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Some advice: Do not open 'til Christmas

SUMMING IT UP

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"If you want to get elected, learn to speak. If you want to stay elected, learn to listen."

An old politico once uttered these words. Too bad for the Republicans that, with all of their consultants, they didn't hear them.

An angry electorate rose against a party that had become arrogant and cut it down to size. The anger stretched wide, all the way to the moderate wing of the party, where elected officials with long and distinguished records were cut down, and as far down as local races, where promising leaders of the next generation were also lost.

Now the Republicans, chastened by their losses, have lost hope for "realignment," and the Democrats are trying to look responsible as they tentatively seize the reigns of power. Thus, we see the beginnings of a new day in Washington, where the Republicans have to work with the Democrats, and the Democrats have to find middle ground if they are to remain in power.

Some Republicans think the best thing for Republicans was to lose the election in 2006, so they could come back strong after the Democrats blow their chances. No doubt the Democrats have heard this too and wish to avoid these consequences. But it does lead us to the point that I spoke about in my last column: gridlock.

Perhaps we get a better, more responsible government if the parties have to work together.

The markets appear somewhat optimistic.

After an initial setback over the Democrat victory, the markets have been generally strong as the Dems have settled into power and have not made too many scary noises. However, it remains to be seen which branch of the Democrats will win out. Will it be the Clinton-Rubin global trade branch or the populist economic wing? The recent death of open market advocate Milton Freidman reminds us again of the dangers of state-imposed economic rules.

A drop in the price of oil has no doubt helped the markets. Inflation numbers have been benign. Consumer confidence is down slightly, and unemployment numbers are up slightly. With the Fed growing the money supply at a rapid clip, it seems to be taking out some insurance too. The Fed actions show less concern about inflation than its governors' speeches would indicate, and more concern about a slowdown, as the government revises growth figures down. Financial experts predict earnings growth to slow to the most recent low of the second quarter of 2003. Furthermore, they say that this slowdown will likely continue through 2007.

And, if GDP slows to the 1 percent to 2 percent range, there could be a lot more downside to earnings growth. If the growth rate continues to slow, the Fed has shown a willingness to be supportive of the economy – and that makes it more likely we will see an interest-rate cut in the first half of next year.

Don't forget that the yield curve is still inverted. Also troubling is that volume on the markets has not been particularly strong, as the markets have recently moved up. Furthermore, the Chicago Board of Options Exchange Volatility Index, or VIX, has shown a decline. Normally this complacency in the markets on an upsurge might be viewed positively, but lower volume and lower volatility may also indicate that the markets are willing to take on more risk. Indeed, a spate of massive buyouts that loaded up companies with debt is worrisome. Commercial traders – those who deal in very large positions and who report to the CFTC one measure of "smart money" – are hedging their long positions and betting against the crowd.

Has the recent run up in the markets borrowed from the "Santa Claus" rally? We won't know until Christmas is over.

About a year ago, I gave a speech to Umpqua Bank's private client services group. In that talk, I discussed the direction of interest rates. I asked, "Who's in charge of U.S. interest rates?" And I answered my own question: Hu's in charge. (Hu being Hu Jintao, the president of China.) Recently we received a lesson; the Chinese Ministry of Commerce stated that it needed more diversification in its currency holdings – probably because of China's large losses in U.S. dollar holdings and concern over a weaker U.S. economy, both of which are bad for the dollar. The Chinese indicated they would be diversifying their holdings into currencies other than the dollar. This sent the dollar plummeting and the euro rising in international currency markets. The markets followed the dollar down. What are the implications for the U.S. economy and interest rates? More about that in future columns.

William Rutherford is the president of Rutherford Investment Management LLC, one of the top firms in separately managed accounts according to Barron's and a four-star rating recipient from Morningstar. Rutherford is also the author of "Who Shot Goldilocks?" a critical appraisal of Alan Greenspan's term as Fed chairman.