Marathon Strategic News

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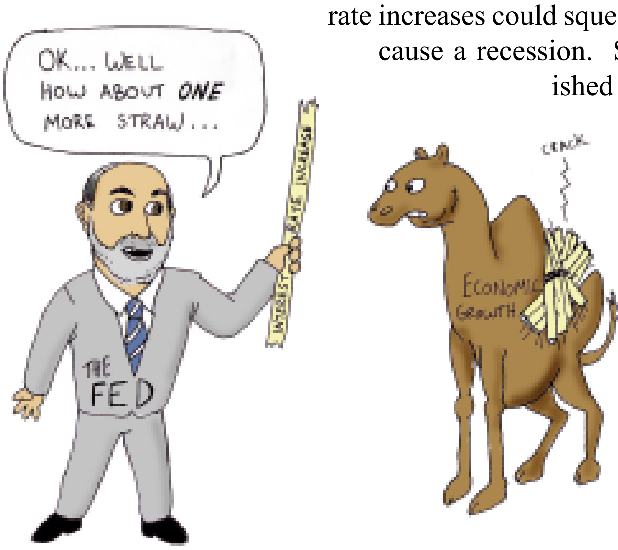
Economic Outlook

It is clear that the US economy is entering a period of transition. The second half of this year and next year will likely experience slightly slower economic growth. This economic moderation is in response to higher interest rates, higher energy prices, slower equity extraction from the housing market, less government spending, and higher tax receipts. The slight economic slowdown is very normal and desirable at this stage in the economic cycle. I believe Gross Domestic Product (GDP) for the next two years should grow in the range of 2.0%-4.0% (GDP has grown by an average of 3.3% over the past 50 years). Over the next year, I suspect that economic commentators will arouse fears in response to a slowing economy - but smart investors will see this as normal cyclical behavior.

Inflation fears are expected to remain somewhat elevated in the near term. However, I believe that inflationary fears are exaggerated and that inflation will subside as economic growth begins to slow.



After 17 consecutive interest rate increases, any additional increase could be the straw that breaks the economic camel's back.

The ongoing instability and violence in the Middle East has recently contributed to financial market volatility. No one knows what the outcomes of these multiple conflicts will be. However, I believe that it is premature to assume that any of these situations will necessarily escalate further or lead to additional financial instability. Historically, smart investors have been known to buy at the "sound of cannons and sell at the sound of trumpets."

The Fed's Fight Against Inflation

One of the Federal Reserve Board's (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 17 committee meetings (by 0.25% each time). In doing so, it has increased short-term borrowing rates from 1% to 5.25%. In the minutes from the Fed's most recent meeting, it stated that interest rates may or may not need to be further increased.

The Fed has made it clear that it would choose to intentionally over-tighten interest rates if it would help insure that inflation would remain under control. With this in mind, I believe the Fed has increased rates enough to slow the economy (and inflation). Moreover, any further rate increases could squelch economic growth – or even cause a recession. Since the Fed may not be finished raising interest rates, the financial markets may continue to experience additional volatility.

Yield Curve Inversion

An "inverted yield curve" occurs when short-term rates are higher than long-term rates. Currently, the yield curve is inverted by 0.15% (the Fed Funds rate is higher than the 10-year Treasury yields). In the past 50 years, the yield curve has been inverted in 43 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 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 (where short-term-rates are around 0.5% higher than long-term rates) 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 perform well.

Expensive Real Estate Market

After years of a booming housing market, the signs are clear that the party is drawing to an end. This is especially true in the most overbuilt and overpriced markets. In the past two and a half years, long-term borrowing rates have increased by 1% and short-term rates have increased by 3%. These rate increases are beginning to take their toll on the housing market. Inventories of new and existing homes on the market have increased 38%, and the average new home price has declined 6% in the past year.

Homes located in regions that have not experienced a significant increase in values should not be as adversely affected by the slowing housing market. However, overpriced regions will slowly deflate – and it can be years before home prices start to rise again. The last California, Connecticut, and Hawaii price bubbles were followed by 6-7 consecutive years of declining prices.

Inexpensive Stock Market

Over time, corporate earnings are the main variable that determines stock prices. A basic method for measuring whether stocks are expensive or inexpensive is the price-to-earnings ratio calculation (also known as the P/E ratio). The P/E ratio for the overall stock market is calculated by simply dividing the price of the S&P 500 by the expected earnings of the S&P 500. The forward looking P/E of the stock market is currently less than 15x – and the stock market has not traded at this low of a P/E since October of 1995. In other words, the stock market has not been this relatively inexpensive in over ten years. No one knows the next incremental step that the stock market will take – especially during times when the economy is at an inflection point. However, sooner or later the stock market will reflect its fair value – which I believe is at least 20%-30% higher than the current value.

What Smart Investors Should Do

Smart long-term investors are wary of the fact that people in general are ill-equipped to deal with the perceptions of risk and return over short periods of time. People seem to prefer substituting hard facts with their feelings of fear or greed. They observe stocks going down and sell them. Conversely, real estate and commodities go up and people feel they should keep buying them. From 2000 to 2005 home prices have increased by approximately 55%. During this same time the stock market (S&P 500) has gone down by 6% (while corporate profits have gone up over 100%). Smart investors are able to ignore the "herd mentality" that chases yesterday's hot investments, and they know that trying to time the market is a losing proposition.

In order to be a good long-term oriented investor one should do the following: develop an investment policy statement that dictates how much risk and return is appropriate given the unique circumstances and goals of an individual; determine the appropriate asset allocation based on the investment policy statement (i.e., the percent of the portfolio that should be in stocks, bonds, cash, and other investments); invest the portfolio wisely; and periodically rebalance it when the asset allocation deviates from the plan. Most importantly, long-term investors need to be disciplined. They must maintain their asset allocations during the ups and downs of the market.

Frequently, investors lack the emotional discipline and investment selection expertise required for the successful long-term management of their assets. In such instances I highly recommend that they seek professional investment management help from the most qualified person that they know. Serious investors are concerned about long-term total returns, not the hot investments that they bought and sold.

Stick to your long-term diversified investment strategy, and ignore any non-fundamental distractions. Wise investors always have diversified portfolios, because there is always uncertainty, and no one is clairvoyant. Overall, we may see some short-term volatility in the markets, but I believe the big picture shows that the long-term outlook for the US economy and stock market is 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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