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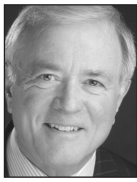
Fed is struggling as the economy falters

Investors will need to have long-term perspective, patience and diversity of holdings



SUMMING IT UP

William Rutherford

As Federal Reserve Board Chairman Ben Bernanke continues to grapple with the hand dealt to him by his predecessor, the outcome still hangs in the balance. He must struggle with a slowing economy on one hand and rising inflation on the other. With a dual mandate of maintaining a strong economy and controlling inflation, the Fed is conflicted in its course. If only they had the mandate of the European Central bank (which is solely to control inflation – economic growth be darned) life would be so much easier.

In past few weeks we have seen gold hitting historic highs. Oil is now at $102 a barrel, and gasoline prices at the pump are up over 10 percent. On February 25, spring wheat traded above $25 per bushel on the sleepy Minneapolis exchange, not only an all-time high, but up from $11 just 14 days earlier. Soybeans and corn all trade at record highs.

For several years I have written abut the rising cost of food. Accelerated by increased purchasing power in emerging markets, and foolish food policies in the Untied States, food prices are setting records. Rising food prices have caused unrest in many countries and history shows us that rising food prices can cause severe disruptions. Not only are food prices rising, but food is become scarce. The World Food Program, a U.N. agency responsible for relieving world hunger, is holding crisis talks to plan for food rationing.

In the meantime, Saudi Arabia is cutting wheat output because of the strain it puts on water supplies, and the Chinese are diverting millions of gallons of fresh water from towns, villages, and farmers in order to have adequate supplies for the Olympics.

While inflation takes its toll, the decline in U.S. home prices continues to accelerate. The home-price index fell 8.9 percent in the fourth quarter this year — the biggest drop in the 20 years they have kept data. January showed no improvement as the median home price plunged a record 15.1 percent compared to last year. The Fed seems powerless to stop the drop in home prices because interest rates are only part of the problem. Also, 30-year treasury rates remain stubbornly high as fear of inflation persists.

As the economy falters, wholesale prices skyrocket. According to the labor department, production prices jumped 1 percent in January alone — more than double the expected 0.4 percent gain. Meanwhile, prices rose 7.4 percent during the last year — the biggest jump in 26 years. Factor in the imprecise nature of the government measurement of the cost of living, and the fact that their measurements are mostly backward looking while booming commodity prices are forward looking, and one can only conclude that we are in for a strong dose of inflation. Historically, inflation has not been kind to equity and fixed income markets. One is better owning tangible things, and owing money.

So the line that the Fed must walk is very narrow, balancing a slowing economy and inflationary pressures.

Thus far the Fed has opted to stimulate the economy (it is an election year) by lowering interest rates. The effect of this has been a rise in commodity prices and a fall in the value of the dollar.

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Thereby, we cheapen our currency and make our exports more exportable. We make our obligations worth less and pay them off in cheaper dollars, and we export our slowing economy as our trading partners find it harder to sell their goods at new, higher prices. "Staying alive at a one-point-five," may be the new mantra of European businesses, as the dollar falls below 1.50 to the euro.

In the meantime, China intentionally slows itsred hot economy to a mere 9 percent growth rate. Hong Kong experiences a budget surplus five times projections and declares a one-time 75 percent tax cut on business, individuals and property; and Vietnam is forced to reign in the rising value of the once near-worthless Dong.

For now, the Fed has no choice but to keep cutting interest rates. But that will not be enough, as credit markets are still in turmoil. When faith in credit markets is restored, then interest rates can begin to do their job. The Fed has been expanding the money supply and begun accepting a broad range of collateral for the credit facility established to assist banks. The Fed has now revealed that the collateral is not all that good. This may be the first step toward nationalizing the problems of the credit. President George Bush and Treasury Secretary Henry Paulson have said that they will not back a bailout of mortgage holders to stem the housing crisis. But at the end of the day, that may be the only viable solution.

Investors need to have a long-term perspective, be patient and be well diversified in their holdings. This too will pass.

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 him at 888-755-6546 or wrutherford@rutherfordinvestment.com.