DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

MONDAY
January 8, 2007
www.djcOregon.com

Reprinted from the Daily Journal of Commerce.
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Market's rally brought a little shock and awe

"We speak with a certain amount of awe, since the last thing in the world we anticipated a few short months ago was that the Dow would be up some 16% on the year, unless it was that the S&P would be up more than 14%."
– Barron's, Dec. 18, 2006

SUMMING IT UP

William Rutherford

In my earlier columns, I have expressed concern about the slowing economy, inverted yield curve, weakening capital spending and housing market. In the middle of the year, we had a sharp drop in the markets owing to a sudden lack of confidence in the Federal Reserve, and a war in the Middle East. Markets dropped sharply. But they reversed direction and by the end of the year reached new highs.

In their climb, the markets were aided by declining oil prices, controlled inflation numbers, strengthening consumer confidence, strengthening home sales, and the purchasing management index, and so managed to turn in an impressive rally in time for the year's end. Impressive profits, global growth and continued low interest rates in Japan led to a strong source of liquidity, which in turn led to massive buyouts of companies, and an increased appetite for risk.

But has this rally borrowed from the usual year end "Santa Clause rally" that often happens at year's end? Is this bull market getting long in the tooth?

The outlook remains much the same, with a threat of inflation, oil at about $60 a barrel, slowing gross domestic product, a fading housing market and possibly fading consumer spending, which would in turn affect business confidence. Although a soft landing looks more likely, it does seem less likely that the Fed will ease rates any time soon. There is still the possibility of further slowing in the economy in 2007, but I think it less likely that we will fall into a recession.

Fed Chairman Ben Bernanke seems to have done a good job in the transition from Greenspan and appears to be in the process of engineering a soft landing – something Greenspan was unable to do.

Look for continued slowing in the economy and the markets to reflect that slowing.

The economy should hit bottom around the third quarter of 2007. By the end of 2007, markets could be 4 percent to 6 percent higher than at the start of the year – but no doubt with dips in between. Add a few dividends and it should be a respectable year, if somewhat below historical trends. As always, external events could make a difference.

For the time being, remain defensive, with a diversified portfolio. Health care, consumer staples, and financials should be market leaders in 2007. Technology could finally make a comeback. This will naturally lead you to larger capitalization and multinational companies. Maintain an allocation to fixed income allocations and international companies. This approach should shield your portfolio from decline and provide growth as well.

In our last column, I promised a word or two on currencies and why international investing is in order. To begin with, the economies of countries outside the United States are often growing faster than the U.S. economy on a percentage basis. This provides the opportunity, albeit at additional risk, for an increase in the value of your portfolio.

In addition, recently the dollar has been weakening against major currencies. Indeed, the dollar has been in decline since President Bush's "Axis of Evil" speech. There may be political reasons why the dollar is falling, but there are certainly good economic reasons as well: a slowing economy and stable U.S. interest rates, coupled with rising interest rates in other major world economies.

Also, recently numerous central banks have indicated they will no longer keep their reserves exclusively in dollars but will use a basket of currencies; this was certainly bad news for the dollar. However, had you been invested in countries outside the United States, you could have benefited from the fall in the dollar.

Multinational countries can benefit from a weaker dollar because it makes their products cheaper in international markets, but a weaker dollar can affect our balance of payments as we import more expensive products, such as oil, into the United States, and indeed a weak dollar can be a factor in keeping the price of oil high. The weak dollar can also have the effect of importing inflation to the United States, which doesn't make the Federal Reserve happy – and causes it to want to raise interest rates.

So, all in all, a strong dollar is in the best interest of America, but while our government talks a strong dollar (and a weaker yuan), it does little to make it happen. In the meantime, you can protect yourself with international investments.

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. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact Rutherford at 888-755-6546 or on the Web at www.rutherfordinvestment.com.