REVIEW & COMMENTARY

2ND QUARTER 2004

Up, Up and Away!

"Faster than a speeding bullet. More powerful than a locomotive. Able to leap tall buildings in a single bound Look! Up in the sky. It's a bird. It's a plane."

No, it is interest rates!

Contrary to this popular belief, we continue to believe that interest rates are not going to go up rapidly and while we believe that we have seen the lows, the increase in rates will be moderate and staged. It will not choke off the economic recovery. Higher interest rates don't mean that the economy or the market will necessarily suffer. The Bank of England has increased interest rates four times since last November and their economy continues to expand. Even real estate prices in the U.K. continue to improve but we wouldn't expect that to continue. Certainly the demographic trends suggest that many homeowners will be downsizing over the next decade and while economic recoveries usually go hand in hand with higher real estate prices, some price moderation in real estate is overdue. However, if we are right about interest rates, the general uptrend in equity prices we have enjoyed over the past year or so should resume.

Predicting anything accurately requires superhuman qualities and while we have been as good (or bad) as anyone else, we do not agree with the prevailing thought that interest rates will move up quickly and dramatically. Agreed, inflationary pressures are evident. China continues to devour raw materials such as steel and oil. Steel prices reflect limited supply. And while the Chinese government has suggested that they are trying to moderate their growth, a recent Goldman Sachs study suggests that their success has been limited. Oil prices are high because of other reasons as well; terrorism within Iraq (and Saudi Arabia) has continued to disrupt the delivery of oil inventories to hungry consumers such as China and the U.S. Every day that these inventories remain unsold, the cost to the Iraq economy is $50 million U.S. Certainly, if this situation was brought under control, not only would oil prices fall to more reasonable levels but the growth of industrialized economies around the world would accelerate. In addition, some of the upward inflationary forces would ease. Meanwhile, if prices remain high, it will restrain economic activity which in turn should reduce the need to push up rates quickly.

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Higher oil prices have already dampened economic growth in the U.S. Wal-Mart and other large retailers recently pre-announced that sales had fallen below expectations suggesting the economy's recent growth trends are moderating. Job creation is improving but a disappointing number of new jobs in June shocked the financial system which had anticipated almost double the reported number. Only time will tell whether this is an indicator of further weakness or part of the seasonal summer trends. However, as we stated before, there are many jobs that aren't part of the official jobs report- including individuals who are starting there own businesses. And while hourly wages for U.S. workers has grown by 2% so far this year, this isn't as inflationary as it first appears- in real terms, it actually declined. Thus, it would appear that the U.S. economy will not sustain the blockbuster pace it established in the latter half of 2003 which again suggests that interest rates will not have to be increased as quickly as many predict.

The U.S. economy has been on a tear but this is typical of the early stages of a market/economic turnaround. In the face of the recession, corporations had ruthlessly reduced expenses and inventories. While inventories still remain low, businesses can no longer defer purchases and remain competitive. This demand/supply issue should maintain growth prospects for the U.S. economy despite marginally higher rates and a lower dollar.

Speaking of the U.S. dollar, after a brief rise towards the end of the quarter, it has recently weakened. While the future of the U.S. dollar sparks great debate even within our walls, an important factor remains looming over its future direction- the U.S. current-account deficit. Theoretically, rising U.S. interest rates should help the U.S. dollar but this reaction was only temporary. Possibly there are more people who think that rates won't rise as quickly or dramatically as before. However, a weaker dollar makes sense, particularly when the U.S. has so much international debt. The current account involves two major components: the trade balance and net income on foreign investments. In April of this year, the U.S. current account deficit was almost $50 billion. If you annualize that it comes close to $600 billion. If these debts continue to grow, doesn't it make sense to pay these debts off with cheaper dollars? Surely, you don't need to be Superman to figure out that.

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