



2008- It's All About The Fed Jan. 11, 2008

As we enter 2008, there is a great deal of market concern about deteriorating credit quality, the decreased ability and willingness of financial institutions to lend money, and the effect of these things on economic activity. Wall Street seems to be much more concerned than the Fed with the potential fallout from the ongoing credit crunch. Wall Street's criticism of the slow Fed reaction to the credit markets and economy has left the Fed with an apparent resentment of Wall Street. At one point the Fed stated that Wall Street will not run monetary policy and they will not bail out Wall Street. This may reflect a desire on the part of the Fed to prove to the market that the "Greenspan Put" of dramatic responses to declining asset prices is no longer valid. The risk is that this ego contest will prevent or delay the appropriate monetary policy reaction to this slowdown. The enclosed picture from Citigroup technician Tom Fitzpatrick depicts the attitude of the Street. It is a picture of Bernanke fiddling while "Rome burns." We must confess to our own frustration with what has appeared to be an obvious need for aggressive monetary easing. Finally, on January 10th, the Fed blinked. The indication from Bernanke was that the Fed has caught on. This means a rate reduction of 0.50% on January 30th instead of 0.25%. The problem is that this cut may be "too little too late" to affect the economy enough to prevent a damaging slowdown / recession. More cuts are on the way which will eventually usher in another bullish cycle in stocks and the economy, at least until the market begins to factor in the implications of the election results for protectionism and higher taxes in 2009. This is a 2009 problem which we will analyze in further detail in the future. In the meantime we are focused on getting from here to there intact.

The sub-prime price decline, which started this financial cycle, was not over as fast as we thought it would be. Wall Street does price securities very quickly to reflect problems, but the problems are still developing. To compound the issue, the economy shows broad signs of a deceleration. Whether we have a recession or not has become moot. It will either be a very mild recession or a very severe slowdown. Either way, markets are beginning to react accordingly to the first decline in S&P 500 earnings in five years. This year is going to be difficult. Success will depend on anticipating and moving decisively, rapidly changing sector weights as well as asset allocation.

The first half of 2008 will have the weakest economic growth in five years. If there is to be a recession, we are upon it now. Our concern is that the majority of Wall Street analysts have not changed their earnings expectations. Earnings should be very disappointing for the fourth quarter just ended and perhaps the first quarter of 2008.



Contrary to those that believe that the market is prepared for this, every hint of an earnings shortfall has sent the stock in question straight down. Financials will continue to have it rough. Retailing, and to some extent, Technology, will report bad earnings. Consumer Staples, Health Care, Energy, and Materials are the place to be for now.

The US is clearly slowing down, and leading indicators show that the Global economy is beginning to slow as well. Europe is still tightening money due to inflation fears, but will follow our Fed soon as their weakness becomes more apparent. China has been tightening credit very aggressively. This, coupled with their trading partners buying less Chinese goods, will hurt their exports and will eventually slow their economy. The Global disappointments are a few quarters off, but the exporting industrial stocks are just beginning to reflect the inevitable. The industrial stocks that have done so well due to exports will weaken until we are through this. Eventually this will hit the commodity stocks too like copper, steel, and chemicals. Slowing world demand will also break oil's climb and oil should retreat back below \$80 a barrel. The dollar will be part of this drama. After reaching the low levels that it has, it will start to trade sideways and eventually go up. It is important that the dollar does not suffer from a bout of inflation. With a slowing economy, inflation will not be a problem. Therefore, the purchasing power of the dollar will not be undermined and this will eventually be recognized. The dollar is cheap. As this becomes apparent, gold will follow the other commodities down in price. This will complete the cycle.

By the time gold cracks, the early cycle stocks will probably have begun their new bull market. As Fed easing finally takes hold, the interest-sensitive stocks will recover. This will happen after they report their bad earnings and we work through more of this credit problem. Financials, then Retailers, will lead the market up in the second half of 2008 and as evidence of Global growth re-accelerating occurs, it will be back to Technology, the Industrials and finally the Materials again. We expect all of this rapid rotation to happen over the next year or so because the slowdown / recession will be shallow and over quickly. Throughout it all, there will be a few key themes or rules to follow:

First, until the market starts to discount the recovery and cheaper credit, stay away from small companies as a general rule. Small Cap is the wrong cap. The big liquid stocks will be the place to be for a while. Defensive areas like Health Care, Consumer Staples, and non-cyclical companies will work for the next several months. Recessionary overtones will permeate all investment themes. The US will be the first into the malaise, and the rest of the world will follow. Then the US will be the first to re-accelerate, and our trading partners will do likewise.



Second, the most important thing is to meet earnings expectations. Owning companies that do not disappoint in their earnings is critical. Volatility and sharp market declines over the next few months will be driven by major earnings disappointments. Predictable and defensive stocks are the way to get through this period.

The market in 2008 will be weak at the beginning and stronger as the year progresses. Having a slight underweight in stocks for the next few months is prudent. The stocks that outperform at the early part of the year will not be the performers at the end. Growth stock exceptions that are insulated from the domestic and global economy will be very valuable. Weakness in the S&P 500 below 1300 will represent a good area to increase stock weightings and rotate into more aggressive holdings.

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