H.M. Payson & Co.
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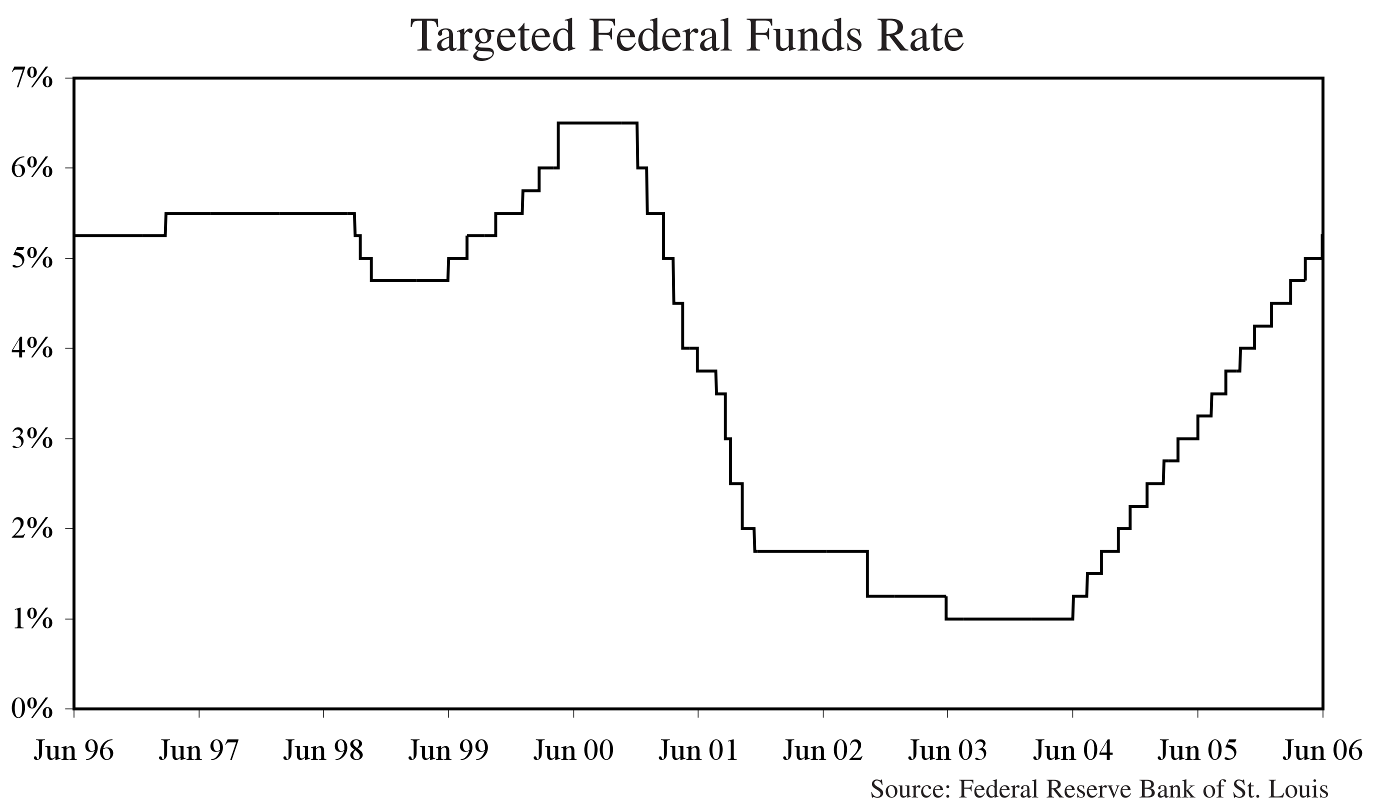
PERSPECTIVES

Dr. Bernanke's Medicine

The first few months of Ben Bernanke's tenure as Chairman of the Federal Reserve have been instructive to say the least. Since being sworn in on February 1, he has experienced both the power and peril of his position. First, an off the cuff (but not off the record) remark to a reporter at a Washington dinner about the potential need for further interest rate increases caused a market plunge the following day. Then, on July 19th, when his testimony to Congress gave investors cause to believe that the increases were coming to an end, the market rallied by more than 200 points. While it has certainly been an interesting few months on the job for the new Chairman, we hope it will not match the first few months of his predecessor, Alan Greenspan, who was appointed Chairman just weeks before the great crash of '87. That was indeed a trial by fire.

Of more interest to investors than Dr. Bernanke's learning curve are the possible implications of not only a pause in rate hikes (if that indeed is what is happening), but the accumulated effects of seventeen increases over the last two years. An increase in the Fed Funds



rate from 1.0% in June of 2004 to 5.25% today begs the question: is it possible for the economy to endure such dramatic increases without some negative consequences? Although the economy appears quite healthy today, there is a significant – and imprecise - lag time for the impact of monetary policy actions to become evident. This, of course, is a major concern for Dr. Bernanke. As he reminded us recently, the effects of the 425 basis point increase “are still in the pipeline.”

Four years into an expansion, it would seem reasonable to expect that such a dramatic increase in short term interest rates would have a cooling effect on the economy. Logically, the most vulnerable industries would be those that benefited from lower rates, such as housing and consumer discretionary spending. The refinancing boom of the past several years allowed consumers to spend freely by extracting large sums of equity from their homes. According to statistics from mortgage issuer Freddie Mac, homeowners cashed out $244 billion in 2005 alone - nearly one-third of which was used for consumer purchases.

Indeed, investors have felt the pain in some sectors more than others. Symptomatic of the myopic forces influencing today’s markets, institutional investors and hedge funds have aggressively shifted their holdings in response to decreasing global liquidity and rising recession fears. Homebuilders, retailers, and anything connected to consumer discretionary spending have been punished in the stock market. Basic materials stocks - which did so well throughout the period of easy money and global liquidity - have corrected significantly, in spite of strong worldwide demand for many of these products.

Harry Truman supposedly said that he wished he had a one-armed economist who could never say “... on the other hand.” But it also could be argued that interest rates had been artificially low in 2004, and are just now approaching their long term equilibrium. If this is the case, the tighter monetary policy of the past two years may enable a “soft landing” now, while avoiding the pain of higher rates that almost certainly would have been required had the Fed not acted.

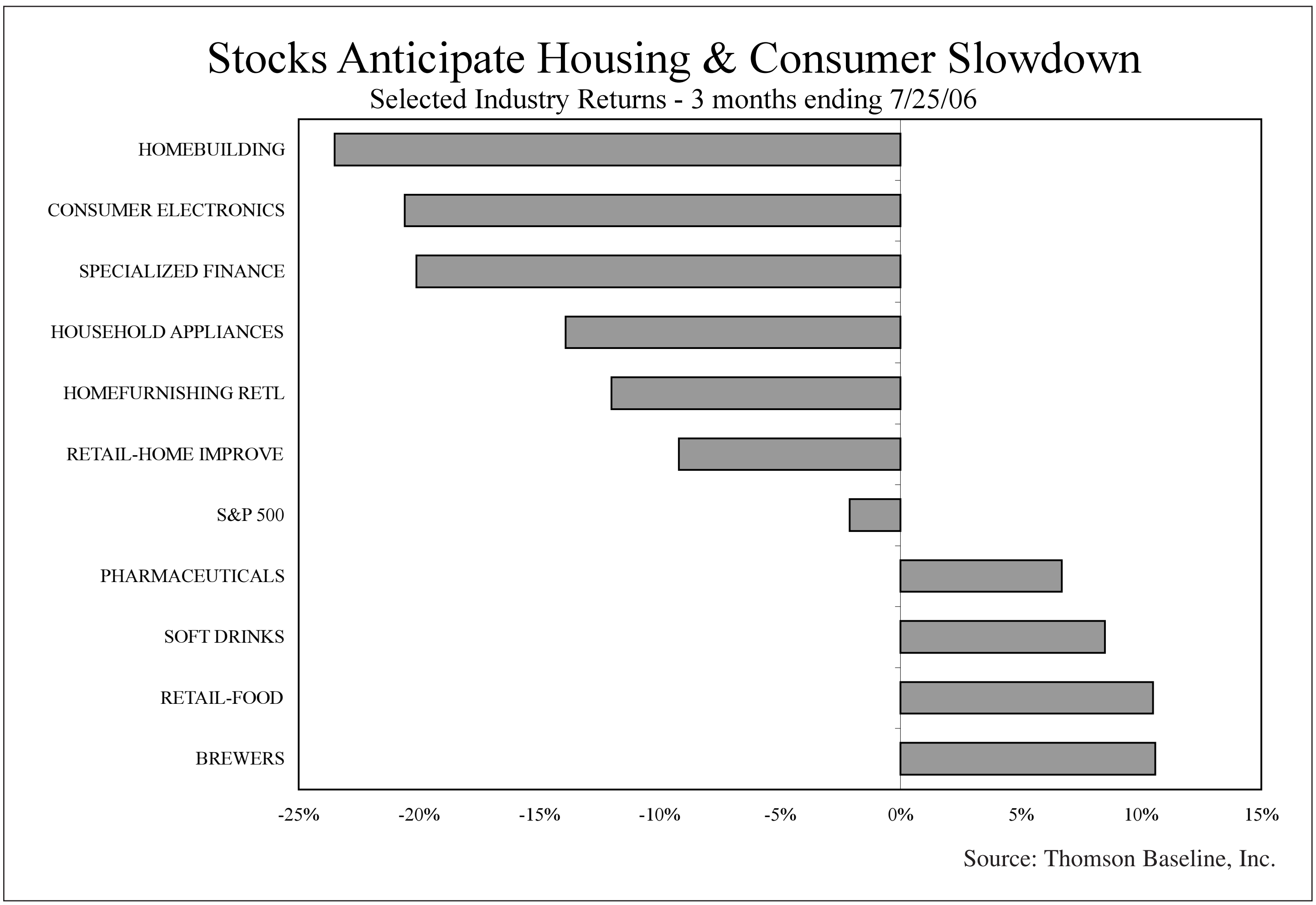
In the opening years of this decade, September 11th, fears of deflation and the first recession since 1991 combined to create a gloomy economic outlook, exacerbating the collapse in stock prices that began in March of 2000. It was against the backdrop of these headlines that policy makers engineered a rapid decline in rates, during which the Fed Funds rate reached the low point of 1.0% in June of 2004. Yet, the U.S. economy actually began to recover rather quickly. In 2002, a year in which the S&P 500 Index declined by more than 24%, the earnings of the companies in the index actually increased by 6.3%, about in line with historical averages.

The recovery picked up steam in 2004, and for the past three years, annual earnings growth for the S&P 500 has averaged 16.6%! Since 2003, job growth and consumer spending have been strong, unemployment has remained low, and until recently, the housing market has been consumed by a speculative frenzy. In a potentially troubling development, commodity prices have also been rising dramatically in response to strong global demand for natural resources, signifying a resurgence of inflationary pressures. Yet, the Fed has been slow to respond to the strong economic and inflation data, preferring a steady, measured approach over a riskier dose of more rapid increases.

Critics have charged that the Fed’s tepid response contributed to the frothy level of activity – and potential instability - in the housing market. Yet, recent evidence clearly suggests that the housing market is cooling. Housing starts peaked at 2.27 million units (annualized) in January of this year and declined to 1.85 million in June. Existing home sales and prices have dipped, and the stocks of publicly-traded homebuilding companies have seen average declines of almost 40%

since the first of the year. The most recent round of rate increases - which have raised recessionary fears and caused a great deal of hand wringing on Wall Street - may have merely served to bring the Fed Funds rate more in line with economic conditions. With some luck, the policy impacts still remaining "in the pipeline" will allow inflationary pressures to abate without causing a recession. A slowdown in housing may spread to other industries, but at least so far there has not been a meaningful decline in consumer spending. Although consumers have been spending more on gasoline and other products, job growth and wage increases appear to be offsetting factors.

Will the Fed now refrain from additional rate hikes to get a better feel for the extent of a slowdown, or will inflationary pressures force a resumption of rate increases? Alternatively, will a slowdown become so evident that the need for a rate *decrease* enters the debate? If in fact we are close to an end of the increases, historical market patterns may offer some clues for investors. As recently cited in a report by Credit Suisse, commodity-related stocks such as chemicals, mining and metals have not fared well after the end of rate hikes. In contrast, bank stocks tend to outperform. Housing stocks may look attractive again in light of their decline. Although historical patterns of "sector rotation" are discernable, every cycle is different, and these movements are usually too brief for all but the most active traders to attempt to capture. Particularly for taxable accounts, we prefer a diversified, lower turnover approach that allows for upside participation with less volatility.



On balance, we think interest rates today reflect economic conditions more accurately than they have for the past two-to-three years. We find bonds (especially short-to-intermediate maturities) more attractive than they have been in some time, given their positive real returns in a flat yield curve. In equities, we continue to focus on larger-capitalization companies with strong competitive positions, generous cash flows, solid balance sheets, and above-average earnings and dividend growth. Because so many high quality companies have been ignored by investors in favor of riskier assets, we believe their valuations are now at the most attractive levels in a decade. Recent price action suggests this tide may be turning, and if we are entering a period of slower economic growth, these stocks may enjoy an extended period of strong relative performance.

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