

July 2003 Newsletter | PDF Version

Dear Clients and Friends,

A CHANGE IN SCENERY

At the time we wrote our previous quarterly letter to clients, the U.S. was fully engaged in the conflict in Iraq, the world looked like an increasingly dangerous place, investor morale was in a deep depression, and the stock market was in a swoon. Now, three months later, equities have staged an extraordinary rally from the early March lows.

The most vigorous advance occurred in technology and the other, more volatile sectors of the market, but the gains have been sufficiently broad to authenticate the recovery. Observers have cited a wide range of explanations for the surge that, ironically, was expected by so few. The standard list of contributing factors includes the end of the armed conflict in Iraq (one should perhaps refer to the end of the "formal" conflict, since the situation remains quite unstable). There also has been an encouraging shift toward improved corporate earnings reports. Additionally, interest rates on money market funds and certificates of deposit have declined to levels best observed under a magnifying glass. Finally, the bond market, repository of huge amounts of institutional and individual funds, offers yields that have no appeal, particularly if one considers the potential risks associated with a reversal of the trend in rates. It cannot be predicted when rates will begin to rise again, but it is very clear that they will at some point. Against this backdrop, the stock market appears to have been the beneficiary of this "flight" from low rates.

THE FED AS STEWARD

The Federal Reserve Open Market Committee ("FOMC") is charged with the responsibility of keeping the economy on a sustainable growth path, while managing the impact of inflation. This is an important mandate that benefits from steadiness in policy making, from deliberate actions and from reasonably predictable outcomes. If the charge is executed well, such success contributes to an environment that engenders confidence. Unfortunately, to this observer, the FOMC in recent years has not been particularly adept at assessing what is happening in the U.S. economy. Further, because its diagnosis of risks has tended to be either inaccurate or late, it has ended up adopting responses that have either been inappropriate or excessive. The skeptical observer might view the net effect of Fed actions as simply setting fires. As it turns the dials on the cost and supply of money, it appears to be moving from one asset class to the next, creating asset bubbles as it goes and touching base in sequence on stocks, bonds and real estate.

This no doubt sounds like a harsh characterization, so we should review the pattern of Fed actions over recent years.

In the Fall of 1999, the Fed began making noises about the risks associated with the Y2K transition that was scheduled for the end of that year. To "mitigate" the risks, without much fanfare, the Fed at the beginning of October began injecting huge amounts of monetary liquidity into the system. We suppose the Fed thought everyone would like to have a few extra greenbacks under the mattress, just in case. Instead of putting the funds into the pillowcase, the excess liquidity was directed into the stock market, particularly the NASDAQ casino, which took off like a rocket when the buying wave hit.

In February 2000, after it became clear that the perceived danger of the Y2K transition had been dramatically exaggerated, the Fed, just as quietly, began to draw liquidity out of the financial system. It seems like too much of a coincidence that the stock market collapsed almost simultaneously with the shrinking of the liquidity bulge. One

could make the case that the Fed was responsible for the final leg and, subsequently, the bursting of the stock market bubble.

The Fed next failed to recognize that the economy was slowing at a rate fast enough to raise a serious risk of recession. By the time this fact dawned on the monetary luminaries, the slowdown was so well established that more than a dozen interest rate cuts have thus far had only a modest impact on economic growth. Instead, the Fed has fueled new, twin bubbles in residential real estate and the bond market. The Fed actions have created a number of problems, some of which are recognized and others of which are being ignored.

Interest rates now are at the lowest levels in decades. That fact alone contributes to the risk of deflation, which the Fed now defines as an emerging risk factor for the economy. Rock-bottom interest rates have been embraced by borrowers, who have used the opportunity to refinance mortgages and extract equity from their homes. What tends to be forgotten or ignored is the fact that every interest payment goes to a lender who holds the instrument as an income-producing investment. The dollar saved on an interest payment is a dollar of income lost to the holder of that asset, and may explain in part why consumer spending, outside of the housing sector, is not particularly robust.

The decline in rates has put a significant crimp in the profitability of the banking industry, thereby constraining the willingness to lend, at a time when borrowers already are being cautious. In addition, it is jeopardizing the viability of the entire spectrum of short-term investment vehicles. Since so much of the effective functioning of the financial and capital markets depends on reasonably stable and predictable spread relationships, it seems likely that the plunge in rates will cause a variety of unanticipated consequences. Whether structural changes will be required is unclear, but it will be interesting to follow events as they unfold over the next few quarters. Interest rates at these levels represent truly uncharted waters, and one wonders how many hedge fund managers and players in the derivatives markets have factored the "100-year flood" into their calculations?

THE "D" WORD

The Chairman of the Fed, in terminology so opaque that only he could have crafted it, is warning about the risk of deflation.

Setting aside for the moment the possible impact of Fed actions, we think the risk of deflation in the U.S. is pretty low. The fundamental forces are aligned to achieve an opposing outcome. Central banks around the world seem united in their desire to reflate and are very anxious to avoid the fate of Japan. The U.S. economy will benefit from a second round of tax cuts in as many years. The U.S. dollar has weakened considerably this year in trade-weighted terms, raising import prices and creating a bit of an umbrella for domestic producers to raise prices. Here and there, companies are testing the reception of higher prices, with occasional success. Commodity prices, both energy-related and industrial, are up across the board over the past year, sometimes by very substantial amounts.

If there is an appreciable risk of deflation, in our opinion it is traceable directly to miscalculations by the Fed and the potential effect of those decisions on the consumer and the financial system. We would hope the Fed would set aside any plans for further rate reductions. Several years ago, we felt the extraordinarily low rates in Japan (actually, negative at one point) had become a significant factor in consigning the Japanese economy to more than a decade of essentially no growth.

AN HYPOTHESIS

If our view of Fed strategies and responses has merit, an intriguing hypothesis emerges. The Fed is avowedly concerned about deflation (we almost said "tilting at the windmill of deflation") and has pulled out all the stops in terms of using its interest rate ammunition. Manipulating interest rates is a blunt and sometimes slow-acting instrument because it affects actions by consumers and market participants indirectly. The next step, if the interest rate medicine does not affect the cure of revitalizing the economy, is to inject the maximum amount of liquidity into the financial system.

This pattern sounds a lot like a repeat of the events of the Fall of 1999, when the market took off for reasons not well understood at the time. As we suggested earlier, it likely was driven by a huge liquidity injection by the Fed. We could be seeing a replay. The Fed may have exhausted the interest rate option and now must play the liquidity card.

If this hypothesis (and it is not much more than that at this juncture) turns out to be useful, we may see a stock market that has a significant further advance, attracting some of the huge amounts of money sequestered in money market funds, certificates of deposit and bond holdings. Such a market would exhibit periods of strong advances, interspersed with brief pullbacks. In this environment, active management, prudent stock selection, and attention to value would be vital to protect capital against the developments of another "bubble" in equities.

Your thoughts and comments are always welcome.

Sincerely,

A handwritten signature in black ink, appearing to read "Johann H. Gouws". The signature is written in a cursive, flowing style with a large initial 'J'.

Johann H. Gouws, CFA
President