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With Democrats in control of Congress, *quo vadis*?

SUMMING IT UP

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Almost a week after Tuesday's national elections, two big questions hang over the market. Will we have a soft or hard landing? And what effect will the elections have on the market?

The Democrats, as my crystal ball predicted, took the U.S. House of Representatives, and a wave of discontent in the country turned into a tsunami and allowed them to take the Senate as well.

A Congress in Democratic hands and a Republican executive means gridlock. Gridlock means nothing can get done. But gridlock can be good for the markets.

Why? Because nothing can get done.

A lot more money is wasted by pettifogging politicians, but the good news is they can't hurt us because they can't agree. Remember the old Jefferson adage: "That government is best which governs least."

Government regulations act as a tax on the economy, slow down business and make costs rise. Oh, I know, we won't get rid of the regulations we have, but one can't have everything.

From an investment point of view, firms that are heavily regulated should benefit. That includes about all business, but utilities, health care, banking and transportation are just a few sectors that should benefit. A Democratic congress should benefit housing and health care. Companies such as Fannie Mae that have been under pressure should find a more congenial atmosphere.

The other question is hard versus soft landing. Ever since the unnecessary market crash of 2000, engineered by Alan Greenspan, the Federal Reserve has been trying to get back on top of the economy. First there was the tardy response to the crash itself; then Sept. 11 woke the Fed from its torpor and it began to seriously inflate the economy. The current Fed chairman even said that if it became necessary the government could fly around in helicopters and drop money, so concerned did the Fed become about deflation. Interest rates were reduced as low as possible and held there as long as possible. The money supply was inflated, and the inevitable happened: inflation. Even though inflation was obvious in the world and to every homemaker, Greenspan denied its existence until he was reappointed. After his reappointment he became an inflation hawk. Conveniently, the interest rate increases that followed would come too late to negatively impact the reelection campaign of George W. Bush.

Then Greenspan left center stage to Ben Bernanke and began collecting $250,000 for lunch speeches. Bernanke inherited Greenspan's mess. Bernanke has been attempting a soft landing; that is, bringing the economy down to a less inflationary level without doing too much damage. According to one of the staffers at the Fed in recently released minutes of a secret meeting held in 2000, "whenever the Fed has tried this it has resulted in a train wreck."

That is the current conundrum of the market. Will the result be a soft landing or a hard landing? The equity markets, which are forward-looking, have been saying "soft landing." The bond markets, in which the yield curve has been inverted for most of the year, have been saying recession. They can't both be right.

Indeed, every yield curve inversion in the past 35 years has been followed by a recession within one year. So who is right? The combined intelligence of all the investors in the equity markets or the combined intelligence of all the investors in the fixed income markets?

My predictions? The economy softens – in fact, it already is softening. The last GDP figures said the economy grew at 1.6 percent in the last quarter, down from 5 percent and below consensus estimates. Some think the economy did not grow at all. The trajectory is down.

What will turn the economy around? Capital spending is slowing. The consumer is getting tired, and sentiment is weakening. We can't count on home refinancing anymore. Indeed, the housing market is softening.

So if it is not capital spending or consumer spending, what is left? The government. But aren't our deficits big enough? It is hard to see what sustains the economy. The one bright spot is that the price of oil was down just in time for the election.

By spring, the economy will be softer. Will it be a recession? I don't know, but the signs are not good. Definitely the next interest rate move will be down. If I am wrong, and the Fed raises interest rates, then definitely we have a hard landing. But the Fed may have to cut interest rates as early as next spring.

The Fed is running scared as it zooms the money supply. So look for interest-rate-sensitive companies to do better. After this valley, with an accommodative Fed, we should be back on track by the second half of 2007.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. Contact him at 503-452-1210.

About 'Summing it up

My firm, Rutherford Investment Management LLC, provides a quarterly letter about the market that we provide to our clients and others.

By way of background, so you'll know my biases, I grew up in an entrepreneurial environment in McMinnville. My family had a retail business, and in the beginning, we lived in the stockroom of the store. I began work there when I was 7.

After graduating from the University of Oregon and later Harvard Law School, I served in the U.S. Army and lived for two years in Europe. While there I visited the stock exchange of every capitalist country that I visited – this would later prove valuable.

I returned to Oregon and began the practice of law. Later I was hired as house counsel for a regional investment company and, through a twist of fate, ended up running the company at age 31. I had a seat on the Pacific Coast Stock Exchange and a host of problems as the Dow plummeted from 1,000 to 500. Eventually I retuned to McMinnville to practice law and oversee the family business (eventually 13 stores).

I was chairman of McMinnville's downtown redevelopment, which you can still see if you go there today. I was president of the Chamber of Commerce. I was eventually elected four times to the state Legislature from Yamhill and Marion counties. I became treasurer of Oregon and chairman of the Oregon Investment Council. During this time Oregon pioneered international investing for public funds (remember my two years in Europe?) and private equity investing. During this period we earned billions for the state and its pension and other funds.

I was hired to be the CEO of an international investment company in New York City with clients like AT&T and General Motors, and we invested in 22 international markets. We had offices in New York, London, Tokyo and Frankfurt, Germany. I was then hired to be president and launch another international investment company. After that company was sold I returned to Oregon, but I was soon called back to New York to aid in the restructuring of one of Europe's largest companies. I was the sole director of over 20 international firms.

Rutherford Investment Management was founded by me in Portland. We have been listed in Barron's as one of the leading separate account managers in the country and received a four-star rating from Morningstar for our risk-adjusted performance during the last three years ending Sept. 30, 2006.

Our Web site is at www.RutherfordInvestment.com, where you can learn more information. Contact us at 503 452-1210.

– William Rutherford