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DAVIS HAMILTON JACKSON & ASSOCIATES, L.P.

Just Do It!

Federal Reserve Chairman Greenspan last week changed his language when discussing future rate increases. In three months we've gone from expecting the Fed Funds rate to be raised after a "considerable period," through "patience," and now at a "pace that is likely to be measured." In other words, it will be sooner rather than later! For the stock and bond markets, sooner would be better.

A 0.25% or 0.50% increase in short-term rates will have little effect on the economy. Rates are currently so low that even the Federal Reserve has said they would have to be raised to 3.5% just to be "neutral" in today's inflation environment. That's 2.5 percentage points from here, and no one expects that large a jump any time soon. Meanwhile, the stock and bond markets suffer rate hike jitters that are a lot worse than the real event will be. Market psychology would be much improved if the Fed would just do it!

I'm sure that the central bankers are trying to give everyone plenty of warning of the impending increases because consumers and businesses have so much of their debt tied to floating interest rates. With the yield curve so steep for so long, this has been the logical thing to do. The Fed knows that not everyone will adapt well to the new rate environment. Consumers with adjustable rate mortgages will see a cash flow squeeze. Businesses, like banks and other financials will suffer margin declines as short-term rates rise relative to long-term rates. I believe the inevitable has been pretty well telegraphed. The markets have reacted. The next probable "surprise" will be that the markets will likely enjoy a short-term bounce when rates are raised, as they have already declined ahead of the event.

Having said that, the longer term outlook for the equity market requires a little more perspective. In the spring of 2003, we had almost a perfect situation for a positive turn in the market. Short-term rates were plunging. The deficit was starting to grow rapidly. The economy had been through an inventory cleansing recession and companies were lean and mean. Given those conditions, any kind of improvement in economic growth would lead to huge profit growth, which is exactly what happened. Investor psychology was decidedly bearish on the eve of the Iraqi War. There was a lot of money on the sidelines ready to get back in the market.

Things look quite different today. Rates are going to rise. The deficit will be dealt with after the Presidential election and it will decline. After a year of recovery, companies have enjoyed huge profit increases. However, they are now starting to hire. These new hires will mean slower growth in productivity and thus profit margins have probably peaked. So, as great as earnings are, it's hard to see much growth next year. Investor psychology is not bearish enough for there to be much money on the sidelines.

Almost every factor is the complete opposite of last year. Earnings are so good that valuations are not at very risky levels, so we don't see a bear market. However, don't expect an easy time of it for the next year. Just buying speculative stocks for the ride last year was the thing to do. The next twelve months will belong to higher quality investment grade issues.

Robert C. Davis, CFA
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