

Market Commentary

A Strong Quarter – Why?

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The stock market just completed a very strong quarter. This followed a very weak second quarter and a robust first quarter. Which quarter represents reality and why has the market rallied so much in the last two months?

We think the explanation for the market's strength is pretty simple: declining interest rates and oil prices. First we'll address each of these factors and then what the longer term meaning of the recent rally is.

Over the long run interest rates and inflation more than other factors drive the stock market and they are interrelated. The Federal Reserve acts to increase interest rates if it thinks the economy is overheating and is concerned about inflationary pressures. Fighting inflation is generally acknowledged to be the Fed's most important job (although some feel full employment is equally important). As interest rates move up, bonds become relatively more attractive investments, and some money tends to gravitate out of stocks into bonds. Given a fixed total investment dollars, stocks decline in value.

During the second quarter the Fed was still in a mode of raising rates and how long this would continue spooked investors. In the third quarter economic reports showed the economy slowing and inflationary pressures subsiding. The Fed had two meetings during the quarter and in both cases left rates unchanged. This increased the confidence of investors that the next Fed move would be a cut in rates rather than an increase. We also returned to a situation in which short rates were equal to or slightly higher than long rates, which causes some to be concerned about a recession (someone has to always be worried about something in the economy!). With rates declining, stocks became more attractive and money flowed the other way, out of bonds into stocks thus causing stock prices to increase.

The second major factor, oil prices, is related to the first. One of the main inflationary pressures on the economy is the rising cost of energy. In addition, high oil prices tend to reduce discretionary spending (for instance, on clothes and other elective purchases), thus reducing retail sales. They also increase the cost of raw materials which reduces corporate profits and earnings. Oil prices declined when tensions came down slightly in the Middle East with the end of outright hostilities

in Lebanon, oil inventories rose, and there was a major oil find in the Gulf of Mexico which has the potential to slightly reduce U.S. dependence on foreign oil in the future, and forestall the time when we “run out of oil.”

Combined with companies reporting generally strong profits in July, these factors gave investors greater confidence to invest in stocks creating more demand and rising stock prices. Not too complicated.

What does it mean? We and others have long contended that short term performance makes investors feel good but is of much less real significance. It is far better to have several years of high single digit total returns than to have a 20% up year followed by a 20% down year. By itself no one quarter means very much, but in aggregate eight to ten quarters combined is of real significance. We’ve said it before and we’ll say it again, focus on the long term both in selecting investments and in evaluating performance. It’s the only meaningful measure.

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