



STRATEGIC FINANCIAL  
MANAGEMENT GROUP



## Investment Strategies & Insights

### “Every Which Way But Loose”

We commented last quarter that the favorite pastime of the financial markets had become watching the Fed and its new cast of characters as they tried to slow the economy without derailing it...desperately needing to get it right. Even though the consequences of their actions were dreadfully serious, what we witnessed was simply dreadful, bordering on comical at times.

The new Fed chairman, Ben Bernanke, pledged to bring a new “transparency” when it came to Federal Reserve policy, but his initial steps to do this left the markets wondering if there was a clear direction when the comments of the policy makers seemed to change from day to day. This was best personified by a conversation that Mr. Bernanke had with a journalist, Maria Bartiromo of CNBC, at a dinner party where he explained to her that a speech he had given the previous day had been misunderstood and that further interest rate hikes were in store. After she used this as the lead story the next morning on her program, the stock market dropped over 200 points. This misstep got the new Fed chief a trip before a Senate committee to be reminded of the power of his words and the need to keep it “professional”.

In the months that followed, the Fed continued to raise rates out of concern for inflationary pressures, while stating at the same time that the economy was showing definite signs of slowing...a mixed message that sent stock prices even lower. It was only after a subtle shift in the language in the press release after the June meeting that the markets saw a glimmer of hope that the cycle of rising interest rates might be over, sending stock prices higher at the end of the quarter.

Mr. Bernanke may become a great Fed chairman, but the first months of his tenure have been less about transparency than conveying a message that the policy was “Every Which Way But Loose”...a picture that created an uncertainty that resulted in a level of volatility in stock prices that we have not seen in over three years.

### Geopolitics Trumps Earnings

The rally in stock prices was short-lived, but not because of concerns over Fed policy or bad corporate earnings reports. It was the outbreak of war in the Middle East between Israel and Hezbollah and Hamas, and indirectly Syria and Iran, that has brought a sell-off in stocks as investors move to the safety of cash.

Many will point to the rise in oil prices to over \$78 per barrel as the reason investors became nervous, but the “fear premium” that speculators are adding to the price could be gone tomorrow. The bigger concern is that this conflict will not be over quickly since Israel will be faced with fighting a group without a conventional army, much like our experience in Iraq. If the fighting expands to include the countries that are supporting these groups, then the backing of Israel by the U.S. may come into play.

### 2nd Quarter 2006

**“If I turn out to be particularly clear, you've probably misunderstood what I've said”**

**Alan Greenspan**

### SUMMARY:

*Fed needs to learn to talk economic direction...not direction of rates.*

*Middle East conflict between Israel & Hezbollah has pushed interest rates and earnings to the back page.*

*Initial economic projections underestimated growth... but signs of slowing are now present.*

*The real estate bubble targeted by the Fed appears to have deflated some and a collapse does not seem likely.*

*Global expansion continues, but central banks worldwide are attempting to slow things down by raising rates.*

*In the short-run, risks in the stock market outweigh potential returns until the psychological barriers are removed.*

*Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.*



## Broad Economic & Business Indicators

If the projections of economists that were made at the beginning of the year had been correct, then nobody would be concerned about rising inflation. The Federal Reserve would have ceased raising interest rates and would be celebrating a soft landing in the economy. The problem is that those projections were wrong.

What now faces the policy makers at the Federal Reserve is a conundrum of persistently higher core inflation and an economy that is showing signs of slowing at every turn. It is becoming apparent that the economy is reaching a critical stage that will require a steady hand to provide the transition to slower, yet sustainable growth.

The Index of Leading Economic Indicators decreased sharply in May, the third decline in the last six months. The largest negative contributors to the leading index in May were initial claims for unemployment insurance and lower consumer expectations.

Both the manufacturing and service segments of our economy have shown declines over the past month, but the indexes used to measure them remain in a range that is positive for further expansion.

Unemployment rates have fallen to a post-recession low of 4.6%, but there is slowing momentum in payroll growth. It was interesting that wage inflation and the number of hours worked were up, leading some to believe that employers were not adding employees because they were getting harder to find. The productivity of workers has continued to increase causing overall labor costs to remain positive for businesses.

Over the last 18 months, the Federal Reserve has been targeting the real estate market and the perceived price bubbles that were being seen in certain markets, especially the East and West coasts. As mortgage rates have begun to rise, the goal of the Fed is being realized as housing starts, sales, and prices have begun to decline. At the present, it appears that real estate markets are moderating without collapsing.

The broad economic and business indicators remain in very positive territories and the slowing has been both moderate and expected so far.

## Central Banks and Consumers

The role of central bankers throughout the world is to worry about inflation, so it is not unusual for the Federal Reserve to use tough rhetoric when addressing the issue. Although it is important for them to be vigilant on the inflation watch, it is equally important for central banks to be forward looking and not base all of their decisions on lagging economic data.

There are many that believe the Fed has already done enough to slow the economy and cap cyclical inflation since it takes 12 to 18 months for rate hikes to work their way through the system. So the question that must be asked is what exactly is the Federal Reserve looking at that would make them continue this tightening policy?

The latest response from the Fed governors is that “core inflation”, which excludes food and energy, is at unacceptable levels. It is ironic that the largest component of this measurement is rising rents, which has been the result of the cooling of the home ownership real estate market. Once again, the Fed is the victim of unintended consequences...slowing the real estate markets and causing rents to go up.

It is true that our economy has been stronger than many expected and it is now being displayed in an area that does not receive much press...tax revenues. We know that historically when tax rates are reduced, tax receipts increase, and in fiscal 2006 revenues have grown 13%. Current projections are that the remaining budget deficit will be about 2.3% of GDP, which is smaller than in 17 of the previous 25 years.

Expansion in the global economy has done much to keep prices low as competition and capacity have worked to the consumer's advantage. However, we are now seeing signs that central banks are beginning to follow the lead of the U.S. and are raising interest rates. In Asia, both Japan and China have adopted policies to make credit more costly and funds less available.

With the real estate market cooling, interest rates rising, higher oil prices, and the possibility of slower global growth impacting import prices, the burden on the U.S. consumer is increasing. With signs that consumers are already spending less, corporate expenditures will be needed to help us sustain the moderate growth rates that are targeted.



## Major Market Trends

Although the stock market remained positive for the year with the S&P 500 up 2.76%, the second quarter showed a decline of -1.46%. The Lehman Aggregate Bond Index continued its decline and is now down -0.79 year-to-date, as interest rates continue to rise.

The stock market's decline from the May highs to the June lows was -7.7%, still less than the classical definition of a "correction" of -10%. After the June Fed meeting, stocks snapped back recouping roughly half of the declines by month end. Despite the market weakness from mid-May to June, the S&P 500 has yet to experience a -10% decline for over 831 trading days... the second longest stretch in history. This increase in volatility is to be expected at this stage of the market cycle and the transition to more defensive stock positions is appropriate.

The bond market saw the 10 Year Treasury yield move from 4.37% at the beginning of the year to a high of 5.25%. With the recent conflict in the Mid East, yields have fallen to 5.05% as investors have rushed to the safety of Treasury bonds. Absent the geopolitical situation, higher interest rates could still be in store and yields for 10 Year Treasuries above 5.3% would make an attractive place to increase bond holdings.

## Inside The Stock Market

With the increased volatility of the markets due to uncertainty over Fed policy and the recent conflict in the Middle East, performance leadership has shifted to the stocks of larger companies. It may be possible to see a bounce in small and mid sized stocks later in the year, but caution is advised at the present time.

With the recent correction in U.S. stocks, an interesting trend has emerged in regard to foreign stocks. In times past, international stocks were viewed as a way to diversify from the U.S. markets, but in recent years they have lost that appeal. In order to find diversification, it will require country specific allocations, not broad foreign exposure.

Valuations of the S&P 500 stocks remain favorable with prices trading at 14 times forward earnings, creating excellent buying opportunities, but only when there is a clearer picture of market direction.

## Inside The Bond Market

Bond yields are now moving within a range after moving up sharply since the beginning of the year. It is interesting to note that the bond markets are much more volatile than stocks on a day-to-day basis since they are subject to a multitude of cross-currents that range from economic direction, to Federal Reserve Policy, to trade deficits, to global demand for dollars.

Our current view on bond allocations is that quality is key in the current environment. This would include a focus on government-backed bonds both in the U.S. and abroad. With the changing position of Central Banks worldwide to a more restrictive policy (raising rates), it will begin to put pressure on sustaining global economic expansion at the same rate that we have seen in recent years. This will ultimately cause corporate debt to become a riskier proposition.

As the U.S. and the global economy begin to slow and the upward pressure on interest rates subsides, bonds will play a more critical role in our asset allocation. That will be the point when we position the portfolios to benefit from central banks lowering interest rates to re-flate their economies.

## Conclusions On The Market Outlook

A grizzled veteran of managing money, Don Hayes, talks often of his "three-legged stool" of investing. This approach includes an analysis of market valuations, monetary conditions, and the psychology of the market. The optimum time to invest is when all three legs of the stool are strong.

At the present time, we believe that market valuations are reasonable. However, the remaining two are questionable at best. The monetary policy of the Fed remains in question and it is obvious that the psychology of the stock market investor is fragile. Even though we know that stock market rallies are built on what is referred to as "walls of worry", we also believe that corrections can also become "bear" markets.

At this time, we do not believe that the potential for return outweighs the potential risk in the markets, no matter how favorable the valuations. Until we see a shift in sustained positive market momentum, caution will be the key.



At this stage of the economic and stock market cycles, an old adage seems to be very appropriate... "What you look for, you will find".

There are many positive things that you can focus on that would give you a sense of comfort ranging from the growth of the economy being greater than expected and corporate earnings exceeding early projections to the probability that the Fed is nearing the end of its restrictive interest rate policy.

However, there comes a point in time when the financial markets see good news and interpret it as being bad. If the economy continues to grow then the Fed will fear inflation...but if it begins to slow then we are headed for a recession. If the Fed continues to raise rates then they will choke off the economy's growth...but if they stop then they must think the economy is weak and beginning to stall. "What you look for, you will find".

We all know that time will tell which perspective is correct, but when the outlook becomes so clouded with a view to the negative, the result can be a self-fulfilling prophecy. The introduction of the conflict in the Middle East into the equation has added to this sense of discomfort and can be heard in the comments of, "I just don't feel good about the market at this point".

Our concern is that we have several additional factors in the immediate future that could add to this feeling of uncertainty. In the first week of August, the Federal Reserve will meet again and there is a real possibility that they will raise interest rates again, a negative for stocks.

Looming in September is the beginning of the political season for mid-term elections, with the control of the Senate and House up for grabs. The political rhetoric will become louder each day with the party out of power telling us that the economy is terrible and we are nearing the precipice, while the party in power will be telling us how great everything is. At best a mixed message that adds to the feeling of uncertainty.

Regardless of the outcome of the election, we believe that some form of gridlock will remain on Capitol Hill. Additionally, the Federal Reserve will stop raising rates soon as the economy continues to slow. The growth of corporate earnings will decelerate but remain very healthy over the near-term. All of these things are good for the markets.

However, it appears that it will take time to get to the place where all of these psychological barriers are behind us, allowing us to once again focus on the fundamentals of the market. Our view is that in the short-run, there are too many hurdles to get over for stocks to sustain a rally that will bring us back to previous highs for the year. Accordingly, we will be increasing our cash positions and become more defensive in our allocations.

Our view of the economy remains positive and the slowing appears to be moderate and should take us to levels of growth that are sustainable. We believe that this defensive posture will allow us to take advantage of buying opportunities later this year.

Best regards,

*Strategic Financial Management Group*

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