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Soft landing? It just might happen

"Recent indicators have suggested somewhat firmer economic growth, and some tentative signs of stabilization have appeared in the housing market. Overall, the economy seems likely to expand at a moderate pace over coming quarters.

"Readings on core inflation have improved modestly in recent months and inflation pressures seem likely to moderate over time. However the high level of resource utilization has the potential to sustain inflation pressures. ... Some inflation risks remain."

– Federal Reserve news release issued Jan. 31, when the board unanimously voted to keep the target federal funds rate at 5.25 percent

The Federal Reserve board seems to be on the brink of achieving its hoped-for soft landing for the economy.

The litanies of concerns over the economy have been well documented in these columns, so there is no need for retelling. Indeed, last summer the outlook was not bright and the market took a nosedive. But then something unexpected happened in a quiet way – the market began to rise. The "soft patch" turned out to be just that.

The economy began to surprise to the upside. Company profits remained better than expected, and fourth-quarter gross domestic product came in

SUMMING IT UP

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at a solid 3.5 percent. Weakness in housing did not slow consumer spending as expected.

The decision of the Federal Reserve to keep rates steady renewed debate on two subjects: (1) Will we have a soft (not hard) landing, and (2) if so, when will interest rates be cut (if at all)?

A soft landing is very difficult to engineer and, more often than not, ends up a train wreck. The wreckage of the Greenspan debacle of 2000-2001 still litters the landscape.

But working through the very difficult terrain left by Greenspan, this Fed appears to be succeeding. Yes, the Fed was aided by declining oil prices and declining yields on treasuries. (Standard & Poor's estimates that, for every $10 decline in oil prices, one can add 0.25 basis points to GDP.) And lower interest rates certainly cushioned the decline in housing and other parts of the economy. This Fed has had its share of breaks and setbacks, but it's managed to keep the economy on a steady keel – so far.

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From an outlook of "near-certain" fed funds rate cuts in the first quarter of 2007, the outlook has changed to only "maybe" rate cuts by the third or fourth quarter of the year. Some prophets expect rates of 4.5 percent to 4.75 percent by the end of the year, and a GDP of about 2.5 percent for the year. Government data suggests the economy is holding up well, giving the Fed room to maintain interest rates at the current level, without doing severe damage to the economy, and while still holding off inflation.

So, in the absence of a shock to the economy from outside events, one can reasonably expect that interest rates will hold where they are for the near term and that inflation will abate somewhat. This scenario could result in a rising market over the course of the year.

Sectors that appear to be particularly well-suited for investors are technology, health care and financials. Although there is much discussion of a return to a "Goldilocks" economy, external events can still knock us off course – so beware of more tension in the Middle East, oil shocks, terrorist events or a financial accident.

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 five-star rating from Morningstar for its three- and five-year returns. 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.