

# *Soggy May Good for Growth*

## **Market Summary**

*May 2008*

Financial markets found the cool and wet weather in May to their liking, or at least no hindrance. Equities in the growth category, certainly well-watered, lived up to their name last month, making creditable progress toward restoring the damage done them earlier in the year. Meanwhile, bonds and larger-cap stocks took advantage of the ample supply of water by treading it. Big-caps moved up slightly, bonds down slightly. Just guessing, we'd say the soggy weather was a non-factor in all cases. More surprising was the equally negligible impact in May of the continued uprising in oil and food prices, and the deep contraction in home values and consumer confidence.

The Federal Reserve certainly was no font of encouragement, though its actions were viewed positively by the stock markets. Its message, made explicit when minutes of the April 30 Open Markets Committee were released, was twofold: 1) You're on your own boys—we've made our last rate cut until further notice; 2) The economy seems back on track, but a little dodgier than we thought before.

The part about a dodgy economy comes from the consensus forecast from Federal Reserve economists, which now calls for real GDP growth of 0.3% to 1.25% this year, and 2.0% to 2.8% in 2009. Unemployment is predicted to be 5.5% to 5.7% this year, and inflation 3.1% to 3.4 percent. "Core" inflation (excluding food and energy) is projected to be 2.2% to 2.4 percent. All of these numbers were revised for the worse in April. The good news: Recession is regarded as less likely.

The end of interest rate cuts is inferred from the FOMC's official statement declaring the risk of recession now to be "more closely balanced" with that of inflation, and it is therefore "no longer appropriate" to give precedence to either risk in setting interest rate policy. That generally has taken to mean the quarter-point reduction in the Fed Funds rate (to 2.0%) approved at the April meeting will be the last we see for a good while. The direction of the next move will depend on

which of the two risks—inflation or an economic downturn—barks the louder.

For now, the Fed seems more attuned guarding the national currency. Chairman Ben Bernanke advised an international monetary conference (by telephone to Spain) that the governors have agreed to direct monetary policy toward collaring inflation and maintaining the value of the dollar.

Many economists—including at least two members of the FOMC—have blamed the Fed's aggressive rate cuts for spurring inflation, abetting the slide in the dollar and encouraging speculation in commodities markets. The Fed has slashed rates by 325 basis points since September, while other central banks—principally that of Europe—have stood firm. A differential in international rates has opened up that might tempt big investors to expatriate their money, thereby putting selling pressure on an already beleaguered dollar. Ten-year European government bonds recently were listed at yields about a half point above comparable-term U.S. Treasuries. Considering that the Euro has appreciated 15% against the dollar in the past year, this superficially looks like a chance to combine better yield with steep currency appreciation. However, such parlays have their quirks, as a large enough decline in the Euro vs. the dollar could wipe out not only the currency gain, but the yield advantage as well.

For consumers the matter is simpler: Paying for a commodity—gasoline, for example—that is going up in price with a currency that is going down in purchasing power makes for a double whammy. Quelled inflation and a stabilized dollar could (in theory) take some of the flux out of energy prices.

The University of Michigan reported in May that consumer confidence is at a 28-year low, and inflation expectations are at a 26-year high. However, there are various lessons to be drawn from these data. The U.S. economy was in recession in 1980, but soon would enter a raging expansion. Likewise, inflation in 1982 had been awful for nearly a decade, but already had entered a precipitous decline. In the quarter century since the cited peak in inflation expectations, the annual rate has remained in single digits.

## Weak Dollar Helps Exports

Weakness in the dollar can be a windfall for U.S. exporters, as it makes their products more competitive. American manufactured exports rose in May for the 66<sup>th</sup> consecutive month, gaining 2 points to a robust 59.5% on the index compiled by the Institute for Supply Management. The ISM said exports are strong because the dollar is weak. The overall manufacturing index rose 1 point to 49.6% in May—an encouraging move, but any mark below 50% represents contraction.

## Deflation Continuing in Housing Prices

As other prices spiraled to the stratosphere, home values have taken a record plunge. The S&P/Case-Shiller home-price index (which obviously was named before anyone suspected it would become famous) logged the worst drop in its 20-year history in the first quarter. Likewise the Office of Federal Housing Enterprise Oversight (known by the world's worst acronym, *Ofheo*) recorded a drop in housing prices of 1.7% in the first quarter, the largest it's ever measured. Ofheo tracks the market for homes with mortgages backed by federally sponsored agencies.

Homes in the possession of lenders (i.e., foreclosures) numbered 660,000 at quarter's end—an increase of about 34% since January, and 186% since January 2007—according to data reported in the Wall Street Journal. This extraordinary inventory growth has come despite deeply slashed prices on repossessed homes.

Bad first-quarter numbers from the housing market were anticipated by the markets, however. The real news in May was an interruption in the long parade of unwelcome surprises from the “subprime” mortgage imbroglio. And in that, perhaps, the markets took heart.

## Markets Respectable

Growth stocks advanced across all categories in May, in reverse relation to their capitalization. Accordingly, the Russell 2000 Growth Index led all benchmarks with a 5.7% gain; Russell Mid-Cap Growth was second with a 5.3% advance; the large-cap Russell 1000 Growth Index was third, gaining 3.7 percent. The overall Russell 2000 Index gained 4.6 percent.

Value stocks also did well, and were also the larger gains were associated with smaller capitalization. The Russell Midcap Value Index led with a 3.5% gain; the Russell 2000 Value gained 3.4%; the Russell 1000 Value lost 0.2 percent.

The large-cap indices acquitted themselves well in May, moving forward at a dignified pace befitting their market value. The S&P 500 Index gained 1.3%, Russell 1000 Index 1.8%, and the Dow Jones Industrial Average 1.4 percent.

International issues continued to recover from a punishing first-quarter, with emerging market indices leading the group. The S&P/Citigroup EMI-EPAC Index gained 2.2%; the MSCI Emerging Markets Free Index 1.9%; the Pacific Rim (Ex-Japan) Index 1.5 percent. The larger-cap MSCI EAFE Index gained an even 1.0 percent.

REITS were essentially static, the Dow-Jones Wilshire REIT Index nudging up 0.2 percent.

## Bonds Clipped

The Lehman Aggregate Bond Index fell 0.7% in May, setting the pace for most of the large bond indices. The Lehman Government Bond Index fell 1.1%, as did the Citigroup World Government Bond Index. Sub-sectors of government bonds fell, with their losses following their term structure. The Lehman Long Government Bond Index dropped 2.0% and the Intermediate Government Bond Index 0.9 percent.

## Commodities Still the Thing

Commodities indices continued their remarkable advance in May. The Goldman Sachs Commodities Index, heavily laden with energy and agriculture, spiked 9.1% for the month, and is up 66.3% on the calendar year. The DJ-AIG Commodity Index, which tracks futures contracts on 19 commodities, gained 2.7% in May and is up 27.9% over 12 months.



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