Marathon Strategic News

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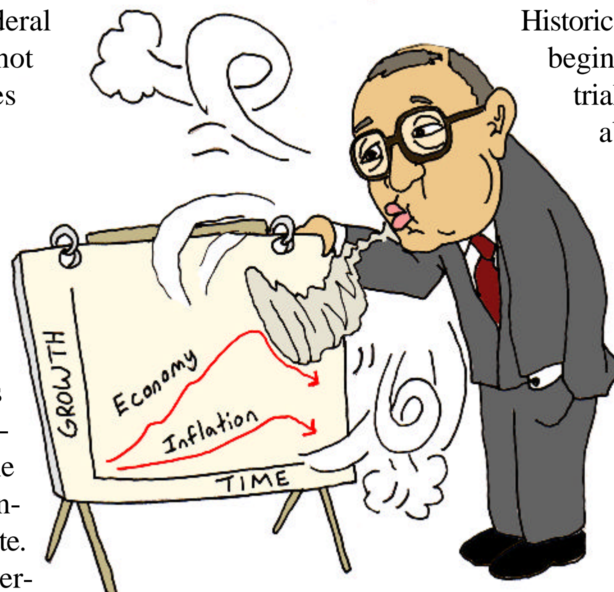
November 2005 Commentary by Nicholas Terezis, CFA

Economic Outlook

Long-term investors should look beyond the current lackluster performance of the stock market. This year corporate profits have continued to grow at impressively-high rates, while the stock market has stagnated. As a result, the stock market has become even more attractive from a valuation standpoint. I believe the stock market should resume its upward path as long as economic growth and earnings continue to be favorable, and as long as the Federal Reserve Board (the Fed) does not raise short-term interest rates above 5.0% in the near future.

The Obsession De Jour – Inflation

The media and some investors always obsess on an issue. In reality, the issue does not need to be noteworthy – but there is always an issue. The most recent obsession has been with the rate of inflation, and that it is increasing at a dangerously high rate. I believe these fears are exaggerated hype. As I have frequently recommended, it is best for long-term investors to ignore "noise" like this.



Hurricane Greenspan's rate increases can slow economic growth (and inflation) more than any other storm we have seen.

Inflation is defined as a persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money. History has taught us that our economy works most efficiently when businesses and households do not need to continuously adjust for changes in price levels prior to making decisions about production and spending. Thus, having a static, low rate of inflation is important.

The Current State of Inflation

The rate of inflation is traditionally measured by the core Consumer Price Index (core CPI), and is considered normal when it is between 1%-3%. Currently, core CPI is 2.0% – right on target. However, the current robustness of our economy could push the core rate of inflation higher.

It is good to have a strong economy, but we do not want it to grow too rapidly. If the economy grows too fast, then prices start to quickly increase, because the resources required to make products become scarce. Historically, we know that resources can begin to become scarce when Industrial Capacity Utilization increases above 80% and unemployment drops below 5%. Both of these economic recovery milestones have just recently been met. Again, this does not necessarily mean that we are suddenly going to have an increase in core CPI. It simply means that our economic recovery has matured to the next stage where the Fed must stop stimulating the economy. In the current stage of our economic cycle, Gross Domestic Product (GDP) should be forcibly kept below 3.5%. Otherwise, we will likely experience an undesirable increase in the rate of core inflation.

Factors that Should Keep Inflation Under Control

Anything can happen in the future. However, I believe that the following trends will continue to keep inflation under control:

Competition – Low prices for imported goods have prevented domestic manufacturers from raising prices. The outsourcing of jobs overseas has curtailed wages. The Internet and large companies like Wal-Mart have increased competition and allowed consumers to purchase goods at lower prices.

Productivity – Higher productivity has been the key to beating inflation. The more a worker produces per

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hour, the more that wages and other costs can increase without becoming inflationary. The recent spectacular productivity gains we experienced could be the fruit of the large investments that many companies made in computers and telecommunications during the 1990s.

Slower Economic Growth – As the Fed continues to increase interest rates, the economy will slow and resources will become less scarce.

Increased Global Trade – The productive capacity of the global economy has increased because the former Soviet Union, China, and India have entered the global market.

The Fed's Fight Against Inflation

One of the Fed's primary mandates is to promote price stability (i.e. protect us from inflation). Over the past year, the Fed has increased interest rates at each of its 11 committee meetings (by 0.25% each time). In doing so, it has increased short-term borrowing rates from 1% to 3.75%. Recently, one of the Fed board members said "The economy seems poised to expand more quickly than its sustainable potential – unless monetary policy accommodation is further removed." This statement, along with other hawkish statements, makes me believe that the Fed will likely increase short-term interest rates to the 4.5% range. If the Fed continues its pattern of increasing interest rates over the next three meetings, then they would reach the level of 4.5% on January 31, 2006. Coincidentally, this would be the same day the Alan Greenspan's long and successful term as Fed Chairman expires.

Misreading the Fed's Comments

I believe that many of the recent inflation fears have resulted from a misunderstanding of the Fed's inflation fighting tactics. Inflation has an unusual quality in that the perception of inflation can become reality. For example, if people think that the rate of inflation is increasing, then they will ask for higher wages – which in turn allows manufacturers to increase the price of goods. If, on the other hand, households and businesses believe that the Fed is committed to preserving price stability, then there is a smaller chance that the rate of inflation will increase. Logically, one of the Fed's inflation reducing tactics has been to make people believe that they will stop at nothing to keep inflation under control. This is why they have been so boisterous lately (and why fear has suddenly reignited about inflation).

Yield Curve Inversion

It will be very interesting to see how Fed policy unfolds over the next several months. I believe it would be foolish for the Fed to increase interest rates above 4.5% within the next year, because this action would likely invert the yield curve. The yield curve compares long, medium, and short term bond maturities. Currently, there is only a 0.80% difference between short and long-term rates. If short-term rates end up rising higher than long-term rates, then we would have an "inverted yield curve."

I have found a significantly inverted yield curve (which would surely result if the Fed increased short-term rates above 5%) to be one of the most reliable early warning indicators of a possible recession. I still believe that the Fed is wise enough not to force the peril of an inverted yield curve upon us. However, if a significantly inverted yield curve occurs, investors would be well advised to remain diversified (as always) and not be overly aggressive with economically-sensitive investments.

Stay Diversified – Do Not Try to Time the Market

Do not be tempted by greed or induced by fear into trying to "time the market" – it is a losing proposition! It is the economic fundamentals that determine the performance of investments over long investment horizons. As I have stated many times before, no one can successfully "time the market." 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 the big picture, long-term outlook for the US economy and stock market is very strong.

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