MARKET NEWS

Keeping our Clients Informed

First Quarter 2006

April 24, 2006

The End is Near

So far, 2006 has gotten off to a good start for the equities market. Despite record high energy prices and higher interest rates, stocks have managed to post solid gains in the first quarter. In the first three months of the year, the Dow Industrial Average advanced 4.24% with the S&P 500 not far behind at 3.73%.

Once again the mid-cap and small-cap group out-performed the larger averages, as evidenced by the Russell Midcap's advance of 7.61% and the Russell Smallcap's gain of 13.94%.

This year's investor enthusiasm can be entirely attributed to the belief that the Federal Reserve is finally coming to the end of their now 15 straight rate hikes. Next month will almost certainly make it 16. With that, the Fed Funds rate will stand at 5.0%. After May, there is little consensus as to what to expect. The market's preoccupation with anticipating the next Fed move has been roiling the markets in recent weeks. As each new piece of economic data is released, the market reacts by trying to guess how the Fed will interpret the news.

The other wildcard in all of this is the new Fed chairman Ben Bernanke. The new chairman took charge this quarter, presiding over his first FOMC meeting in March, as well as making several appearances in front of congressional committees. Bernanke is, generally, considered to be of the same mindset as the former chairman Alan Greenspan, but as we near the end of this two-year long rate hike campaign, we'll learn more.

The March FOMC meeting and the resulting 25 basis point rate increase could have been as much a signal of policy continuity as a true belief in the risk to sustainable economic growth (the Fed's stated policy mandate). The next meeting will take place on May 10. Although there will likely be little surprise as to the outcome of that meeting (expect another .25% increase), it is the wording of their statement and release of the minutes weeks later that should be of most interest.

Seeking Direction

The wording issue encapsulates Mr. Bernanke's challenge. He came to the Fed promising to make its policy-making more transparent, but arrived at the very moment when economic circumstances make it less clear what their policy will be. Under Greenspan, financial markets had grown accustomed to the Fed telling them pointedly where rates were headed. After nearly two years of raising rates, the Fed's efforts to convey that it now isn't certain where rates are headed has been read by markets as a sign that they're almost done.

Since Mr. Bernanke talked this week on Capitol Hill about the possibility of a pause in the Fed's rate increases, bond and commodity markets have signaled increased concern about inflation. With the latest data showing robust growth and inflation ticking higher, we've seen a significant sell-off in the 10 and 30 year Treasury issues. There has also been a big jump in commodity prices. These markets seem to fear that the Fed will stop raising rates too soon. Yet, this has been good news for stocks. During the same time we've seen bond prices drop, the Dow has gained roughly 300 points.

Fed officials always have an expectation of where rates will go, at least privately. But their confidence that their expectation will be met, and willingness to talk about it in public, varies over time. Back in 2003, they were confident the funds rate could stay at 1% for a "considerable period," and said so. That was a strategy that Mr. Bernanke, then a Fed board member, strongly backed as part of an effort to avoid the sort of deflation that was ravaging Japan. By 2004, Fed officials were confident they would lift rates at a "measured" pace, and said so. At every meeting since, the federal-funds rate has risen, staircase-like, by a quarter of a percentage point.

With the economy back to full strength, rates closer to normal levels and mixed messages in the economic data, the Fed's confidence about the future path of rates has dissipated. Fed officials still believe rates are more likely to rise than fall, but they figure that may happen irregularly, over several months, depending on the incoming data. That is what's usually happened in the past. The recent staircase pattern is anomalous. A more gradual, less predictable path gives Fed officials, especially those worried about raising interest rates too far, time to assess the impact on the economy of past rate moves.

Through all the pain that the sell-off in bonds has created, one benefit is that the yield curve is no longer inverted. Earlier in the year the yield on the 1 and 2 year treasuries was actually higher than the 10 and 30 year issues. Historically, this signals a pending recession. At least that concern has been put aside for now. That has certainly been a welcome relief for stocks.

The Big Oil Conspiracy

You're, no doubt, aware of the assault on oil companies by state and local governments and consumer groups over the record high price of gasoline. There is barely a news program aired these days that doesn't show someone calling for an investigation into alleged price gouging by the major gas producers in this country.

Because all of our clients have a significant stake in these firms, we feel that it is worth taking a moment to separate the facts from fiction.

To be clear, the higher prices at the pump are the result of more demand than there is supply of both oil and gasoline. These higher prices are not the result of the major producers getting together in a back room somewhere and setting the price that they're all going to charge. This, in fact, would be impossible to do because the prices for both oil and refined products are set openly every second of everyday worldwide in the commodities markets. If a buyer in the U.S. was unwilling or unable (let's say by Federal mandate) to pay the current price in the open market, the sellers would simply sell their product to another buyer (possibly a European or Asian company).

It is true that oil production is dominated by a relatively small number of companies worldwide, although no fewer than in the past. This is more the result of the capital intensive nature of the business than an effort to fix prices. The only realistic way that the oil producing nations or companies (i.e. OPEC, Exxon, etc.) can affect the price of oil is by manipulating the supply. With production at record high volumes, it's obvious that supply is not being artificially suppressed. Demand for oil is simply higher than it has ever been.

All of this is different than buyers bidding up the price of oil due to a perceived risk to supply. This supply risk premium is a major factor in oil prices now. It is estimated that as much as $20/barrel of the current price can be attributed to this belief. One of the great ironies is that most of the energy to power the free world comes from some of the most corrupt and dangerous places on the globe (Iran, Venezuela, and Nigeria to name a few). The political risks to supplies have never been greater. Compound this with the daily global demand and it is easy to see why buyers are willing to secure their needs at virtually any price.

Where we have real supply shortages is in refining capacity, especially in this country. Even though our domestic usage has dramatically increased over the years, our ability to refine oil has barely changed. Interestingly, the government has been the primary obstacle here. Due to the heavy burden of regulations, it has been almost impossible to develop new refineries, pipelines or even explore for our own sources of oil in promising places like Alaska or the coast of Florida.

Furthermore, government regulations mandate that over 100 different blends of gasoline be produced across the country throughout the year, all but eliminating economies of scale in production. In the latest energy bill passed by Congress this year, more mandates were put in place requiring certain levels of Ethanol be included in varying amounts across the country. Of course, now the price of that input has skyrocketed due to shortages. In typical fashion, the farm lobby pushed for Ethanol mandates even though the manufacturing capacity wasn't in place to meet demand. Ethanol is available from foreign sources but tariffs make them cost prohibitive.

Political pandering has led to a host of proposed "solutions" from Capitol Hill. The first order of business, of course, is to look into price gouging. Although no one is entirely sure how that is to be defined, our representatives in Washington want to make sure no one is pocketing too much money at the pump. An interesting footnote here is that the entity that is making the most off each gallon sold is, in fact, the government, to the tune of about 50 cents per gallon in taxes (compared to Exxon, who makes only about 9 cents per gallon in profit). Maybe it's time the big oil companies start screaming "tax gouging" the next time a politician asks for a government probe into their business practices.

Another preposterous idea being floated by Congress is to send every household a check for $100 to assist with energy bills until they can come up with a solution to higher costs (which they won't be able to do). While we're all for free money, we're also for fiscal responsibility.

We trust that the private sector will, ultimately, find a real solution to high oil prices through research and development in the near future. With energy prices this high, many alternatives become economically viable. In the meantime, this is beginning to feel a lot like another government shakedown, similar to the Microsoft antitrust battles when that company was "too profitable".