

THE BUTTONWOOD



Third Quarter 2007



On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street.

There they signed the *Buttonwood Agreement*, creating the first investment community, which later evolved into the New York Stock Exchange.

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Thoughts on Recession, Bernanke and Inflation

By Kevin VandenBerg, MBA, LIFA

Recession? Not Likely. There were two economic reports released recently that portrayed two different economic pictures. The Commerce Department's release of new home sales showed a drop of 8.3%, which is the slowest pace since June of 2000. We've all seen and heard the resulting fallout in the news media: the housing problem has always led us into recession and is leading us down that path once again. On the contrary, a recession usually leads to a decline in housing, but not vice versa. In this case, we are witnessing a weak housing market at the outset of a slowing (albeit still growing) economy. As usual, the media seems to have it backward.

The other economic report that showed a positive foresight regarding the economy was the decrease in claims for unemployment by 15,000 to 298,000. That release was much better than expected and points to a relatively healthy economy. If we were headed for recession, we would expect to see claims increase in the next four weeks in the 350-360,000 range.

Although the third quarter growth figure will be much less than the 3.8% figure in the second quarter, the biggest leading indicator for the economy, the stock market, is once again pushing toward new closing highs. If we were on the brink of recession, the market would undoubtedly be much weaker than its current bullish advance. Also, market volatility is subsiding and fear over the credit squeeze seems to be abating as a result of the decline in both the Fed Funds Rate and the Discount Rate.

Lastly, industrial commodity prices continue to march higher.

While gold can remain strong in the face of economic weakness, commodities like rubber and copper cannot and are strong only when the economy is growing. Many also point to the Fed's rate cuts as contributory to the increase in commodities, but that is not the case. It typically takes months for a rate cut to affect industrial commodities.

These factors point mostly to a continuation of a slower growing economy, but one that is advancing. We believe the increased liquidity injected into the system in the last six weeks will support our economy as well as provide a calming effect on the recently volatile financial and credit markets. The odds of a recession in the near term with the current information contained within the marketplace seem to be less than 40%.

Bernanke Fed Makes Its Mark. Federal Reserve Chairman Ben Bernanke couldn't have chosen a better way (through the eyes of investors) to break tradition with the Alan Greenspan Federal Reserve's policy. Rather than lowering interest rates in mere quarter point intervals, like his predecessor favored, Gentle Ben opted for 50 and 50: a half point cut in the fed funds rate and a half point reduction in the discount rate. Wall Street was anticipating a 25 basis point cut in the funds rate and was not anticipating the second 50 basis point discount rate cut.

While inflation is certainly not out of sight or out of mind, Bernanke seems far more concerned with preventing the housing sector and sub-prime mortgage lending-induced credit crunch from spilling over into the broader economy. A modest

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Year to date performance and yield for various benchmarks

| | |
|---------------------------|--------|
| S&P 500 (large cap) | 9.13% |
| S&P 400 (mid cap) | 11.01% |
| S&P 600 (small cap) | 6.58% |
| EAFE (Int'l Developed) | 13.15% |
| EAFE (Int'l Emerging Mkt) | 32.02% |
| Dow Jones Industrials | 11.14% |
| | |
| Treasury Yield (2-year) | 4.01% |
| Treasury Yield (10-year) | 4.52% |

Have you been in recently to review your portfolio? If not, please contact us to schedule a meeting.

cut now and the promise of another cut later would likely have led borrowers to postpone taking any action. However, the surprise move will help banks not only deal with current credit market problems, but also lead to new credit market activity sooner rather than later.

The market seemingly found a bottom after the Fed's first discount rate reduction and has since rebounded 13% off its lows to 1540 as measured by the S&P 500. We do expect some profit taking soon, most likely a pullback to the 1440-1450 area (5-6% at the most), but a higher market is probably in the offing over the long term. The most recently completed reverse head and shoulders top formation is a technically bullish signal in the market, and it has also embarked on another interestingly bullish pattern induced by the Federal Reserve. Several years ago, economist Norm Fosback popularized the concept of "Two Tumbles and a Jump". This includes the Fed lowering the discount rate twice in succession and the market following with strong gains. The indicator is definitely not foolproof, but it's one that is worth a look. While many are worried about the economy faltering, keep in mind that Fed cuts spur the economy and increase market liquidity. When this happens, and there is slack in the economy, stocks normally advance.

The "Two Tumbles" theory demonstrates (through quick calculation) that post WW II, the 6 and 12 months following two discount rate cuts, the S&P 500 has increased 7.8% and 17.1% respectively (adding in dividends would push these figures even higher). The lone big downdraft was witnessed in 2001 when the index lost 14% in the following 12 months. If we were to see similar positive advances as listed above, we would see the S&P nearing 1800 and the Dow moving from 13,800 to 16,000. As mentioned, we wouldn't use this as a sole barometer of things to come in the market, but the backdrop seems to be predisposed toward a higher move.

Ahead of the Fed's rate cuts, energy and commodities were

moving higher with the increase in global demand. The dollar was under pressure as many key overseas economies were outperforming the U.S., and has continued to fall after the rate cuts. The Fed seems to have decided that it's more important to grow the economy than to fight inflation. Although this will help to stimulate the economy somewhat, it will not curb the effects of inflation and consumers will have to spend more and more of their discretionary income on commodities (heating oil, gasoline, food, etc).

Therefore, our tactical strategy remains to overweight faster growing international investments, increase our exposure to commodities and metals, while also pursuing more growth-oriented companies (as opposed to value) because of their more reliable and less cyclical earnings streams.

Bond Investors Beware. As remarked above, inflation could remain a nuisance going forward, especially for investors on a fixed income stream or with a large portion of their portfolios in bonds. The reason we are cautious about bonds and fixed income going forward is that our current situation is resembling a period in the late 1960's and 1970's. In 1965, for example, bond yields approximated 4.5% while headline inflation was close to 2% year-over-year (similar to the past few years). The fifteen years that followed were catastrophic for bonds, but very good for commodities and especially metals. Additionally, securities leveraged to growth in the developing world (China, India and other emerging countries) are now carrying the load with regard to the global economy. However, the continuation of that growth will most likely lead to higher inflation in the next several years and beyond.

Should this be the case in the next several years or the next decade, bond investors are going to face a declining "real income" as higher prices erode their purchasing power. The way to offset this type of erosion is to allocate more dollars to inflation fighting vehicles such as metals, commodities or equity securities.