



The Mist Clears

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Economic Outlook

As the year begins to unfold, the economic landscape has become clearer. The most striking surprise this year is certainly the high price of oil, which led to a decline in almost all stock groups except energy during the first quarter. At the current price of fifty-five dollars per barrel, there is no doubt that the high price of oil will have a slowing effect on the economy. Furthermore, the suppressive oil prices have been coupled with the Fed's increase in interest rates. Although monetary policy is not restrictive at this point, the Fed has removed a strong stimulus from the economy. With the dollar well off its December low, another potential stimulus is beginning to have a reduced impact on economic growth. Finally, the Bush administration's tax refunds have worked their way through the system and will no longer supplement economic growth. The combination of these economic factors therefore strongly suggests that the economy will slow down around mid-year.

Stock Market

The short-term behavior of the stock market is reflecting this slowdown now. Although most companies' first quarter earnings might meet expectations, the guidance on future earnings will probably be quite disappointing. During a time of turmoil, it is even more important than usual for portfolios to have exposure in companies that will deliver on earnings projections. Assuming the dollar has bottomed, it is also important to concentrate assets domestically, as domestic profits should improve relative to profits in weakening currencies. Companies' additional reported earnings from foreign exchange gains, however, will surprisingly not drive stocks up as professionals have already discounted the effect of the weak dollar. If the dollar is in a bottoming process, weak dollar plays are over. From this viewpoint, it appears that domestic Health Care stocks will be likely winners as well as stocks that have defensive growth characteristics such as drug stores (e.g. WAG).

Bond Market/Housing

With building inflationary pressure in the near-term, it is unlikely that bond rates will remain at these unforeseen low levels much longer. Expect the ten-year government yield to be five percent by year-end, a slight increase from current yields. Similarly, financial companies have recently been on the defensive and will remain so until signs of economic weakness and lessening inflationary pressure are present. Yet as these factors come to fruition over the coming months, Financials and bonds should do well only until

the economy starts to re-accelerate. A stronger economy in the second half will again put upward pressure on inflation and interest rates. Rising rates and a slower economy is also a bad combination for banks and their loan portfolio, as default rates will most certainly rise. Credit cards are especially vulnerable. The Housing market is a little less clear, but the inflection point in earnings growth is probably past. Thus, the relative strength in the Housing market should begin to wane as rates rise and housing prices continue to increase faster than consumer incomes. Even though Housing values are still relatively cheap, Housing inventories are building and the easy profits are past.

After a long sustained move, Real Estate Investment Trusts (“REITs”) definitely need a rest, yet economically sensitive ones based on hotels, for example, should continue to do well. If a REITs’ cash flow growth is slow, it is essentially a bond surrogate and that should be avoided, as only changes in interest rates would move the securities’ value. Utility stocks have been quite strong and are probably due for a strong correction. The current state of four percent yields combined with four percent growth is not compelling. The economic slowdown will create a respite here but one better be out of these stocks by the fall.

Commodities/Energy

Chemicals, metals and other commodities will perform well so long as the slowdown is brief and there is no negative growth. As the world economy picks up later this year, they should do quite well again. Pay particularly close attention to China, as commodity-based companies are strongly dependent on China. China’s strong growth is also necessary in order to generate growth throughout Asia. Manufacturers that utilize commodities and basic raw materials such as plastics are in trouble. If they cannot pass along these higher costs in their product’s price, they are then subject to a severe margin squeeze. The Auto industry provides a stark example of this problem.

In this sea of change, the true wild card is the price of oil. Despite relatively high inventories throughout the system, some fear that there is not much more available production in the world, meaning that an increase in demand will not be met by more supplies over the next few years. This fear has led to significant stockpiling of oil reserves in anticipation of a large increase in demand this fall. Any reduction in price could curtail speculative purchases in the short run, leading to plummeting prices. Corrections in energy will be sharp and terrifying. With oil priced at fifty-five dollars per barrel, the odds favor a lower price, but current speculation is that the price will remain above forty dollars per barrel for quite some time. This bodes well for energy profits. It is therefore unwise to underweight energy, but I would be tempted to let some positions go when things become over-extended. To some extent, a portfolio manager has to go with the flow rather than fight the current. One way to navigate through this group is to own energy companies with strong growth in reserves and strong unit production. These stocks should have good returns even without any price increases (e.g. UPL, TRGL). In contrast, the dependence solely on a price increase is dangerous.

Technology

As the market bottoms, technology should lead the market up. Generally speaking, technology values are low and expectations even lower. Capital spending will be the theme as the economy picks up again, as this is typical in this phase of an economic cycle. With capacity utilization moving up and corporations flush with cash, companies will spend to expand their business as well as increase productivity with technology. Technology and machinery should show strong earnings growth.

The Future

Value stocks with strong earnings growth in spite of the slower economy will prove to be the winners this year. The market should continue to slide lower into the spring until pressure comes off interest rates and stocks start to account for the economy picking up strength in the later part of the year. The S&P 500 will likely have a low of about 1140 and close the year at around 1275 for a gain of about eight percent. However, most stocks will actually decline this year while energy stocks help prop up the market, making it difficult to keep up with the indices. We are preparing our portfolios for a strong market move in the second half of this tough 2005.