



A Cold Winter Approaches

By Peter D. Scholtz
October 18, 2005

Regardless of which index is measured, the market's returns this year have been minimal. This is a direct reflection of a slowing economy leading to investor's apprehension about the future course of corporate earnings.

High energy prices, inflationary pressures, and Fed policy have been the primary underlying causes for the slowing economy and corporate earnings worries. The front and center cause for concern has certainly been high energy prices. Although the economy is not as dependent on oil as it once was, the high oil prices still cause a drag on economic activity, as consumers are robbed of some disposable income. Inflationary pressure created by these energy prices has worked through most of the system to raise the costs of various raw materials (i.e. chemicals and plastics), but has not yet reached final consumer goods or wages. Furthermore, the Fed has been raising interest rates to a point that it too might decrease economic activity, especially in the housing market. The governmental debt situation does not help much either. Katrina has left the state of Louisiana in need of \$200 billion to repair the damage. The government deficit was estimated to be \$450 billion in the current fiscal year and was revised to an estimate of \$330 billion earlier this year. Now that number has increased back to over \$500 billion as the rebuilding in Louisiana begins. Spending on Iraq also strains the government's wallet as well as people's patience. These problems combined with some other issues have resulted in the President's approval rating hitting low levels. Clearly, people are feeling pretty bad about things, but we suspect that the despair is becoming a little overdone.

Over the last several years, the consumer has relied on the rising value of their homes to generate wealth and disposable income by increasing the size of their mortgage to tap the added equity. However, it appears that the housing market is finally feeling the effects of both higher interest rates and much higher prices which can no longer be sustained by consumer's modestly growing income. The positive effect from the cooling housing market is that the Fed might stop raising rates. The primary reason the Fed increased rates initially was to prevent a housing bubble and subsequent crash. As the housing market subsides so will the Fed's desire to raise rates. We consequently welcome the slower housing market as it ultimately has positive implications for interest rates and the entire economy. At some point, the Fed might even lower rates.

Despite the negative pressures the economy faces, there are several positive economic factors beyond the cooling housing market that must also be considered as a foundation for extended economic growth. First of all, the economy does have excess resources in the form of unused manufacturing capacity as well as a slack labor market. This mitigates any concern over

rising wages. Second, competition from overseas will prevent many companies from raising their prices. Their solution has been an increased effort to boost productivity and lower costs. This should help prevent any sustained wage-price spiral. Furthermore, energy prices, although currently high, are simply not sustainable in the longer term. The oil experts believe that a long-term equilibrium price for oil is around \$40 a barrel and \$7 for natural gas. Oil is currently at \$63.70 and gas is at \$13.50 per thousand cubic feet. These prices will slowly wane as new supplies increase which usually takes a year or two. In the meantime, this winter should see spot shortages with gas prices possibly spiking up to \$20/mcf before subsiding in the spring. The point is that prices will peak in 2006, setting up some positive news as energy prices decline. Finally, of direct importance to equity valuations, corporations are stockpiled with cash at unprecedented levels. As a result, they have increased their dividends and bought back stock, but are still sitting on the bulk of this reserve. A decline in the market will therefore be controlled by companies eager to purchase their own shares or potentially another company. For this reason, mergers and acquisitions should increase in the coming months.

The market has reflected a “less growth means less profits” outlook and has remained weak, but the economic slowdown will not last. The slower housing market will take pressure off of interest rates. The declining energy prices will take pressure off of inflation, putting more money into consumer’s pockets. Spending on New Orleans will not go on forever and if the economy grows, the Federal deficit should once again dip below \$400 billion. A reduction of troops in Iraq could also have a large effect on consumer sentiment. As these events occur, the economy should accelerate and the market should put in a strong move, reflecting this anticipated economic shift. The timing of this is tricky so it pays to go slowly and not resist the market’s movements. There could be another swoon between now and next spring, but by the end of 2006 we expect the S&P 500 to be over 1450. It is currently at 1183.