

Has the Bear Lost Its Bite?

Last quarter the invasion of Iraq weighed heavily on our minds. Now that we are getting used to the idea of occupation we can turn our foremost thoughts toward the economy. For the first time since December of 1999 we have seen a strong positive quarter. In fact for the first time since the start of the new century all of the major equity indexes are net positive for the year (New York Times, July 6, 2003).

Last summer, the pending war with Iraq became a topic of national debate and weighed heavily on the markets. Its quick end in March helped to start a relief rally. Last month the Federal Reserve Board lowered the interest on the Federal Funds Rate to 1%; the lowest rate since 1954 (according to the Federal Reserve Board's website). With interest rates low and corporate profits improving (65% of all companies reporting earnings for the last quarter met or beat their estimates according to CNBC), there seems to be hope the market will continue its upward turn through the balance of the year.

Bank CD's are showing national average rates at 1.05% for 1 year, and 2.45% for 5 years (New York Times July 6, 2003) and many investors starving for revenue are beginning to put money back into the market with the hope of a decent return. Congress has passed the tax cut bill lowering the double taxation on corporate dividends and also lowering the capital gains rate. All of these are positive for the markets. So the question is: Is the bear gone?

Well, not all news is positive. The recovery is slow, and unemployment is still a problem. Last week the unemployment rate was 6.4% - the highest it has been in nine years. However, we need to note that at the end of the last three recessions (1975, 1982 and 1991) unemployment peaked at 8.5%, 9.6% and 7.5% respectively. So although it is relatively high, it is still much lower than it has been under similar economic conditions.

Other questions that come to mind are: If the economy was really strong would the Fed need to keep interest rates this low? And if not for the housing boom would the Economy be growing at all? Both are good questions and only time will tell. That brings us to the recurring question of "how should one invest in these markets and what should one do to take advantage of these economic conditions?" There are few absolutes, however, if you have not refinanced your mortgage now would be a great time. If you are thinking of buying a new car, it is hard to get a better deal than 0% financing. Regardless of the economic data we must remember that we are invested for a reason. In most cases it is to generate enough "income" from our investments to supplement our retirement. If the banks and money markets are paying only about 1% we need to take some risk in the market to have any chance of meeting our goals. Bill Gross, considered by many to be the best fixed income manager in the U.S., has said on many occasions that we should be happy to earn the coupons on bonds over the next few years, and we do not disagree. This means that the high total return we have experienced from bond investing is likely to be a thing of the past. Most of the excess returns on bonds have come from the lowering of interest rates.

Over the near term we do not believe that interest rates will rise, however we believe they are at or near their lows, and clearly over the next five years we believe that they will rise again. To properly manage fixed income investments in this environment we must continue to protect ourselves from possible rising interest rates in the future, therefore as your bonds and CD's mature we must plan to get by on lower dividends and interest. To help offset this problem and to take advantage of the tax law changes we are looking to adjust your portfolios with higher dividend paying stocks.

Although we feel that the recovery is around the corner, it is not here yet. We remain cautiously optimistic about the future and expect that by the fourth quarter we will see true signs of recovery, which would let us continue on a path of higher stock prices.

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