to stable or perhaps rising valuation levels would be a nice change, and would benefit both stocks and bonds.

Frankly, we felt the Fed was pushing the upper limits on the Fed Funds rate, but in the end, its Chairman, Big Ben Bernanke may have gotten it right. While the year-over-year economic growth numbers are still healthy (with the exception of the Philadelphia Fed Manufacturing Index), the last couple of economic releases indicate a slowing from the prior month’s activity, and last quarter’s Gross Domestic Product report was revised lower from an annual rate of 2.9 percent to 2.6 percent growth, a healthy rate by European standards, but a little lackluster when compared to the U.S.’s multi-decade average growth rate of approximately 3 percent. These developments have accentuated the market’s focus on whether past Fed rate increases will continue to hamper future growth. One would hope that economic data in the ensuing months will show improvement, just as business and consumer confidence and sentiment have shown and should continue to show improvement. If this is the case, Fed policy could remain neutral. As we “wait and see,” corporate earnings and international issues will likely take the limelight in the coming months and economists will re-evaluate future economic growth and inflation rates.

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