Marathon Strategic News

500 Market Street, Suite 610, Steubenville, OH 43952 · (740) 282-5198 · Toll Free (866) 435-4224 · www.mstrategic.com

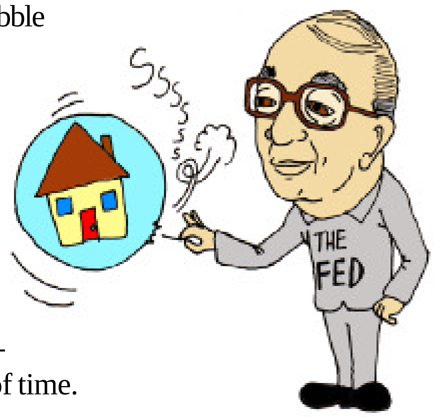
April 2005

Commentary by Nicholas Terezis, CFA

Economic Outlook

Welcome to normal!

I believe the economy is looking very "normal." If we take a big step back and observe the health of the economy, we see that: Gross Domestic Product (GDP) grew last year by 4.4%, and it is expected to grow between 3.0%-4.5% both this year and next year (GDP has averaged 3.3% over the past 50 years); core inflation[1] is slightly below normal at 1.5%; productivity and corporate profits are still stronger than normal and are expected to be strong in the future; and corporate balance sheets are the strongest we have seen in decades. Offsetting some of these strengths are worries about the following: a growing bubble in real estate, fiscal policy, the war in Iraq, and terrorism. In my opinion, when we add all of these variables together, the economy looks very "normal." In fact, I believe that our economy appears to be in a balanced "sweet spot" where growth and other factors are not too hot, not too cool, but are just right – sustainable for an extended period of time.



Investment Bubbles

During the past decade investors have experienced bull markets in stocks, real estate, bonds, and alternative investments. Occasionally, as in the late 1990s, some asset classes such as stocks go up too far too fast – and form a bubble. The correction to this overshoot in price inevitably ends up in either a sharp downward correction or a non-growth slumber for a number of years.

I believe that real estate values in the Northeast and West Coast have gone beyond healthy, bull-market growth and into bubble territory. No one knows whether this bubble will end in a "pop" (like the abrupt stock market sell-off five years ago) or will deflate with a slow "hissing." But, it will eventually end, and the bubble will deflate.

Bubbles that "pop" often affect the economy and hurt GDP. When the stock market bubble "popped," the US economy experienced a small eight-month recession where GDP was negative.

The Real Estate Bubble

When the economy slowed during the last recession, the Federal Reserve Board (The Fed) dramatically reduced interest rates in order to stimulate the economy. Not only did these actions successfully boost economic activity, but they also led to significant property value increases. Real estate investors and speculators have taken advantage of the 40-year-low borrowing rates, and have purchased (and are still purchasing) as much property as they can finance. Total mortgage debt outstanding has been increasing at a significantly higher rate than normal (up 13% since last year), and the average amount that investors have borrowed against the value of their homes has increased to near record levels of 44%.

As rates have hovered at historic lows, real estate has become an attractive, seemingly riskless investment alternative. In the past year, real estate values in some cities have appreciated by over 50%. Anecdotally, I have heard numerous people say that real estate prices never go down. Either these people have forgotten the pain caused by the real estate bubbles in the late 1980s and early 1990s, or they have never experienced the previous bubbles because they are new to real estate investing.

The Fed's Conundrum

The Fed's mandate is to facilitate strong, long-term economic growth by regulating monetary policy. In other words, it tries to smooth US economic cycles and avoid feast-or-famine situations by adjusting short term borrowing rates. Presently, the Fed is trying to slow the possibly disruptive, red-hot housing market by increasing short-term borrowing rates. This strategy will eventually work, because most of the speculative real estate purchases are being facilitated by short-term-based adjustable rate mortgages. Since last June, the Fed has increased short-term interest rates seven consecutive times from 1% to 2.75%. I believe its goal is to raise the short-term rates until they are between 3.5%-4.0% (this should be completed by August and November of this year).

Recently, Alan Greenspan commented that long-term interest rates were a "conundrum" (meaning they were a difficult problem or dilemma), because they are not increasing as much as he thought they should in a strong economy. Traditionally, when the economy is strong, we observe inflation in all areas of the economy – not just housing. This time there is no observable increase in the core inflation rate. Perhaps this is a signal that there is a problem in the economy, or maybe it is simply because productivity has been so strong. In either case, the overall economy could probably maintain a better, balanced growth rate if the Fed maintained low interest rates – but the Fed must raise rates because of the growing housing market bubble.

This is the heart of the conundrum, and the issue about which the Fed is paid to worry. By increasing rates and trying to diminish the housing bubble, the Fed will reluctantly and unnecessarily slow the growth rate of the entire economy. Thus, which is the greater evil: allowing the housing bubble to grow, or unnecessarily slowing the entire economy? From its actions, I believe the Fed is more concerned with the housing bubble. Regardless, Fed policy shifts often create turbulence in the investment markets, and I believe this is what we have been seeing lately in the stock market.

Investors' Medicine for Bubbles

As an individual investor, your response to the changing economic environment is simple. Remain diversified and maintain your long-term asset allocation strategy. If you own <u>a lot</u> of real estate investments, now might be a good time to sell <u>some</u>. Don't be greedy and hope for greater appreciation. This diversification strategy is applicable for any asset class that grows too quickly and has become overvalued.

The four primary causes for long-term investment failure are: 1) lack of diversification – such as over-concentration in a single asset class or stock; 2) high expenses – usually because of excessive trading or high investment management fees; 3) chasing momentum – basing investment decisions on tips or fads rather than on a thoughtful long-term disciplined process; and 4) timing the market – buying and selling investments in the short term based on some feeling of clairvoyance. Remember – fear, greed, expenses, and a short-term outlook are your enemies.

Although the current environment may appear tentative, I believe that 2005 will end up being a good year in the stock market. Investors cycle through emotional extremes of fear and greed, and create opportunities for the unemotional long-term investor. Further, I believe that stock market investors should replace their reluctance with optimism. People are currently fearful of the stock market and greedy to invest more in real estate. Rise above the fray and ignore the performance-chasing conventional wisdom. Long-term investors that remain diversified and stay the course are rewarded over time.

[1] Core Inflation defined as the Core Personal Consumption Expenditures Deflator

Marathon Strategic Advisors is a fee-only investment advisor that specializes in creating customized investment portfolios based on clients unique financial goals, risk tolerances, return expectations, investment horizon, tax brackets, and cash flow needs. Please do not hesitate to call us for more information on our company and the services we provide.

Nicholas E. Terezis, CFA is President and Chief Investment Officer of Marathon Strategic Advisors, LLC.

For more information contact Nicholas E. Terezis, CFA
Phone: 740-282-5198
Email: nterezis@mstrategic.com
Web site: www.mstrategic.com