Marathon Strategic News

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

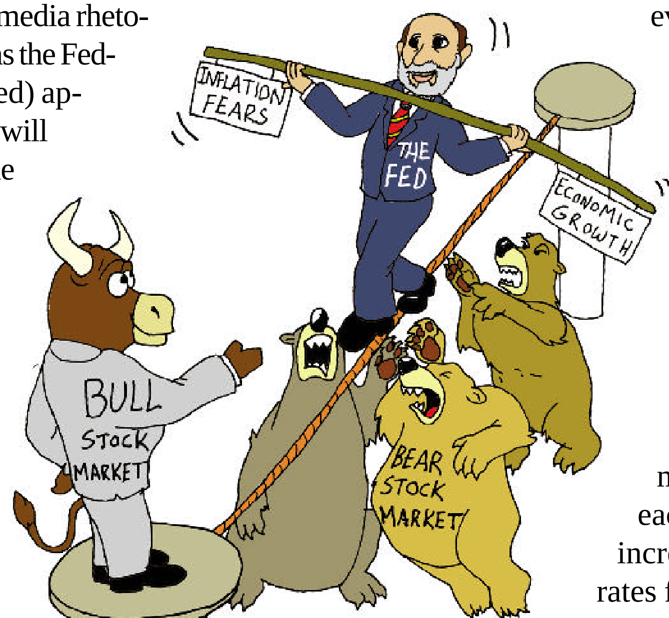
May 2006

Commentary by Nicholas Terezis, CFA

Economic Outlook

In its fifth consecutive year of expansion, our economy is continuing to enjoy a combination of steady growth, low inflation, high profits, and a high rate of employment. Over the next two years, I believe that our economy, as measured by Gross Domestic Product (GDP), should grow by 2%-4% annually (GDP has grown by an average annual rate of 3.3% over the past 50 years).

Economic uncertainty and media rhetoric have recently increased as the Federal Reserve Board (the Fed) approaches the point where it will likely stop raising rates. The list of repetitive questions that have been frequently asked include: Will the long awaited economic slowdown commence in the second quarter, or later? Will the Fed pause at 5%? Will inflationary pressures emerge – forcing interest rates higher? Will the price of energy continue to increase? What will be the economic impact of the housing market slowdown? Will productivity continue to surprise us in a positive way? Will unexpected strength in emerging countries and Japan significantly boost economic strength at home? Can corporate profits continue to exceed everyone's expectations?



These are all good questions that are difficult to answer with certainty. In fact, we often do not know the answers to these questions until they become part of history. However, as I have said in the past, the presence of these uncertainties and "worries" should not overly concern investors, because people will always worry about and question something. Bull stock markets are said to "climb a wall of worry."

The Fed at a Crossroad

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 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.

In the past two years, the Fed has increased interest rates at each of its 15 committee meetings (by 0.25% each time). In doing so, it has increased short-term borrowing rates from 1.0% to 4.75%. In the minutes from its most recent meeting, it suggested that interest rates may not need to be increased much more. I am hoping that this means the Fed will announce its final 0.25% rate increase on May 10 – thus capping short-term rates at 5.0%.

The Fed has a history of raising interest rates past a "neutral" rate, and I believe that it has already done this. A "neutral" short-term interest rate is a rate that does not stimulate or constrict economic growth. I believe that the neutral short-term rate is around 4% and that on May 10 the Fed will increase interest rates to 5% – one full constrictive percent past neutral. I believe the Fed intentionally over-tightens interest rates, so that it can feel more certain that inflation will remain under control. It correctly sees the risk of increased inflation as a greater evil than a slightly more pronounced slowdown in economic growth. However, I believe that the Fed is playing with fire if it raises interest rates much past 5%.

Inflation Will Likely Remain Under Control

Over the short term, we will likely see a slight cyclical increase in the core rate of inflation. This increase is being driven by a low unemployment rate of 4.7%, a strong factory utilization rate above 81%, and high commodity prices. In spite of these short-term inflationary pressures, I believe the following long-term factors 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 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.

Real Estate Troubles

It looks like the housing market has peaked. In the past two years long-term borrowing rates have increased by 1%, and short-term rates have increased by 3%. These increases are beginning to take their toll on the housing market. The supply of homes for sale has spiked 39% in the past twelve months. Also, the average home price has started its decline, and is now 5% below last summer's peak.

The Emerging Economies Wildcard

It has been almost twenty years since President Reagan proclaimed "Open this gate. Mr. Gorbachev, tear down this wall!" After the Berlin wall was dismantled, numerous "close-gated" economies opened to capitalism. Slowly at first – but more pronounced recently – these formerly closed economies have energized global trade and economic growth by infusing the markets with massive amounts of labor, natural resources, and capital. It is difficult to understand all of the implications of these economic windfalls. However one thing appears clear – these new participants will prove to be strong positive wildcards for global economic activity and future growth in the US economy.

Stay Diversified – Do Not Try to Time the Market

Since the Fed started raising interest rates, many investment commentators have advocated a wait-and-see approach toward investing in the stock market. Interestingly over the past two years, the stock market has averaged an annual return of approximately 10% per year. The moral of the story is, of course: 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 – and the fundamentals are strong! 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 shows that the long-term outlook for the US economy and stock market is 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.

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