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Resolutely Ambivalent

Oft expectation fails, and most oft there where most it promises – William Shakespeare

I attended an investment conference for two days last week and had the opportunity to listen to some very smart folks give their opinions on the state of the economy and the direction of the stock and bond markets. Leaving the conference, I was reminded of the childhood game wherein one group of kids is shown an object and then has to describe this object to a partner in another group of children who then has to draw the object. If you've ever seen this game played, you know that the pictures drawn bear little resemblance to the original object, *or* the pictures drawn by the other children. Such are the pictures of this economy.

In the glass half-full camp, proponents will point out the following: Although the economy is slowing, it is still growing at over 2%. Inflation both domestically and abroad is restrained (global inflation is at about 4%, a 10 year low). Corporate balance sheets are the strongest in 40 years (corporate cash balances are at about 5%, the highest since 1963). The unemployment rate is near 30 year lows (approximately 4.6%). Price Earnings ratios are at average levels (currently about 16 versus a 47 year average of 16.14%). And stocks typically perform well when the Federal Reserve eases interest rates (in the eight episodes starting in 1966 of Fed easing, large-cap stocks returned an average of over 20% in the year following the mid cycle easing efforts).

From the "who drank half my beer?" contingent you will hear such things as: The consumer is weakening (current retail spending is up 4.3% over last year, but down significantly from the 7% growth in 2006, and this number continues to fall). House prices are on track for the first recorded decline *ever* since this statistic was first followed (June's numbers showed a 1.6% decline from last year). The inventory of unsold homes (vacant units) is at an all time high of 2.1 million (the previous high was in 2002 at about 1.35 million). Subprime Adjustable Rate Mortgages are set for significant resets (read: interest rate hikes); over 30% are set to reset in 2007 and another 26% in 2008. And finally, the old inverted yield curve - a measure of long term interest rates versus short. In a normal environment, long term bonds pay higher interest rates than short, but not so in the current market. The yield curve has been inverted since 2006. This has accurately predicted a recession 6 out of 6 times (that's 100% for those without a calculator).

One of the things I've learned in 25 years is that as soon as you start thinking you're smarter than the market, you're bound to get your head delivered to you on a shiny platter. We are currently pursuing the following themes: Overseas investments in equities and bonds should continue to perform both in the face of a weakening dollar and higher growth rates abroad. Energy prices should ease somewhat, but probably never back to the good old days of $35 per barrel. Large company stocks, which have underperformed small stocks since 2002, should outperform going forward, and growth stocks which have lagged value stocks for the same period will also outperform. And finally bonds, which have recently been as sought after as halitosis, will come back into favor again. But of course, being absolutely irresolute about the future, we will continue to hedge portfolios against our own hubris.

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