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## Market Commentary

A Review of the Markets and a Look into the Future

### Defying Threats of Violence, Iraqis Hold Elections

"The world is hearing the voice of freedom from the center of the Middle East."

- President Bush

As January drew to a close, Iraqis embraced democracy in large numbers. In spite of strong threats of violence and a string of suicide bombings, their purple-ink-stained fingers testified to their strong desire for freedom and America's undying support of democracy. Completion of the elections was just a first step, but a big step in terms of the pride and hope many Iraqis now feel. The endeavor also attracted strong interest and curiosity from the rest of the Middle East. Let's hope and pray Iraqis are successful in the long run as they move forward in their pursuit of a free and democratic country. As a nation, we are all proud of the sacrifices made by both American and coalition forces in making this possible.

Back here in the U.S., the strength of 4<sup>th</sup> quarter earnings, softening oil prices and conclusion of another presidential election cycle all contributed to a strong finish for stocks in 2004. Since the new year started, however, enthusiasm has clearly waned. Contributing to the more somber mood on Wall Street is perhaps the realization from investors that the Fed will continue its steady hike in short-term interest rates until they are at least "normalized" (i.e., neither accommodative or restrictive). This means unwinding post-911 emergency interest rate levels originally intended to prevent a deflationary spiral. Those fears have now dissipated and the Fed is turning its attention to avoiding a sustained rise in inflationary expectations.

This begs the questions, "At what level will short-term interest rates be considered to be normalized and will the Fed stop their rate hikes there?" Experts believe normalized interest rate levels to be around 3.5% to 4%, roughly 2% above the core inflation rate and 1.25-1.75%

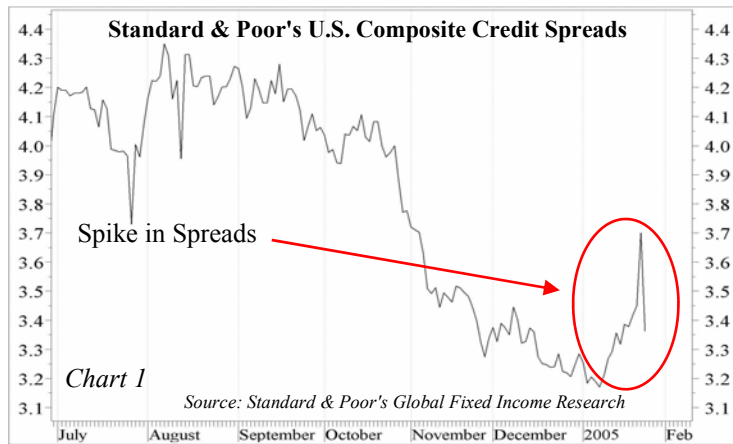
above current levels. The Fed may raise interest rates above the normalized level if they choose to become somewhat restrictive unless major weakness develops in the economy. Inflation is relatively low right now, but a mild upturn in core consumer price inflation appears to be underway. Most economists do not perceive this as the early seeds of a more pervasive long-term rise in inflation, rather a short-term cyclical upturn that is a normal part of the business cycle. However, some Federal Open Market Committee members have voiced concerns that housing and general consumer prices will rise at more rapid rates if not contained.

Ironically, early confidence in the Fed's ability to apply just the right amount of brakes to the economy have caused long-term interest rates to decline since June when the Fed first began raising short-term rates. A decline at this point in the economic cycle is very unusual and could potentially counterbalance the Fed's efforts to contain inflation. To the extent this proves to be the case, the Fed may be required to raise rates even more than would generally be necessary. Regardless, the Fed will eventually achieve its objectives.

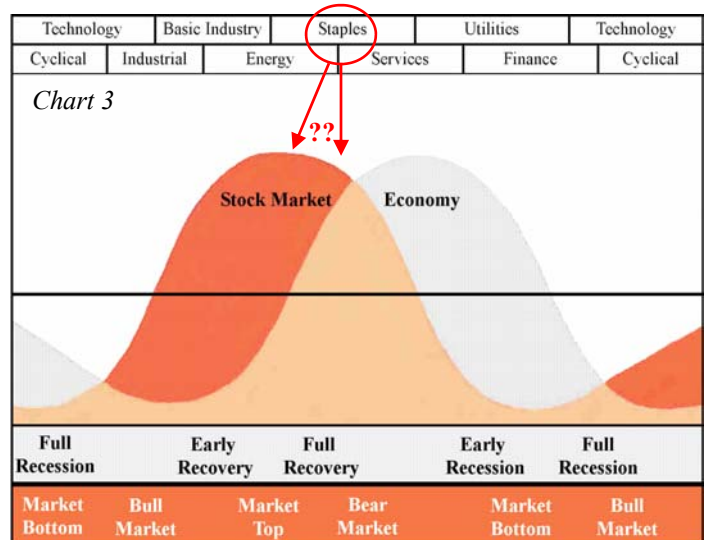
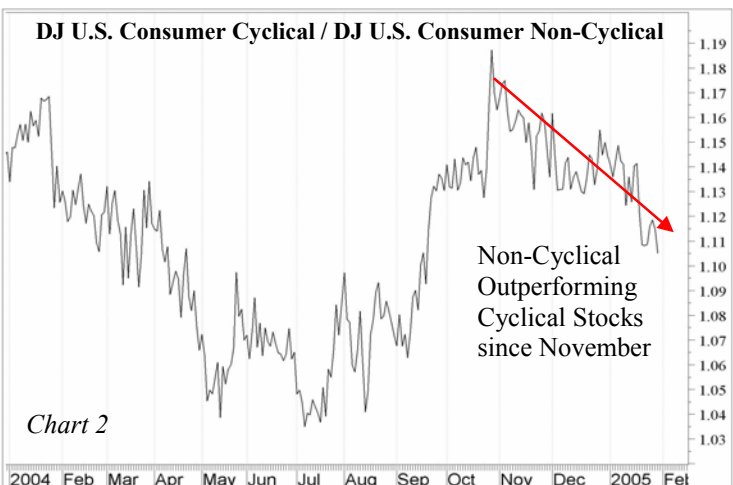
Periods of rising interest rates generally result in slowing economic growth. Reduced growth rates should suppress the modest inflationary pressures we are currently experiencing, especially given there are no signs of global inflation. This should allow us to avoid the potential for a recession that sometimes results from efforts to suppress inflation. The Fed successfully achieved this in the two most recent post-recession tightening periods of 1983-84 and 1994. In both cases, the economy responded well while the stock market experienced limited difficulties for a few months. In

both cases, the stock market eventually resumed its upward trend.

In the meantime, we will closely monitor the mood of Wall Street by measuring the risks investors are willing to accept with their investments. One such gauge is called the credit spread. The credit spread reflects the interest rate differential of speculative grade bonds versus their government counterparts. A widening spread indicates an increasingly cautious stance by investors. These spreads became wider after the first of the year (Chart 1), only to retrace part of their advance in recent days. If these spreads begin widening again, it could signal investors' diminishing comfort with the outlook for the economy in the coming months.



Another measure of Wall Street's mood is the recent improving performance of defensive consumer staple stocks (such as grocery and drug stocks) relative to cyclical stocks (Chart 2). This is consistent with a stock market that may be entering into the late bull market or early bear market phase of the investment cycle (Chart 3). This does not mean we are destined to experience a long difficult period for stocks. It does, however, increase our



need for close surveillance of developments in the coming weeks. It may also increase the likelihood for a near-term "soft patch" as the market digests the Fed's efforts to contain inflationary expectations.

A recent research report by Merrill Lynch indicates since World War II, stock market advances have averaged 36% in the first recovery year following a bear market, 11% in the second year and 3% in the third year. True to form we advanced 34% in our first year of this recovery, 11% in our second year and we are three months into our third year. Whether equities will return 3% this year or not is uncertain. One thing is clear, corporate fundamentals are extremely sound and companies are sitting on over \$2.1 trillion in cash. Large amounts of this cash will likely be used by companies to either increase dividends or finance mergers and acquisitions – both very bullish for the stock market. This makes the mid-term outlook for U.S. equities very favorable.

In our opinion, ten-year Treasuries seem to have unrealistically low yields right now. With real rates averaging 2.6% over the last five years, current rates of 4.25% imply a 1.6% inflation assumption. This seems too low to us. As such, we believe Treasuries are overpriced presently and we favor the prospects for equities over Treasuries for year-ahead performance.

*The views expressed are those of Byron Green as of February 1, 2005, and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.*