Marathon Strategic News

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August 2005

Commentary by Nicholas Terezis, CFA

Economic Outlook

Overall, the economy is growing at a healthy pace, and there are no indications that economic expansion should falter during the next few years. As the second quarter closed, Gross Domestic Product (GDP) grew at a rate in excess of 3% for the ninth consecutive quarter. To put our economic progress in perspective, this makes it the fourth year of uninterrupted economic expansion during an era where we have suffered only two recessions in the last 23 years (a recession is defined as two or more consecutive quarters where real GDP decreases).

In reviewing the healthy aspects of our economy, we see the following: continued strength in the labor market; benign inflation; record corporate profits; higher than average productivity; the strongest corporate balance sheets since the 1960s; and low interest rates. Offsetting some of these strengths are the following worries: persistently high energy costs; a real estate bubble; undisciplined fiscal policy; a growing trade deficit; and terrorism. When we look at all of the strengths and weaknesses, I believe the economic outlook is very solid. Last year GDP grew at a rate of 4.4%, and I believe this year and next year it should grow between 3.0%-4.5% (GDP has averaged 3.3% growth over the past 50 years).

The Fed & Interest Rates

If the economy grows too quickly, then the destructive forces of inflation begin to heat up and hurt the economy. To prevent this from happening, the Federal Reserve Board (the Fed) has been assigned the mandate of protecting us from inflation (promoting price stability). Through decades of experience, the Fed has found that one of the best ways of slowing economic growth is by increasing short-term interest rates. This may seem simple; however it takes 1-2 years for an interest rate change to measurably impact the economy. Thus, being wrong about the amount or the timing of a rate change can be economically devastating.

The decision that the Fed currently faces is how much more it needs to increase interest rates so that the maximum amount of <u>sustainable</u> long-term economic growth can be achieved. Through its calculations, it believes that the economy can comfortably experience 3.0%-3.5% annual growth without the threat of increased inflation. With last year's economy growing at a rate of 4.4%, the Fed knew that it had to take action to slow the economy. Therefore, starting last June, the Fed increased short-term interest rates nine consecutive times from 1.00% to 3.25%.

Yield Curve Inversion?

As the Fed has acted to slow the economy, short-term interest rates have risen faster than long-term rates. Currently, there is only a 0.94% difference between short and long term rates. If short-term rates end up rising higher than long-term rates, we would have an "inverted yield curve."

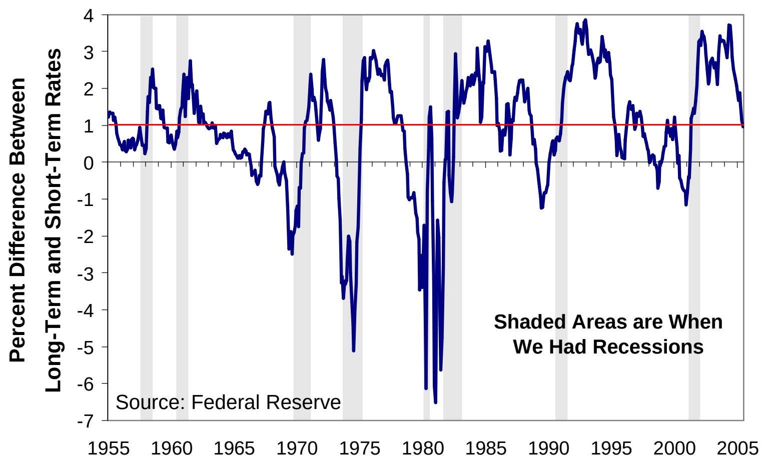
There are several reasons that we would not want to have an inverted yield curve. An inverted yield curve is typically a destabilizing economic phenomenon, because it hurts financial intermediaries and disrupts investment flows. For example, banks are forced to pay higher rates to their deposit holders, and are not able to increase the rates they charge people on long-term loans. In this environment, banks are put in a situation where it becomes almost impossible to make money on loans.

Historical Yield Curve Inversions

Investors and economists always worry about something. Increasingly over the next several months, I believe the worries will focus on the difference between long and short term interest rates – "Are we now headed for an inverted yield curve? Will we have a soft landing? Did the Fed increase rates by too much?"

Inverted yield curves typically foreshadow a weak economy and sometimes a weak stock market. In the past 50 years, the yield curve has been inverted in 42 quarters, or 21% of the time. One year after the occurrence of an inverted yield curve, the average rate of GDP growth has typically dropped to 1.1% (compared to the 4% in all other years). Further, in the two years following an inverted yield curve, the economy has experienced a recession two thirds of the time. I have found a significantly inverted yield curve to be one of the most reliable early warning indicators of possible rough water ahead.

Historically the Yield Curve has been Inverted 20% of the Time, And We Are Currently Entering a Period Where the Difference Between Long and Short-Term Rates is Just Below 1.0%



However, if the yield curve does not significantly invert, then the stock market will likely continue to prosper. Since 1989 there have been four times when the difference between long and short-term rates have decreased to less than 1.0%. The average one-year increase in the stock market after one of these dips begins has been 16.46%. This past June, the difference between long and short term interest rates dipped below 1%.

Eighth Inning of Rate Increases

Recently the Dallas Fed governor commented that we are in the "eighth inning" of Fed rate increases. This was taken by many as a signal that the Fed is nearly finished increasing rates. Between now and the first of November, the Fed will hold three committee meetings. I believe that the Fed will make two or three more rate increases at these meetings, and will push short-term rates up to 3.75-4.0%. Further, I believe that during one of these meetings, the Fed will either announce that it is finished or that it is pausing on its steady path of rate increases.

Another reason that I believe the Fed will stop raising interest rates in the next several months is because core inflation is under control – mission accomplished. I don't expect we will experience an inverted yield curve in the next year or two, and I have faith that the Fed is wise enough not to force this peril upon us. However, if one appears, investors would be well advised to remain diversified (as always), and not be overly aggressive with economically sensitive investments.

If the Fed is truly entering the ninth inning, then the recent stock rally is likely to continue. Regardless of how this scenario unfolds, it is important to recognize that no one has a crystal ball – including myself. The best course of action in both bull and bear markets is to maintain a diversified, long-term, buy-and-hold investment strategy. Overall, I believe that the long-term outlook for the US economy and stock market remains very strong.

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.

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