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Is this the year the consumer stops spending?

Since the market crash of 2000 and the rapid reduction of capital spending, the U.S. economy has depended on the consumer. The consumer has had to overcome war, higher oil prices, higher food prices and now a slumping housing market. Food prices are rising, not only because of the effect of higher crude oil prices but because Bush administration policies toward ethanol are pushing up the price of animal feed and food for human consumption.

The Conference Board and University of Michigan consumer sentiment indices both have shown slumps, with the Conference Board expectations index tumbling more. The Conference Board also noted that consumers' view on the economy turned more cautious, with more respondents expecting the economy to worsen and fewer believing the economy will do better. This worry over the outlook lowered expectations for future job and income gains.

With events in and around Iran heating up, the price of oil spiked to $66 per barrel, and markets swooned, adding to a sense of unease. Traders say if shooting starts with Iran, oil prices could easily challenge the $80 mark set last summer during the conflict between Israel and Hezbollah. Consumer stocks have been under pressure.

There is fear that the subprime mortgage loan problem will spread, and because of lack of transparency it is hard to know to whom and how far it will reach. The Fed acknowledges this new problem and says it will monitor the mortgage sector.

Gross domestic product figures for the fourth quarter of 2006 are revised up to 2.5 percent, but the consensus is that the economy is still slowing. Still, construction spending – but not residential spending – is up, and Midwest factory activity has been strong, easing fears of a sharp slowdown.

SUMMING IT UP

William Rutherford

However, Wall Street analysts see earnings growth in the first quarter of '07 at 3.8 percent versus 16 percent last year. This will mark the first quarter in a long time that we will have not had double-digit earnings growth. Analysts also see earnings growth on the year at 6.7 percent, a sharp slowdown.

With the Fed focused on inflation, rate cuts are unlikely. And with the lack of rate cuts to stimulate the economy, we are back to the consumer. What will he or she do?

In the meantime one Fed governor speaking in Beijing and another in the Midwest predicted that the economy will be stronger by year's end, comments that were eerie reminders of the predictions of Fed governors in early 2001 that the economy would strengthen as the year went on, comments made even as we were sinking into recession. Financial stocks have come under pressure. Safe-haven stocks such as utilities and health care have done better.

With the economy weakening and the Fed constrained in its response because of the threat of inflation, we cannot look to the Fed for much help. Capital spending is slowing because of the weakening outlook, and if the consumer were to pull back maybe we would get a recession, but I don't think that will happen. I think it will be a difficult year for the economy, maybe even a period of stagflation.

The bond market and the Fed chairman are in disagreement. The Fed has made clear that inflation is still its priority. Chairman Ben Bernanke tried to give the Fed more leeway on rates in the last Fed meeting by removing language about firming rates from the Fed's usual statement, saying the Fed's decisions would also be measured against economic growth in case the economy faltered further. The markets took this as a positive sign and rallied, but Bernanke, afraid the markets had misinterpreted the Fed, made clear in congressional testimony that rate cuts were not imminent. The bond markets disagree; while the yield curve is no longer inverted, nevertheless the bond market sees rate cuts this year. The bond markets apparently believe the economy will worsen and the Fed's hand will be forced, and rate cuts will follow.

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Alan Greenspan, former Fed chairman, speaking by video link in Hong Kong, used the R-word to describe our prospects and rattled the markets. Some saw Greenspan's comments as opportunism. Others pointed out that his policies are the basis for the problems we are facing today in the subprime market. Barron's pointed out that in April of 2005 Greenspan had praised subprime loans, saying that "lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately." Sen. Christopher Dodd (D-Conn.), chairman of the Senate Committee on Banking, Housing and Urban Affairs, said quite plainly that Greenspan had helped to create the "perfect storm" in the subprime market and that up to 2.2 million Americans could be exposed to the threat of home foreclosure. The number 2.2 million is interesting because it nearly equals 2.5 million Americans thrown out of jobs in the 2000 Greenspan-led debacle. With Greenspan contradicting himself, Wall Street was peeved.

These conversations in Asia point out the importance of Asia to us and our importance to Asia. We buy their goods, and they lend us the money to do so. But suppose one side of the equation gets tired. If the American consumer's spending slows, then Asian economies could also slow. Conversely, if foreigners, particularly the Chinese, who are now the second-largest holder of our debt, change their investing plans, we could see a rise in interest rates in the United States, a decline in the dollar, or both. China has already indicated it plans to diversify its dollar holdings and perhaps its mix of assets following Singapore and others. Therefore, with the U.S. economy already weak, one can expect a weakening of the dollar, and this suggests more emphasis on international investing, both fixed income and equities.

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A key to the solution of many of these problems would be a resolution of the war in Iraq and our relations with Iran. The price of oil has doubled since the start of the Iraq war, and the dollar has fallen sharply since the "Axis of evil" speech. If we could get some of these matters off the table, it would benefit the economy.

In trying times like these, one needs to be a long-term investor. Despite all the crises we have had since 1987, remember the S&P 500 has returned 10.6 percent per year, including dividends.

This just in: The General Services Administration last week announced the biggest telephone contract in history for telephone service for the U.S. government. Reporters attending the press conference by telephone were left out of the announcement, however, because of a telephone failure.

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.