

STOCKS HOLD AT IMPORTANT SUPPORT LEVELS

Will Rebound Continue?

By J. Andre Weisbrod

July was a tough month. The S&P 500 slipped around 3.4 percent for the month, despite a gain of 1.4% this past week, breaking six weeks of decline. The NASDAQ lost almost 8% in July.

Last week's rebound offers encouragement that the short-term trend has turned favorable. While a day or two of retrenchment early this week might be expected, another positive week would confirm this change and provide indication that the long-term bull trend can be continued. If that is the case, then this week could be an excellent buying opportunity.

It is important that the DOW and S&P 500 stopped their slides at the previous low (DOW) or above the previous low (S&P). Had they fallen below those support levels, the long-term trend would have been threatened. Now we would like to see these indexes rise above their most recent short-term highs. (Note: The NASDAQ shows greater weakness than the Dow and S&P500) But will the rebound continue? The answer is at the end.

ECONOMY SHOWS SIGNS OF SLOWING, BUT IS THAT BAD?

With a lower than expected 3% GDP growth rate for the second quarter, some commentators and investors fretted that the economic recovery that began in 2002 was in jeopardy. I would submit that economies are, by their natures, fluctuating phenomena. One quarter does not make a trend, whether it was the 4.5% (annualized rate) first quarter or the 3% second quarter. Also, GDP numbers often need revisions. The first quarter's rate had to be revised upward.

More important is the overall trend and average growth rates that are neither too high nor too low. The signs of slowdown are not alarming to me.

Over the 50-year period from 1954 through 2003 the GDP grew at an unadjusted rate of just over 7% per year. Inflation grew at approximately 3.9% per year. Three month T-Bills returned 5.3% per year and the S&P 500 index appreciated (without dividends) almost 8% per year.

The "spreads" between these rates is important. Over 50 years, the economy grew faster than inflation by 3.1 percentage points annually. T-Bills rates averaged 1.4 percentage points and stocks almost 4.1 percentage points higher than inflation.

	Inflation since Beg 1954	GDP since beg 1954	US T-Bills since beg 1954	S&P 500 Price Appr since beg 1954	Inflation 10/1/01-6/30/04	GDP 10/1/01-6/30/04	T-Bills 10/1/01-6/30/04	S&P 500 Price Appr 10/1/01-6/30/04
Annualized Appreciation	3.9%	7.1%	5.3%	7.9%	2.3%	5.2%	1.4%	3.4%
Amt over/under Inflation		3.1%	1.3%	2.6%		2.9%	-0.9%	1.1%
Amt over/under 50-year Avg					-1.6%	-1.9%	-3.9%	-4.5%

The more recent numbers offer some trend insights. First, the economy has recovered and is growing. Second, it is growing at a rate above inflation in line with historical average. Third, it is normal for growth to peak and then back off; the economy is not static; it ebbs and flows dynamically. Fourth, current interest rates are artificially below inflation and therefore their rise is virtually certain.

Now the highest growth rates for both the GDP and the stock market occur following recessions. The most recent recession (a mini-recession) ended in the summer of 2001. Therefore we would expect growth rates to pick up by 2002. Indeed, GDP turned positive in the third quarter 2001. Stocks didn't begin their recovery for another year. Both GDP and stocks

reached higher rates from mid 2003 through mid 2004. Here are the numbers for the 12 months ended 6/30/04.

	Inflation 7/1/03- 6/30/04	GDP 7/1/03- 6/30/04	T-Bills 7/1/03- 6/30/04	S&P 500 Price Appr 7/1/03- 6/30/04
Annualized Appreciation	2.9%	10.5%	1.0%	17.1%
Amt over/under Inflation		7.6%	-1.9%	14.2%
Amt over/under 50-year Avg	-1.0%	6.6%	-2.9%	13.1%

Part of the problem in determining how fast the economy is growing is that there are a number of ways GDP is viewed, and the numbers published are usually “adjusted” and often pegged to a previous year’s value set at an arbitrary 100. It can get rather complicated. I have used the “current dollars” figures. Therefore GDP may be more valuable as a trend identifier than as an actual number.

THIS IS A PRETTY GOOD ECONOMY

The second chart (above) shows with outstanding clarity that the trends in growth for both GDP and stocks accelerated greatly during the past year. This is as it should be, and since there was acceleration above the norms, it only makes sense that some backing off can and should occur without alarm.

The most notable imbalance continues to be in interest rates. Short-term rates will have to rise 2.5% or more to get back to a reasonable historical relationship with the other statistics. And that assumes no increase in inflation.

My best “guess” as to the direction of these over the next 6-18 months is as follows:

GDP Growth: Expect a 5%-7% annualized growth through 2004. Some slowing should occur in 2005, but another recession is a low probability.

Inflation: As long as energy prices stay high, there will be a “trickle down” inflationary effect. I can see inflation rising from 2.9% to around 3.5% sometime in 2005.

Interest rates: If inflation rises to 3.5 %, short-term interest rates are likely to rise from a current 1.45% to 3.5% or 4%, possibly higher if the Fed decides it must battle higher inflation. Long-term rates could go from the current 4.5%-5.2% range (treasuries and investment grade corporate bonds) to 7%-10%; again depending on the route inflation takes.

Stocks: Companies are making money. They are increasing capital spending. They will be hiring more people. While inflation and higher interest rates will be a negative, reaching a historical balance in these should not hamper stocks from continuing within historical norms. I am cautiously optimistic that the S&P 500 will successful hold and move upward from current levels and that it can still finish 2004 up 6%-8% (not including dividends) for the year.

Of course, this assumes there are no major terrorist or other events that are significant. There can be no guarantees.