

# Marathon Strategic News

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Commentary by Nicholas Terezis, CFA

## Economic Outlook

As 2005 came to a close, most signs pointed toward a continuation of healthy economic growth. I believe Gross Domestic Product (GDP) for the next two years should grow in the range of 2.5%-4.0% (GDP has grown by an average 3.3% over the past 50 years). The slight economic slowdown that we are currently experiencing – and will continue to experience over the next 12-18 months – is very normal and desirable at this stage of the economic cycle. The highlights of this past year's economic strength include: GDP growth of approximately 3.6%; core inflation slightly below average at 2.2%; productivity and corporate profits at unusually high levels; and the strongest corporate balance sheets that we have seen in decades.

As the economy enters its fifth consecutive year of expansion, I believe that the scales are again tilted toward continued strength in the economy and stock market. As we take inventory of the positive and negative factors that may influence our economy over the next few years, I believe the main areas of concern are limited to: ramifications of a deflating housing market bubble; large budget and trade deficits; expensive energy costs; and higher short-term interest rates. In contrast, the lengthy list of positive factors that will likely continue to support our economy include: low unemployment; very high productivity; record high corporate revenues, profits, and capital spending; relatively low interest rates; benign inflation; and squeaky clean corporate balance sheets that have multi-decade low debt levels and near-record high cash levels.

As always, there are also a host of "worries" upon which people will fixate during the next year. These worries include: the Federal Reserve Board (the Fed) over tightening short-term interest rates; Middle Eastern turmoil; further appreciation in oil prices; decreases in earnings or productivity growth rates; an increase in the inflation rate; and domestic

terrorism. The presence of these "worries" should not overly concern investors, because people will always worry about something. Also, bull stock markets are said to "climb a wall of worry."

### It Looks Like Goldilocks Might Be Back

Our economy appears to be reaching a balanced "sweet spot" where growth and other factors are not too hot, not too cold, but are just right – sustainable for an extended period of time. As I mentioned earlier, the mid-economic-cycle slowdown that we are experiencing is normal. In fact it resembles the mid-1990s "Goldilocks" period, where the economy accelerated during a time of low interest rates, tame inflation, and a strong stock market. Goldilocks periods tend to be ideal economic climates which are good for the stock 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 and a half, the Fed has increased interest rates at each of its 13 committee meetings (by 0.25% each time). In doing so, it has increased short-term borrowing rates from 1% to 4.25%. In the minutes from the Fed's most recent meeting, it suggested that interest rates may not need to be increased much more. This statement, along with the current value of the Fed futures contract, makes me believe that the Fed will likely increase short-term interest rates one last time at their January 31 meeting, and then stop at 4.5%. Coincidentally, this would be the same day that Alan Greenspan retires as Fed Chairman, and is replaced by Ben Bernanke.

### 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



We may be entering a "Goldilocks" period similar to the mid-1990s where the economy is able to grow for an extended period of time at a rate that is not too hot, not too cold, but is just right.

yield curve compares long, medium, and short term bond maturities. Currently, there is only a 0.10% 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 to 5% or higher) 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. One thing is for sure; we will have a clearer picture of the status of the yield curve within the next four months. If the Fed chooses to significantly invert the yield curve, it will do so one step at a time during their next three meetings (January 31, March 28, and May 10).

### Historical Yield Curve Inversions

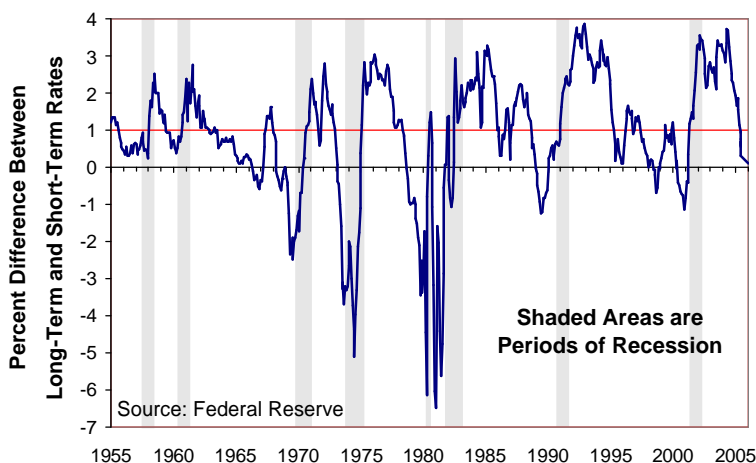
Inverted yield curves typically foreshadow a weak economy and sometimes a weak stock market. In the past 50 years, the yield curve has been inverted in 42 quarters, or 21% of the time. One year after the occurrence of an inverted yield curve, the average rate of GDP growth has typically dropped to 1.1% (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. During the 12-18 months following a significantly inverted yield curve, investors would be well advised to remain diversified (as always) and not be overly aggressive with economically-sensitive investments.

However, if the yield curve does not significantly invert, then the stock market will likely continue to prosper. Since 1989, there have been four instances 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%.

### Stay Diversified & Do Not Try to Time the Market

Although the current environment may appear tentative, I believe that 2006 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.

**Historically the Yield Curve has been Inverted 21% of the Time, And We Are Currently Entering a Period Where the Difference Between Long and Short-Term Rates is Just Below 0.1%**



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. Also, be certain to plan for an adequately

long investment horizon. The average person celebrating his or her 65th birthday today has a greater than 5% chance of living past the age of one hundred.

If we continue to see the stock market improve over the next few years, do not change your investment strategy. Do not begin to concentrate your investments in any single stock, sector, or asset class. Stick to your long-term diversified investment strategy, and ignore any non-fundamental distraction. Wise investors always have diversified portfolios, because there is always uncertainty, and no one is clairvoyant.

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