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Mister Bull, meet Mister Bear

SUMMING IT UP

William Rutherford

Last month we asked the question, "Is this the year the consumer stops spending?" This is an important question because the consumer makes up about 70 percent of the economy.

The remaining 30 percent is government spending and capital spending. While government spending keeps the wheels greased, it's capital spending that helps to increase our productivity and standard of living, so capital spending is often the more desired spending. Some government spending, as in the case of war spending, is simply the destruction of capital, so what the consumer decides to do is very important to us.

So far this year, the consumer has slowed spending somewhat, with personal consumption in March growing by 0.3 percent compared to 0.7 percent in the prior month, and consumer sentiment easing slightly. The lower sentiment indicators might be the explanation for lower spending even though the consumer had more money to spend as personal income advanced 0.7 percent in March for the second month. Lower job creation must also give the consumer pause.

Construction spending rose more slowly than expected. International trade hurt the economy as exports surprisingly fell. Business spending rose, but inventory spending fell.

Corporate profits were higher than expectations but considerably off the trend of the last several years. Overall the GDP grew in the first quarter of 2007 at the rate of 1.6 percent, which was below already-lowered expectations.

A 7-year recovery

All this sounds bearish, and yet the market has rebounded to levels last seen in September of 2000. In other words, it has taken the market nearly seven years to recover from the Alan Greenspan-led market crash of 2000-2001.

With the economy slowing, Greenspan saw an opportunity to get back into the game with his famous prediction in Hong Kong of a recession later this year. This prediction sent the market into a tailspin. The subprime loan debacle (which Barron's points out was Greenspan-promoted) also contributed to the market decline. But Greenspan has never been known for his forecasting skills. Recall his famous "irrational exuberance" comments came years before the market peak. What Greenspan apparently did accomplish is to get Greenspan followers to short the market. Thus, when earnings began to come in somewhat better than expected, the market rallied, perhaps more than it should have, both to celebrate the earnings but also to cover shorted stock as well.

With the economy softening, attention turns back to the Fed. But the Fed is unlikely to change its course. The futures market is changing its view of Fed policy to a view of no rate cuts in the near term. The Fed is likely quite comfortable with the market reaction, as inflation still remains a threat even as the economy may be bottoming. If the Fed stands pat, we can expect further slow growth.

Inflation is another story, with the price of oil remaining high and now food costs rising in part because of increased global demand and the ability of consumers to buy more food.

In China, for instance, where food represents nearly 40 percent of an average family's budget, the price of food has increased nearly 8 percent year-over-year. This must be especially worrisome to the Chinese government because a similar spike in food prices was part of the ramp-up to 1989's protests at Tiananmen Square.

What's happened of late seems bearish, and yet the market has rebounded to levels last seen in September of 2000. In other words, it has taken the market nearly seven years to recover from the Alan Greenspan-led market crash of 2000-2001.

Closer to home, we learn milk prices at Starbucks are narrowing margins, and since Starbucks is not able to hedge the price of milk, that price hike is affecting margins. Furthermore, we cannot ignore the effect of ethanol policies on our own cost of food. So, with inflation still threatening, the Fed cannot afford to be lax.

The Fed may also want to follow a different path from the so-called "Greenspan put," the notion that, if the market fell, Greenspan was there to cut rates and lift the market back up. A Fed chairman, you will recall, has only two constituencies: the president of the United States and Wall Street. In order to keep his job, Greenspan had to keep one of these happy. Since he was usually on the outs with the president (until George W. Bush), Greenspan had to keep Wall Street happy;

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hence the Greenspan "put."

Chairman Ben Bernanke seems to have no such agenda, and he seems more intent on doing his job than keeping it. Thus, if inflation remains high, we may find the Fed holding firm, even if the economy slows further.

Look to Europe and farther east

Because of government policies, the dollar will likely remain under pressure. For instance, as the European economy strengthens, the European Central Bank has indicated it plans to continue to raise rates. The Bank of England has done the same. As a result, it becomes more attractive to hold non-dollar currencies and assets.

If you have not already done so, you should increase your exposure to the international economies, both European and especially Asian. One indicator of the changes in world economies is that, for the first time since before World War I, European market capitalization exceeds that of the United States.

Remain well-diversified not only between asset classes (real estate, stocks, bonds and cash) but within asset classes as well. Remain a long-term investor. Don't be shaken out of the market by short-term events, and rebalance your portfolio to retain your desired asset mix.

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.