

Perched on the Precipice

May 17, 2004

A couple of days ago we received an e-mail from Matt Peters, our Research Analyst. In his message, he described how an acquaintance sent him a message asking Matt's take on the current interest-rate spike. Matt's response was perfect, so much so, in fact, that we have decided to make it this week's Web Buzz.

Currently market participants are adjusting to the ever-nearer Fed decision to raise the Fed Funds rate. This plus more new jobs* and signs of greater economic growth causes speculators and investors to readjust their positions in light of the new information. Much unhealthy speculation and unproductive investment has taken place with the low rate environment. The real estate bubble mushroom cloud has covered practically the whole country. Derivatives of all kinds have been put on the books and with markets violently wrenching, their expected price behavior will not pan out, upsetting the best made plans, causing further portfolio adjustments and future large losses.

Quality is the key, there's no reason to take credit risk. Treasury bonds are the best for liquidity and marketability plus no state income taxes are due. Call features are a critical component of a bond's price behavior.

We're now in an interest rate "spike" environment and how high they'll go no one knows. But it presents an opportunity to capture better bond prices for what will happen next - lower long-term rates. The world economy is perched on a debt precipice and its economic growth is soon to slow. China is trying to pull away the punch bowl - they will succeed; Europe is dead in the water and the US stimulus from mortgage refinancing and tax cuts is over. The consumer is exhausted; one might even say spent! Where would our economy be if the government wasn't spending like there's no tomorrow?

**The Efficient Market Theory, that is near 100% accepted by Wall Street, says investors are rational. If so, then tell us why the spike in interest rates started with the 308,000 increase in employment last March. The facts are that after 29 months of recovery through April, there are working today only 31,000 more people than at the time the economy turned around in late in 2001.*