Marathon Strategic News

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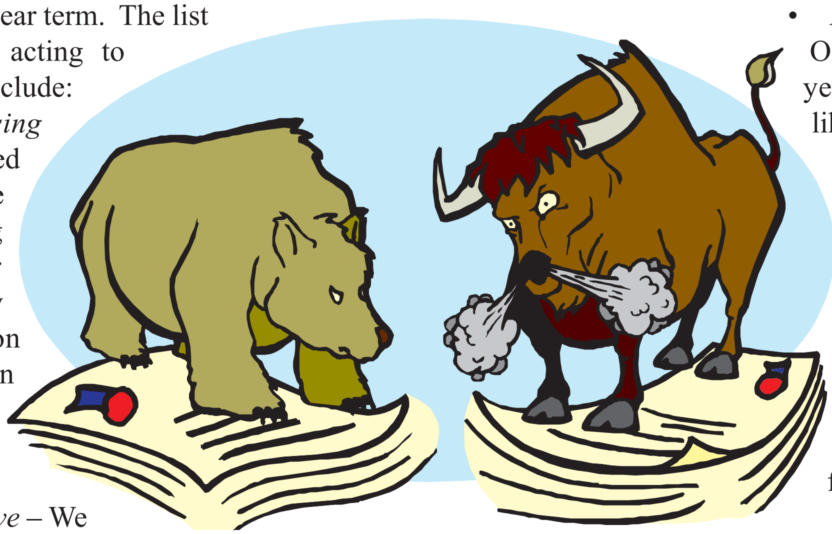
Commentary by Nicholas Terezis, CFA

After three years of above-trend growth, the US economy seems to be slowing to a more moderate and sustainable pace. Over the past few months, employment growth has slowed, housing activity has cooled, and consumer spending has moderated. I expect GDP (Gross Domestic Product) will continue to slow into the end of 2006, and will strengthen gradually thereafter. By 2008, the GDP growth rate should increase back up to its long-term average growth rate of around 3.5%.

The Bear's Argument for Slower Economic Growth – or Recession

Economic Bears and Bulls both agree that the economy will slow in the near term. The list of factors that are acting to slow the economy include:

- *Contracting Housing Market* – Compared to last year, the number of existing homes sold, their prices, and new home construction starts are all down 12.6%, 1.7%, and 19.8%, respectively.
- *Inverted Yield Curve* – We are currently experiencing an inverted yield curve where short-term interest rates are higher than long-term rates. Among other implications, this makes the money lending business less profitable and makes banks less willing to lend money.
- *Relatively High Oil Prices* – Oil is still 50% higher than it was two years ago.
- *Higher Short-Term Borrowing Rates* – Over the past two years, the Fed (Federal Reserve Bank) has increased short-term rates from 1% to 5.25%.
- *Slower Money Supply Growth*
- *Less Fiscal Stimulus* – Deficit spending has declined.
- *Higher Mortgage Rates*
- *Higher Global Interest Rates* – Central banks have recently begun a cycle of interest rate increases.
- *Higher Inflation Rates*



The Bull's Argument for Slightly Slower but Strong Economic Growth

The Bulls believe that the economy will slow just enough to reduce inflation before resuming a stronger rate of GDP growth. The list of factors acting to maintain strong economic growth include:

- *Low Interest Rates* – Interest rates have increased over the past couple years. However, they are still relatively low in comparison to where they have been over the past 40 years.
- *High Corporate Profits* – Profits have been growing at double digit rates since 2002.
- *Strong Corporate Balance Sheets* – Corporations currently have record-high levels of cash.
- *Declining Dollar* – Over the next 5-10 years the Dollar will likely decline in value resulting in increased export demand.
- *Recently Declining Energy Prices* – Energy prices have dropped sharply from their recent highs and will likely experience further decline.

Inflation's "Head Fake"

The rate of inflation will likely increase over the next 6-12 months due to the lagged effects of the following: higher energy, commodity, and housing rental prices; low unemployment rates; and high capacity utilization. This temporary uptick or "head fake" in inflation may cause anxiety for some investors. However as the economy slows, these inflationary forces should subside (we are already seeing preliminary evidence of this occurring).

Implications of the Inverted Yield Curve

Yield curve inversions are rare, and usually signal a recession. Over the past 45 years there have been eight yield curve inversions, and six recessions. Every recession during this period has been preceded by an inverted yield curve. The two times that an inverted yield curve did not correctly signal a recession was when their occurrences coincided with a low interest rate environment – like we are experiencing today.

Soft Landing vs. Recession

I believe that the economy will most likely experience a soft landing – not a recession. In other words, I believe that the Fed has increased interest rates enough so that GDP growth will slow – but not enter a period of prolonged sub-par growth. If all goes well during this economic slowdown, our economy could experience a healthy rebalancing where economic growth becomes less dependent on housing and consumer spending, and more dependent on exports and business investment.

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 a P/E this low since October of 1995. In other words, the stock market has not been this relatively inexpensive in over ten years. Another interesting statistic is that corporate earnings are growing approximately three times faster than the yield on 10-year government bonds (corporate profits are growing at around 16% per year vs. 4.74 for 10-year bonds). 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.

This Time is Different?!

The four most dangerous words for investors are "This Time is Different." The sobering fact that an inverted yield curve has preceded 75% of recessions in the past 45 years should give investors pause. With this in mind, I believe that there is only a 20% chance that we will experience a recession.

However, if I am incorrect and we do experience a recession, I believe that long-term investors should not take any preemptive asset allocation actions. A recession will likely be short-lived, and we will not likely know that we are experiencing one until after it has occurred. Further, the impact of a recession on the stock market should be muted since valuations (P/E ratios) are not high.

Stay Diversified and Do No 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. 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.

As we experience volatility in the stock market during this economic transitional period, 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.

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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