

Southern Capital Perspective

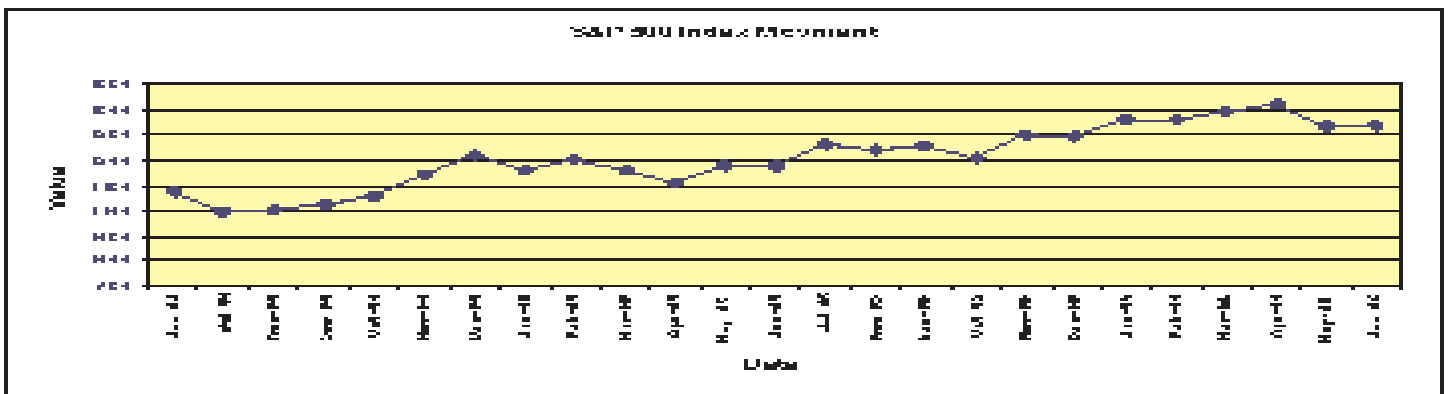
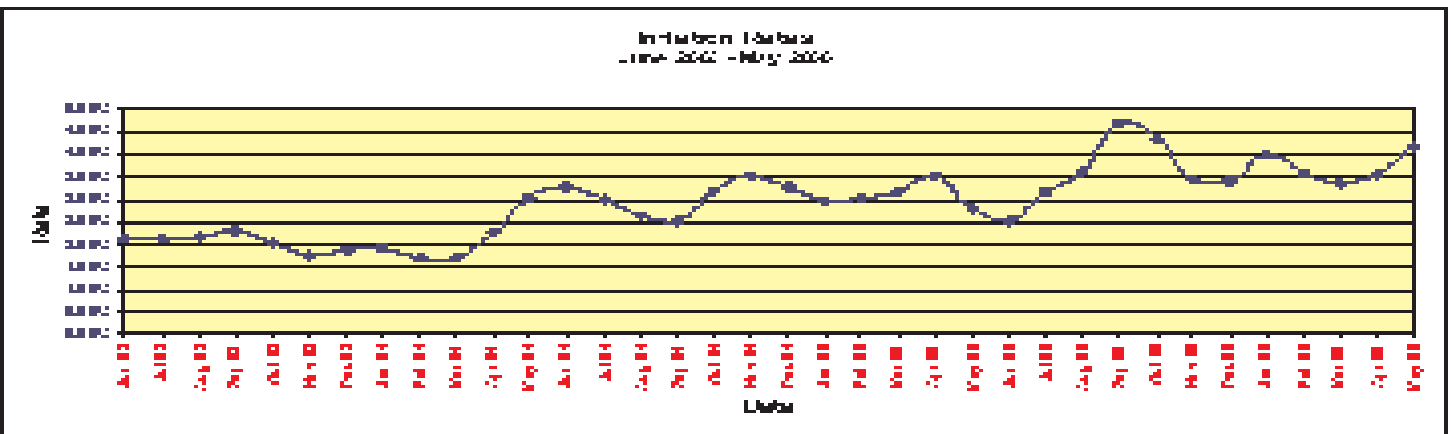
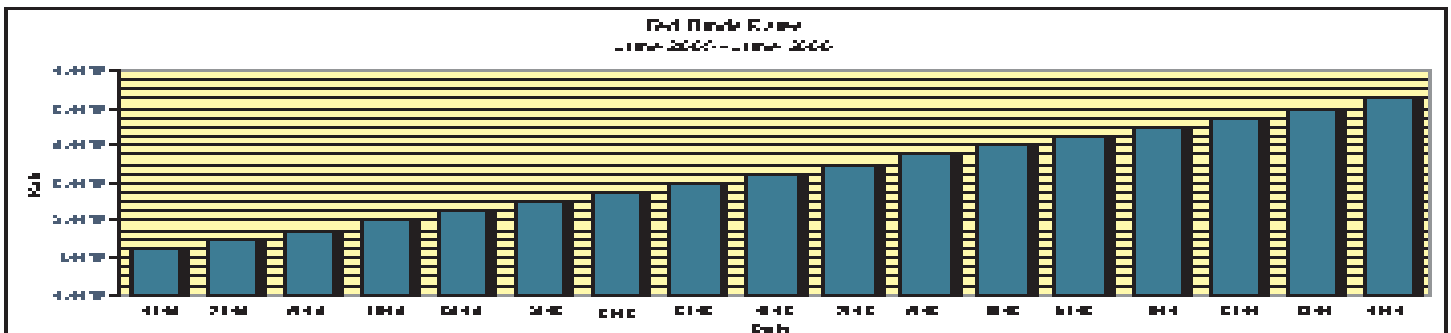
July 2006 The Summit, Ste 201A, 29000 Hwy 98, Daphne, AL 36526 Volume 14, Number 3

IS FED CHAIRMAN BEN BERNANKE GOING TOO FAR WITH INTEREST RATE HIKES?

By Terry Nager

Interest rates have been raised 17 consecutive times from 1% to the current 5 ¼%. The new Federal Reserve Chairman Bernanke has continued the steady ¼% increases that were started by his predecessor, Alan Greenspan. These increases have been instituted to fulfill two purposes: first, to reload the FED's gun with ammunition so that they can respond to a future economic problem by being able to lower interest rates. This is very difficult if the rate is only 1%. Second, the specter of inflation has reared its ugly head and the FED wants to act resolutely to contain the rate of inflation around the 2% level. The burning question is how many rate hikes are enough? If Bernanke miscalculates and goes too far, as the FED has done many times in the past, then the economy will slow down or possibly even go into a recession. However, their concern is also not going far enough and the rate of inflation getting out of control which would necessitate having to take drastic steps to regain control.

The first graph shown below illustrates the steady interest rate increases from the Federal Reserve. The second graph depicts the persistent rise in the consumer price index, or inflation, including food and energy. Each monthly measure is annualized to present a rolling picture of the upward tack of inflation. The third and final graph is of the Standard & Poor 500 index (S&P 500). It shows that the cumulative effects of the interest rate hikes are now beginning to weigh upon the stock market over the last few months.



Benjamin Bernanke and the rest of the Board have an extremely difficult task before them. They have to consider the input from numerous variables and then without benefit of an exact formula determine the proper weighting for those variables. Then they have to make a determination regarding the level of interest rates, upon which the entire world depends, to avert inflation and ensure continued economic prosperity. Their decisions are usually criticized severely by different groups that disagree with their conclusions. I want to categorically state that I am not criticizing, but I am questioning. When interest rates are raised, it usually takes about 9-12 months for the effects to work their way through the economy. Therefore, why not pause in the rate hike process to see if the cumulative effect of the rate hikes have done the job, knowing that the increases could easily be reinstated if needed?

My reasons for questioning are based upon three pieces of anecdotal evidence. First the consumer price index graph seems to be more in a flattening rather than an ascending mode. Second the S&P 500 graph hit its peak in April of this year and has been declining since then. Finally, the yield curve has once again inverted – that is the short-term rates which the FED controls are higher than the long-term rates which reflect what is going on in the economy. Often (but not always) when an inversion occurs it indicates that the short-rates are getting too high and if this situation is not rectified, it could lead to an economic slowdown or even a recession. This is critically important because I believe that the level of interest rates, the inflation rate, and the money supply, all of which are under the watchful eye and influence of the FED, are the greatest determinants of the environment for the stock market. Thus, the FED policy is the greatest big picture influence in shaping the overall trend in the market.

Even though the FED is the key to the big picture, current geo-political events are playing havoc with the stock market on a day-to-day basis. There are so many “hot spots” all over the world that the level of uncertainty which the stock market hates has caused a sell-off that erased much of the year-to-date gains. Many of the problems relate to oil producing nations like Iran, Nigeria, Venezuela, and of course Iraq. As the fear of supply interruption grows, so do the oil and gas prices as the speculative frenzy drives the futures prices to record highs. This in turn causes investors to be anxious about the economy and sell stocks.

The outbreak of a shooting war in the Mideast is the most recent addition to market anxieties. This is a tragic event because people are being wounded and killed. Also the damage to homes and businesses is enormous. However, it would be even worse if the countries involved were oil exporters. This last point, although it may seem to be somewhat insensitive, is the most important from an investment standpoint. Remember, geo-political events (e.g. Arab-Israeli conflicts, North Korean missile testing, assassinations, terrorist bombings, even “911”) are relatively short-lived economic events. These types of occurrences rarely determine the trend of the market and the short, often sharp, reactions to them are usually reversed in a matter of weeks or months. If we reflect back on 2001, we see that the stock market was in a steep downturn before September 11 and then it sold off sharply over the following couple of weeks. But before the end of the year the “911” losses were recouped. Then the overall downward trend of the market took over and drove it down to the bear market lows in 2002.

The best way to illustrate the point that we have been discussing is to use the analogy of a child walking upstairs while playing with a yo-yo. The walk upstairs is the overall trend of the market – influenced by FED policy interest rates, the money supply, inflation, and other macro economic factors. The yo-yo is the daily or weekly ups and downs of the market determined by short-term news events. It is very easy and tempting to get caught up with the action of the yo-yo, but investment dollars are made and lost by watching whether the child is going up or down the staircase.

Our outlook for the balance of this year is pretty much in accord with what it was at the beginning of the year. We had been looking for a year of increased volatility which has certainly been the case thus far. We think that FED is almost at the end of their rate increases which will give some perceived relief, although we will not know the full effect of the rate hikes on the economy until sometime in 2007. Even with all the volatility, assuming no

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By Eric M. Nager

At Southern Capital Services we employ some of the best mutual fund managers in the world on behalf of our clients. These managers have long, successful track records in managing billions of dollars in all kinds of market conditions. Many of these managers are not available to individual investors at the retail level, so how do we obtain their services through Southern Capital?

First, some of these funds are normally load funds, meaning there is an extra charge to acquire them either at purchase or redemption. But as investment advisors, we can acquire almost all load funds at no load. This gives us virtually the entire mutual fund universe from which to choose.

Second, because we are able to trade on an omnibus basis through our custodian of client funds (this means we can bunch our fund trades together and keep transaction costs low), we do not have to be concerned with those funds that have high minimum investments. This allows our clients to diversify into more funds than they would otherwise be able to afford.

Third, if we have existing positions in funds that are closed to new investors, we are frequently able to add new investors to those funds. This is currently the case for two of the six funds in our Growth & Income portfolio, and again it allows wider selection for our clients.

We select the managers based on how they compare to their peers in addition to other criteria, and we believe we are well positioned for the remainder of 2006. In fact, while past performance is no guarantee of future returns, all of the funds in our current mix of assets in the Growth & Income portfolio made money overall in the 2000-2002 bear market. We offer these managers to work for you, all within our low annual management fee, and we will continue to hire and fire them on your behalf

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