# MV Capital Management E-Update

Nowhere to Hide
June 8, 2006

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The merry month of May was anything but that for most investors, and the markets have kept humming the same dismal tune going into June. Both the Dow and the S&P 500 have given up over 3% since May 1 (through June 6) while the NASDAQ composite has lost twice that much, ceding 6.2% to be in slightly negative territory for the year to date. Bonds continue to be sluggish as well, with the Lehman US Bond Aggregate index off 0.32% year to date. At times like this people want to know two things. Why is this happening, and what do we do now?

The "why" of course is the subject of much cocktail party chatter, but eventually it comes to the topic of inflation. Core inflation grew at an annual rate of 3.2% for the past three months and 2.8% for the past six. Core inflation excludes the volatile energy and food sectors, so the Fed looks at this number to gauge the magnitude of the inflation threat in the broader economy. Right now that is inching above the range in which the Fed feels comfortable. Other market indicators are also casting a vote for inflationary expectations – high commodity prices and a weakening dollar being two such measures.

In his speech to the International Monetary Conference in Washington on June 5 Fed chairman Bernanke articulated this concern very clearly. Investors, perhaps having grown more accustomed to the opaque pronouncements of Bernanke's predecessor Alan Greenspan, were taken aback by the clarity of these statements and ran for the exits. Inflation fears mean tight money and tight money is bad for equity markets, went the conventional wisdom as the Dow started dropping nearly 200 points before Bernanke had finished gathering up his speech papers and stepping off the podium.

We are not big fans of conventional wisdom herd moves. In the historical context we do not see current monetary policy as tight. During much of the second half of the 1990s – a period characterized by strong organic, entrepreneur-driven economic growth – the Fed Funds target rate moved in a range of 5 – 6%. We think this is a good proxy for neutrality – neither accommodative nor tight – and that is where we are now with the Fed Funds at 5% and likely to rise to 5.25% after the next FOMC meeting in late June. Underlying economic growth remains strong. Consumers are benefiting from stronger job and payroll numbers even as they pay more for gas. Housing is slowing down, but only in a measured way from the torrid pace of the past several years. In other words – it is highly unlikely that another one or two Fed Funds target increases will kill off economic growth. Economist Brian Wesbury noted in a recent Wall Street Journal op-ed piece (June 7) that in the past 45 years there has never been a recession in the US when the nominal GDP rate (currently 6.9%) is higher than the Fed Funds rate (5%).

That, in our opinion, is good news. But it is not the whole story, and it brings us to address the second question we posed above: what do we do now?

As we always say in these e-updates, patience and discipline are the antidotes to fear and greed. We also believe in the primary importance of an asset allocation strategy that is sensitive and responsive to changes in structural market trends. And we believe in the principle of mean reversion, otherwise known as "what goes up always comes back down, and what goes down comes back up".

When interest rates are at historic lows, as they have been across the globe since 2002, easy liquidity tends to favor the prospects of historically riskier asset classes. In the equity markets

this has helped drive US micro caps and emerging market stocks among others, while in the bond market credit quality spreads have been at historic lows, so yields for speculative-grade bonds have been priced not much above those for US Treasuries. REITS have been on a tear in the age of Florida condo flippers.

One logical case to make from this is that curtailing easy money will send more wealth into traditional safe havens such as large value stocks, high-quality intermediate term bonds and similar investments. We believe this is an important piece of the puzzle. But we also have to pay attention to structural trends. Continued dollar weakening is in our opinion likely, meaning further potential gains in international equities. Volatility will probably be a bigger factor across almost all asset classes – but keen investors will be paying attention to *relative* volatility more than absolute numbers, meaning that certain historically riskier classes or sub-class sectors may not be as out of favor as others.

Tactical asset allocation is an important part of our strategy. We are not market timers, and we are not "flavor of the month" stock pickers. As William Sharpe and others have noted over time, asset allocation accounts for a large part (by most measures over 90%) of the variability in the return on a typical investment portfolio. We make strategic asset class rebalancing decisions typically on an annual basis. By making periodic additional, cost-effective tactical adjustments we maintain results-oriented thinking along the lines of important underlying market developments.

The other side of the question "what to do" is "what NOT to do". Nobody likes 200 point drops in the market. The news media are all too willing to feed the twin-headed beast of fear and greed with breathless commentary and splashy graphics of big red arrows dropping straight down. "Sell now!" scream the charts. Rare is the news report that puts today's price drop in the context of the 5-year and 10-year performance charts. Rarer still is the sober, hype-free analysis of what short-term movements may mean in the larger picture. Perhaps that kind of analysis is not what today's entertainment-prone journalists do. But it is very much what we do, and will continue to do, to give our clients the best chance to win in any market.

With warm personal regards,

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