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THE SEVEN YEAR ITCH

Investors are a curious lot. I have proposed for the last three issues of this outlook that (among others)

- inflation is not an immediate issue for good reasons, including excess capacity and a rapidly growing non-U.S. labor force;
- the economy was slowing and switching from a consumer-driven one to a broader manufacturing- or industrial-driven one and
- stocks, to me, were cheap last quarter because the "r" word had crept into the investor thought process. [That might be a new oxymoron.]

Nobody said it would be smooth or simple – economic transitions seldom are. Yet each announcement of employment or capacity utilization or retail sales, among hundreds of others, sends the investing public into lemming-like panic. The collapse of stock prices in the third quarter was a case in point. Yet the world continues – night follows day in spite of the pundits' endless hand wringing over oil ". . . going to the sky . . ." or ". . . the consumer is going to stop buying because his house has declined in value . . ."

To me, what most investors miss is the self-correcting aspect of excesses – tech stocks in 2000, hedge funds in 2005, gas prices last summer and on and on. Consumers are sensitive to excess and do adjust to prices that are too high, but it can often take longer than we would expect. There is also a subset of consumers that don't care at all – more on that in a moment.

So, housing prices are likely to record a year over year decline in price for the first time ever. Estimates range as far as 10% down – more in the Midwest – because, unlike prior slowdowns, the number of homes for sale is rising at the same time that sales are declining. Here, too, an excess is being corrected and I am amazed at the number of people who have forgotten the double-digit increases they were receiving on their homes in the last few years.

On the plus side, history shows a decline in gas prices seems to have a stimulating effect on consumer spending – but here, too, we think another positive factor is at work – we'll touch on it shortly.

It helps, too, that mortgage rates are back to April levels – not surprising to see pricing fall when demand softens.

Wal-Mart's strategy of selling generic drugs at $4.00 a month isn't alone – K Mart is already selling about 200 different prescription generics at $5.00 a month.

And, of course, commodity prices have dropped a ton – the most in one month since 1974 – all to the point that excesses ultimately correct.

To some, this is all a harbinger of disaster – a pending recession. I accept that too much correction too fast is not a good thing, but to me, this is a correction of excesses, not a

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collapse in fundamental economic growth. The economy should continue to grow at over 2% - not the blistering 5% pace we saw earlier, but recall that our overall inherent growth rate is about 3%. So when it ran at 5% we knew we were stealing from the future.

The risk in all of this is too much growth – a slow down that is suddenly refueled by rising consumer income and rising corporate profits. Some parts of the economy are quite strong, but too much growth may bring another round of Fed tightening – a view I still assign a better than 50% chance. A recession seems even less likely. I, for one, do not view the slowdown in consumer spending as being greatly explained by consumers taking less out of their home equity – there being less available, by the way. Rather, I think the consumer somewhat over-reacted to the spike in gas prices and is adjusting that over-reaction as this is written.

My son, Mark, shared an excellent point developed by the analysts at Citigroup who have coined a word - plutonomy – to capture the spending of the rich. Avoiding moral judgment here, there is a gap between rich and poor and it is growing. For these rich, the top 20% of consumers, their consumption is nearly indifferent to gas prices, home prices, job issues and the like. What makes them doubly important is they, according to Citigroup, account for something like 60% of spending whereas the bottom 20% account for about 3%. One begins to see how consumer spending can remain quite strong.

In short, there is no “average consumer.” It also goes a long way to explain why, to the top 20% (or more), “savings” isn’t important given their net worth growth. Citigroup’s paper goes on at length about how this came to be, but for our purposes, I think it’s important both for the “risk” of accelerating growth (and thus Fed tightening) and for picking stocks. With the caveat that these are not, repeat not, recommendations to buy or sell, one is inclined to research firms like Coach, Porsche, LVMH, etc.

The stock market, of course, is trying to follow each piece of economic news. One day it’s up on bad news, the next day it’s down on good news. It seems our typical investor, like Goldilocks, wants to have the economy “just right.” Grow too fast and the Fed steps in and the market weakens; grow too slow and the “r” word returns.

Through all this we note that after seven years or so, we’ve regained the Dow prior high. Not the S&P 500, not the NASDAQ, but the Dow. Seven years of working off the excesses of Y2K, dot.com euphoria, oil shocks, political rapscallions, etc. seems to be ending. Through it all, growth stocks – our preference – drifted while value stocks – a traditional haven in tough times, did well.

It’s a lot like marriage. After about seven years things look different and passing strangers, I’m told, look interesting. Growth stock investors this year are seeing returns of 1% to 5% for 9 months ending September, while value investors are seeing returns near 12%. Yet, over time, the difference in returns between value and growth are minute. Prior to the 15% dividend tax rate, after-tax returns were modestly higher for growth, in fact.

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As we managers measure ourselves and our clients' returns we can see the difference in the results of our "conservative" portfolios versus our "growth" portfolios. The temptation, obviously, is to scratch the itch and try something new . . . . try value stocks. That temptation will be ignored here as we believe the excesses of the last boom are being steadily worked off and there is little reason to switch styles at this (or any) point. Firm believers that switching is a bad decision, we intend to go on as growth investors with a solid economic environment as our baseline argument. We will continue to work at the hardest part of all this – ignoring the crowd looking for a quick buck.

Some detail:
The Russell 1000 is, as the name implies, 1000 stocks thought to offer a broader view of the market than the Dow, S&P 500, etc. For the nine months ended September 29, 2006, the growth versus value war looks like this:

Russell 1000 Growth	*+2.9%*
Russell 1000 Value	*+13.1%*

Nearly half of the Russell 13% came in the third quarter – thus the temptation . . . .

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