

September 30, 2005 Market Commentary

The Dog that Didn't Bark

Why have U.S. stock and bond markets remained relatively calm in the face of hurricane devastation, surging energy and housing prices, and unrelenting war in Iraq?

It's a mystery worthy of Sherlock Holmes. The U.S. stock market has been eerily calm during the past two years (see chart), with market expectations of volatility hovering near a 10-year low. Yet, the country's economic situation remains as uncertain as ever. Are equity investors simply shrugging off risk, or are there other forces at play? In this article, we put on our detective caps and attempt to solve this mystery.

A Prime Suspect: The Federal Reserve

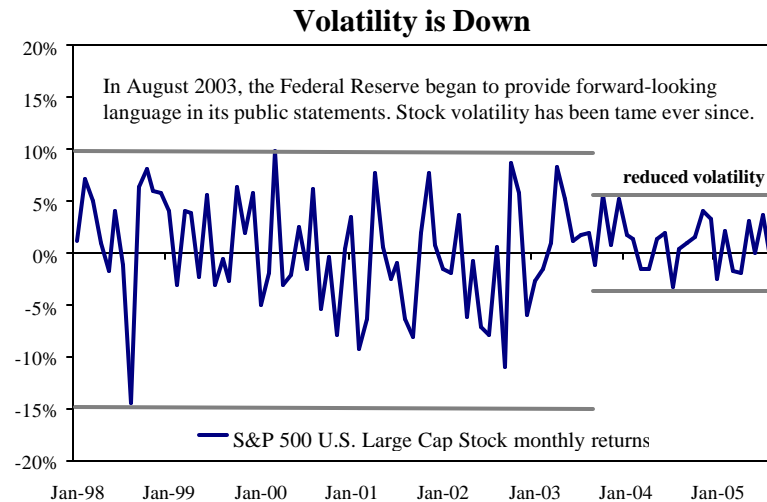
After considering a number of possibilities, we've identified the Federal Reserve as a likely suspect in this case of economic whodunit. The Federal Reserve's job is to govern the U.S. money supply. By controlling the interest rate at which banks lend to each other, the Fed has the power to stimulate or slow economic growth.

The Fed's job is anything but easy. In 2003, Federal Reserve chairman Alan Greenspan was concerned with persistent sluggishness in the U.S. economy. Tired of cutting rates with little effect, Mr. Greenspan took the bold step of inserting some forward-looking language into the Fed's

communication, effectively assuring investors that interest rates would likely remain low for "a considerable period".

Realizing that investors are often more concerned with the future than the present, Mr. Greenspan made what appears to be a great innovation: the forward-looking Fed statement. Taking the Federal Reserve's word that easy money would be available for some time, Americans aggressively ramped up their investment and consumption. The home mortgage market skyrocketed as low-cost mortgages fueled liquidity and price appreciation. In a matter of months, the U.S. economy roared back to life.

The Federal Reserve was pleased with this outcome. Mr. Greenspan had discovered that by giving investors better information, the economy's growth prospects could be noticeably improved. Knowing a good thing when he saw it, Mr. Greenspan made forward-looking statements a regular part of the Federal Reserve's communications. Investors, too, were pleased as volatility fell and stock prices rose. Watching their portfolios grow, many investors concluded that Alan Greenspan was more than a faceless bureaucrat – he was an economic superhero, ready to come to America's rescue at a moment's notice.



By 2004, the Federal Reserve saw that the economy had recovered and it was time to start raising rates. To avoid frightening investors, the Fed communicated assurances that rate hikes would not begin for several months, and once they did, would proceed at a "measured" pace. Thus assured, investors continued to merrily pursue risk.

No More Mr. Nice Guy

Unfortunately, the era of comforting, forward-looking assurances may be coming to an end. The U.S. economy appears to be approaching a delicate stage where the Federal Reserve may be unable to provide any useful advance warning of its future actions. Having gradually raised the federal funds rate target from 1.0% to 3.75%, the Fed is now preparing to deal with the touchy problem of deciding when to stop raising rates in the face of surging inflation, mounting budget deficits, trade imbalances, and almost full-throttle current consumption by the American consumer. Given the magnitude of the U.S. economy's imbalances, the Fed will have to operate with extreme caution. Unfortunately, the Fed's work will be complicated by the fact that the economic results of any decision may not be known for 12-18 months. If the Fed miscalculates and either overshoots or leaves rates too low, the results could be harsh and long-lasting.

Normally, the Fed's interest rate management decisions are supported by armloads of economic data. However, in the wake of hurricane Katrina, the decision may have to be made differently, as the wild economic fluctuations kicked up by the hurricane will likely cloud the country's economic data for months to come. We therefore expect the Fed to be less confident in its decision-making and more cautious about setting any meaningful forward-looking guidance.

Further complicating the Fed's outlook is Chairman Greenspan's impending retirement, set to occur in January 2006. Should Greenspan be replaced with an "inflation hawk", short-term interest rates could rise much higher, putting a squeeze on the economy. If, however, the new appointee takes a more accommodative approach, easy money policies could become the norm.

Investors Dislike Uncertainty

As currency values and interest rates are the foundation on which financial markets are built, investors have good reason to be extremely sensitive to changes in the Fed policy. Should the Fed lose credibility in its role as inflation-fighter and growth-stoker, investors could quickly take their capital elsewhere. Given the low savings rate in the U.S., the impact on "skittish" foreign investors is of particular concern.

During the next year, we believe it will be difficult for the Federal Reserve to continue to provide a meaningful picture of where interest rates are heading. Therefore, we believe that there will be a chance that investors may become less willing to accept risk. Should this happen, we could see stock market volatility jump to pre-2003 levels. While a rise in volatility is sometimes accompanied by strong returns, more often than not, a surge in volatility is accompanied with below-normal returns.

What We're Doing About It

For starters, it is important to keep things in perspective. The risk of an increase in stock market volatility due to difficulties at the Fed is merely one of a multitude of factors that should be considered. It's important, but it doesn't dominate our thinking. We believe in taking a balanced approach to risk – identifying all the possible factors and outcomes, setting aside resources in proportion to the likelihood of each outcome.¹

It's as if investors are sailing their boats 100 miles from shore and Alan Greenspan is the weather forecaster.

If, for some reason, Mr. Greenspan can't provide a forecast, the boaters will likely move closer to shore.

Over the long term, we expect that the world's economies will generally find ways to overcome whatever problems they face. Therefore, we plan to continue to invest in a broadly diversified mix of stocks throughout the world.

However, we also believe that U.S. stock and bond investors may have become unduly complacent under the current Federal Reserve administration. In our view, there is a chance that in the coming year, the Federal Reserve's performance may not live up to investors' expectations. In such an event, higher levels of market volatility could occur, driving investors to reduce their risk exposures, causing some stock and bond prices to decline. To guard against this and other risks that we've outlined in earlier communications, we've increased our cash position, taking advantage of rising short-term yields.

With short-term yields rapidly approaching 4.0%, a sea change may soon occur in investor psychology. Given that the S&P 500's return has been sub-zero for the past five years, it may be only a matter of time before investors begin to consider cash as the more attractive place to invest their money, at least for the short term.

Looking beyond the future volatility issue and the stock/cash decision, we are also taking steps to achieve broader diversification against other risks, such as inflation, deflation, credit, currency, etc. While risk can never be eliminated, we believe it can be managed. Our upcoming communications will explore strategies for both risk control and return enhancement.

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Northwest Capital Management
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¹ In our 2nd Quarter, 2005 commentary, we identified a range of economic risk factors that may adversely affect the U.S. economy, including declining savings rates, ballooning U.S. trade and budget deficits, rising short-term interest rates, bubbling housing and energy prices, and overextended home buyers. These factors do not appear to have improved during the third quarter as the estimated \$200 billion cost of rebuilding after hurricane Katrina will likely be added to the U.S. budget deficit. While many post-Katrina statistics have not yet been compiled, consumer confidence and new home sales declined in September.