"Storm Clouds On The Horizon"

Market Commentary – July 2005

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If foreign investors stop buying U.S. Treasuries, long-term interest rates in the U.S. would spike, thus cooling off the U.S. economy. Thanks to record American demand for imported goods, exporting nations are flush with U.S. dollars. Rather than swap those dollars for other currencies, however, they have been keeping the dollars and buying U.S. Treasuries. If foreign investors find more attractive investments elsewhere and they sell U.S. Treasuries, long-term interest rates in the U.S. would spike. This would slow U.S. economic growth. Moreover, the spike in long-term interest rates could be a catalyst to burst local real estate bubbles that have formed throughout the U.S., especially in baby boomer retirement havens like Florida, Arizona, California, and Hawaii.

The revaluation of China's currency, the yuan, versus the U.S. dollar would eventually help lower the record U.S. trade deficit, but it may also trigger higher U.S. inflation and higher interest rates. China's yuan, pegged at 8.3 to the dollar for a decade, is artificially weak. After years of red-hot economic growth, China's currency should be much stronger than the policy-made peg indicates. Many economists estimate that the yuan is up to 40% undervalued versus the dollar. Because of the undervalued yuan and sharply lower labor costs, Chinese companies are easily undercutting the prices of goods made by U.S. companies. With a stronger yuan and weaker dollar, however, the prices of Chinese goods imported into the U.S. would rise. Rising prices means inflation. The Federal Reserve would then need to combat this inflation with tighter monetary policy.

Futures markets forecast that the Federal Reserve will raise their benchmark Fed Funds rate another 0.50% to 3.75% by their meeting in September. As expected, the Fed raised the short-term Fed Funds rate another 0.25% to 3.25% today, the ninth consecutive quarter-point tightening move since June 2004. The accompanying statement cited that U.S. economic growth continues to be strong, labor markets have improved, and pricing power (inflation) has "stayed elevated". As a result, the Fed continues to expect to raise rates at a "measured" pace. The next Federal Reserve meeting is on August 9.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Throughout 2005, the stock market has traded toward the high end of fair valuation. If long-term interest rates spike, stock prices would likely feel pressure and move down.

Technically, volume has taken a decisive turn for the worse, rising on days when the market declined. High volume tends to give more credibility to movement in price, both on the upside and downside. While our proprietary market breadth indicator has been positive since May 16, it is weakening at an increasing rate. It will likely turn negative during the first week of July. Our proprietary sector analysis shows that while 32% of the 209 industries spanning the entire stock market are in either "strong" or "medium" uptrends, 22% of the industries are in either "strong" or "medium" downtrends. This has been a "stock-picker's market", favorable for active management.

Our simultaneous emphasis on defense and offense has our portfolios in a favorable position regardless of what happens in the market. If the market rises, our clients own some excellent companies that would likely rise with the tide. If the market moves sideways, our portfolios will profit from dividends and melting covered call premiums. If the market declines, we are prepared to cut losses on stocks that get too weak. Moreover, our cash positions will allow us to "buy low" when stocks are temporarily down in price. Defense creates offense. In the meantime, we are patiently observing storm clouds on the horizon and plotting our next moves.