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# When is "Bad News, Good News"?

Global equity markets have been in a quandary lately between worrying about inflation and higher interest rates, and at the same time, slowing economic growth. We are at that point in this economic cycle where the tug of war between higher interest rates and slowing profit growth may determine the near-term outlook for the markets. Ed Hyman, of the ISI Group, has for many years described this situation as when "bad news becomes good news."

Economic growth is stellar, and corporate profits are great. Yet the market is struggling as investors fear that rising interest rates worldwide will cause a slowdown in growth with a commensurate severe hit to profits. Mr. Hyman would say that the way out of this box occurs when there are sufficient signs of slowing economic activity that the central bankers feel they can stop raising rates. Since the market is forward looking, that would likely mean monetary easing would be the next change in policy. And easy money is the best tonic for stock markets everywhere. Thus, "bad news", i.e.: slowing economic growth, is "good news" in that monetary tightening may be close to an end and easier money is just around the corner. However, chances are that we are still a ways from "bad news" really being "good news."

The muddle-through scenario remains the highest probability, as always. The Federal Reserve does not work for Wall Street; it works for Main Street. They will try their best not to generate a severe slowdown. They may even pause in their ongoing rate hikes this summer to get a feel for just where things are. We are probably <u>a long way</u> from easing, but the Fed will not bail out the market.

Compared to the last forty years or so, interest rates are really not very high at all. And, adjusted for current inflation levels, they don't seem high. So it is very unlikely that short-term rates will come down through the remainder of this year. The market will remain in the trading range in which it has been for the last year.

In recent weeks the market has been moving down toward the bottom of that range. As usual, investor sentiment has gotten more bearish as the market has pulled back. Currently, Investor's Intelligence reports that 38.7% of investment letter writers are bullish, and 34.4% are bearish. The four percentage point difference is the lowest since last October, when the market staged a good year-end rally. With this much fear in the market, it is a good bet that the bottom of the range, about 1200 on the S&P 500, will hold. A relief rally should ensue over coming weeks.

We would guess that smaller stocks, energy stocks, and some commodity cyclicals will be sold into the rally, and larger, higher quality companies will be bought.

*Robert C. Davis, CFA/CIC*
*June 14, 2006*

## CURT ROHRMAN JOINS DAVIS HAMILTON JACKSON & ASSOCIATES

DHJA is pleased to announce that Curt Rohrman has joined our Investment Team as an equity portfolio manager/analyst. Curt has over 18 years of investment experience as both a portfolio manager and equity analyst. He was most recently with Vaughan Nelson Investment Management here in Houston and prior to that, with USAA Investment Management Company in San Antonio. As a technology analyst at CS First Boston, he was named to Institutional Investor's All-America Research Team. Curt has a BBA from Texas Christian University and a MBA from the University of Texas at Austin.

A copy of our Form ADV, Part II is available upon request.
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