



## ***A Troubled Market***

By Peter D. Scholtz  
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The international scene is depressing. Iran has threatened to cut off oil supplies, driving energy prices higher. At least, however, Iran has failed so far to provoke us into attacking their nuclear facilities. Attacking them would motivate terrorists to sneak into Iraq and attack US targets. Our restraint has forced them to get what they can at the bargaining table. Killing al-Zarqawi is a victory at the margin, but Iraq still teeters on civil war.

The picture throughout the rest of the world is equally disconcerting. Chavez has sent Venezuelan advisors to the new populist leader in Bolivia. Now, the Venezuelan leader is expanding his anti-American influence. Bolivia has already seized oil properties from foreign companies – an aggressive move that has Brazil in disbelief. Africa has had such violent disruptions that oil and copper producers have seen production fall dramatically. And does anyone even remember that North Korea is supposed to be a major problem with its nuclear program? If you have forgotten, you can always focus your anxiety on the terrorists recently arrested in Canada or the inevitable arrival in the US of the Bird Flu. Now how about hurricane season?

Beyond geopolitical risks, global monetary policy is also worrisome. The Central banks around the world have been raising rates led by the US and its' rookie central banker, Ben Bernanke. Some of the smaller countries have also followed suit and raised interest rates just to prevent their currency from crashing. Thus, there is a fear that the world economy might be slowed to a crawl or even slip into a world recession if the central banks are not careful.

Domestically, the political scene is still ugly and high gasoline prices are affecting consumer as well as voter attitude. The Fed has failed to miss a rate hike at each meeting and investors are worried that the Fed may go too far. The most recent Fed meeting revealed a split in opinion among Fed board members. Some thought that with the current economic slowdown, they should not raise rates and others thought that they should be raised a half point to curb inflation. They settled on a quarter point, but the message is that the Fed is confused and a dichotomy of opinion prevails at the central bank. Inflation is rising, but the economy is already slowing down. The housing market is rapidly cooling off. Housing supplies have increased, demand has slowed due to higher interest rates, and prices are up less than three percent nationally versus a year ago. Finally, in a show of solidarity several Fed members last week publicly announced the Fed's key concern is the risk of higher inflation. The markets routed again in predictable fashion.

Now before you leap, let me attempt to talk you off the ledge. The fact that several Fed Presidents showed unity in their inflation concern is actually a positive sign. It reminds one of Greenspan's "irrational exuberance" comment that was designed to "talk" the market down INSTEAD of raising rates. The Fed is trying to talk the economy into slowing down by hitting the stock market and making CEO's hesitate before expanding their business and hiring more people. I am sure they will raise rates again in late June, but I strongly suspect that is the last increase unless the economy shows an accelerating pattern. Any sign of economic weakness is extremely bullish for the stock market. The Fed is trying to take pressure off of inflation while not being so restrictive as to create a recession. This is what Greenspan did in 1994. It led to six more years of expansion. Inflation is a lagging phenomenon so we would not expect to see much progress at this point. It starts with a slower economy.

Investors are depressed. They either fear a recession or a continued bout with inflation, forcing interest rates higher. It appears we have the worst of all worlds. The correct sequence is a slower economy leading to less inflation and then potentially a decrease in interest rates. This in turn, revives the economy and we then witness a period of accelerating growth while inflation and interest rates continue to decline due to the lag effect. This flip-flop from the worst conditions to the best of conditions is why the stock market comes exploding out of a recession or slowdown to the upside. The bearishness is so pervasive that the stock market is very close to a bottom, if not at the bottom.

CEO's, a group that has been selling their stock for the longest time, have aggressively started to buy. Stock buybacks and buyouts are increasing. The issuance of new stock is very low. The supply is therefore shrinking. Valuations are also at levels we have not seen since the 1994 bottom so the market has a solid cushion underneath it. The dramatic decline has simply taken the indices from the top of their trading range to the bottom in short order.

Forget the politics. Forget an eventual bomb in Iran. This market is solely about interest rates both domestically and abroad and in turn whether we have a slowdown (bullish) or a recession (bearish). It should be pointed out that other central banks have not raised rates as aggressively as ours. Our Fed funds rate has reached five percent while Europe is still only at 2.75%. They are not being restrictive. There is still plenty of global liquidity. As the US economy continues to ease this summer, we should get the indication from the Fed that June is the last rate hike. This will do wonders for the stock market. The high interest rates should also strengthen the dollar, which is disinflationary. The only potential problem is that the Fed over-does it. At this point it is not very likely. This should be the best buying opportunity since March of 2003. From current levels I would suspect that the broad market will be up twenty percent in eighteen months.