MV Capital Management E-Update

Sprints and Marathons, Exuberance and Endurance
May 19, 2006

There has been plenty of exuberance in the markets thus far in 2006, following one of the strongest first quarter performances in recent years with several asset classes returning double digit returns for the first three months. As we move towards the end of the first half of the year, however, seasoned investors are more interested in long-term stamina than in the thrill of the short-term sprint. There are plenty of issues out there helping to frame the debate – how sustainable will the strong first quarter performance be over the rest of the year?

It is hard to get too far into a conversation about nearly anything these days without turning to the dominant topic of high gasoline prices. For market-watchers that topic is a springboard to a smorgasbord of economic variables – inflation, consumer spending, geopolitics, demand from China – that all lead back to the question of sustainability. As always, the market's eyes are on Ben Bernanke and his colleagues at the Federal Reserve. The Fed tends to focus on one inflation measure in particular – core inflation, which excludes the volatile sectors of energy and food prices. As long as prices at the pump aren't spilling over into other areas like durable goods or housing rents, conventional wisdom says the Fed would be unlikely to take aggressive measures to put the brakes on growth through higher interest rates.

Thus investors were thrown for a loop on May 17 when the Labor Department's Bureau of Labor Statistics released Consumer Price Index (CPI) data for March showing that core inflation had increased 0.3% for the month, higher than analysts' consensus of 0.2%. Equity markets were quick to respond with broad declines across the board. The S&P 500 lost 21.76 points (1.7%) to end at 1270.32, while the Dow Jones Industrial Average retreated further from last week's approach to its all-time high, falling 1.9% (214.28 points) to 11205.61. The technology-oriented NASDAQ index moved into negative territory for the year to date. In the bond markets, a steepening yield curve indicates increasing inflationary concerns. The probability of a Fed rate hike to 5.25% at the June FOMC meeting, reflected by a popular futures contract at the Chicago Board of Trade that measures traders' expectations about rate moves, increased from 38% to 50%.

A series of ongoing rate hikes by the Fed would indeed be likely to further dampen the markets' first quarter enthusiasm, mainly because investors had already priced increases up to 5% or so into their forecasts, so anything too much beyond that would have a negative effect on valuations. The data on this is conflicting, however. The Fed keeps a close eye not only on inflation, but also on developments that could cause a slowdown in real growth. The housing market, a perennially influential component of GDP, may be one such development. The latest data releases confirm the presence of a slowdown. Housing starts for April declined by more than had been expected (1.85 million down from 2.0 million in March), new building permits fell below 2 million for the first month since February 2004, and the National Association of Home Builders/Wells Fargo Housing Market confidence index (a popular measure of market sentiment) fell to its lowest level since mid-1995. And higher interest rates are pricing new buyers out of the market while putting a strain on the monthly payments of buyers who took advantage of the riskier "all-interest" mortgages so widely available in the lower rate environment of 2005.

The Fed always walks a tight line between controlling inflation and not choking off growth, and this appears to be one of those times when the data pull in both directions. What is important to bear in mind is that in the long run, growth is good. If the Fed does raise rates another 25 basis points in June then it will probably have concluded that the economy's underpinnings are resilient enough to absorb this rate increase. The economy grew 4.8% in the first quarter. Employment and income levels are strong. Our major global trading partners also have good growth trends.

In the short run, rate hikes get priced into investors' expectations. Economic growth and sustained corporate profitability are what drive the market in the longer run. It is always worth keeping in mind that investing is akin to a marathon, not a sprint. Success comes to those who look towards the long term goal, not what is around the next corner.

With warm personal regards,

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