



## The Slowdown of 2006

By Peter D. Scholtz  
July 31, 2006

Over the past year, our working assumption has been that the United States would experience an economic slowdown similar to 1994, allowing the Fed to pause or ease rates sending the stock market soaring. 1994 had a soft landing where GDP growth slowed to less than two percent. There was plenty of available labor and production capacity, which mitigated increased pressure on inflation. The market rallied sharply in 1995.

Recently, my concerns have increased regarding the economic outlook. Our assumption is now in doubt as the slowdown builds momentum; becoming riskier. The economic headwinds of high oil prices, a declining housing cycle, and rising interest rates all take their toll on the consumer, but the timing and degree are very hard to determine. For instance, last week second quarter GDP growth came in at 2.5%, well below the 3.3% consensus economist expectation, signaling that a possible quick deceleration is in the works. Oil prices and interest rates affect the economy with lags, so we have not even seen the full effect of these increases yet. However, unemployment is very low (labor markets are tight) and average hourly wages have continued to accelerate and are now approaching 4% year over year growth. This should prop up consumer spending to some extent, but it also implies that inflation is beginning to spread beyond the increase in commodity prices and is thus becoming more insidious. Furthermore, inflation fears and our large trade deficit should continue to put pressure on the dollar. Along with this weak dollar, the strengthening world economy will continue to push U.S. economic growth. Exports to Canada and Mexico, our largest trading partners, are up 8.4% over last year. Japan's economy is awakening after stagnating for over ten years. Their economy is huge and is only beginning its upswing. Europe is growing steadily, led by Germany. Asia continues to grow strongly, keeping demand for commodities firm.

We believe that the market is at risk if GDP growth remains over two percent for the next two quarters. Although the Fed might not raise rates in August, it might have to tighten additionally later this year. The market is not prepared for the Fed Funds rate to go to six percent and will eventually stop believing that higher inflation reports are a lagging statistic that will subside soon. Further weakness in the dollar will hit the bond market and longer rates could rise towards six percent. The persistent strength in the economy and inflation ultimately would force the Fed to be very aggressive; leading them to sharply raise interest rates and this in turn could create a recession. A soft landing is harder to engineer than in 1994.

It is currently too premature to look for a recession, but the odds are increasing as the economy continues on a firm growth path. This may seem counterintuitive, but the implication is that the strength will eventually cause the Fed to go too far, leading to a more dramatic downturn. We at Scholtz & Company have decreased our holdings in economically sensitive stocks as we believe they will have trouble with a slower economy, either near term or later. The themes to own are exporters, companies with little sensitivity to the domestic economy, and financials. The last is interesting since we are not bullish on interest rates short-term, but once the economy slows and the Fed is done, the first stocks out of the gate will be financials and interest sensitive stocks. Financials with very high yields will not be as vulnerable to higher rates as bond surrogates or interest sensitive stocks. This leads us to own many high yielding stocks as a defensive measure. We are very light in technology and retail stocks, especially domestic-oriented ones. We maintain a full weight in energy and healthcare although it is hard to find stocks in healthcare that are acting well. Dollar weakness and inflationary risk makes us bullish on gold. In addition, the supply and demand balance looks very favorable to gold over time.

The market still has many things going for it. Valuations are very low relative to other major asset classes. Cash at corporations is at extremely high levels and recently has approached over twenty percent of the value of the market. Stock buybacks and takeovers are shrinking the supply of stock at an increasing rate. KKR is buying out HCA for a record \$21 billion dollar LBO. New stock issuance is very low. Dividend yields are on the rise. This puts a safety net under the market. Our conclusion is that the economic uncertainty and world political turmoil will restrain the market, but the strong underpinnings prevent much of a decline. Therefore, we want to be fully invested, but we want to own defensive stocks with good value. Signs of a real economic slowdown are what we are waiting for to become more bullish. GDP growth well under two percent for one or two quarters should force the Fed to loosen monetary policy; then, stocks will start to discount the acceleration in economic growth. This is when the big rally will occur. It is still possible that the current deceleration will be enough. The odds have simply increased that this has been postponed until the first half of 2007.