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summaries

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Crude Mentality

A very interesting and timely article appeared in the Financial Times last month that explains much of the surge in energy stocks over the past year. While it may be a sign of my age, the so-called herd mentality of this new breed of energy hedge funds has played a part in my trepidation to chase this sector higher given the fundamentals.

Roger N. Steed
Chief Investment Officer

Desire to Cash in on Crude Brings Out Sector's Volatility

Financial Times
January 17, 2006 *Pan Kwan Yuk*

Energy stocks revealed their wild side in 2005. Long viewed as the investment equivalent of a faithful, long-term commitment, they became a vehicle for traders' one-night stands. Soaring crude prices, and the resulting rise in corporate profits have made energy stocks an attractive target for momentum players - funds that buy an asset because it is showing a trend in one direction on high volume.

This might explain the sharp increase in the number of speculative positions in energy stocks. Although exact figures are to hard to come by, one conservative estimate puts the amount of hedge fund money invested in energy stocks at $10bn at the end of the third quarter last year, compared with $4.8bn in 2004.

Of this, according to Hedge Fund Research, a Chicago-based research group, 31 per cent was new money invested last year. The inflow of new funds into the sector surged six-fold from $429m in 2004 to nearly $3.2bn during the first three quarters of 2005 as investors piled in on the bandwagon.

Peter Fusaro, co-principal at Energy Hedge Fund Center, a consultancy, said the number of people who were looking to set up energy hedge funds grew "substantially" last year. But with oil itself seen as close to fully priced, he said the strategy among new investors has been to exploit the high oil prices through equities…

…Marc Pado, market strategist at Cantor Fitzgerald, said the influx of speculative traders had transformed the sector from an investment strategy into a trading vehicle. "The more people who were not normally investors in energy came in, the more energy stocks took on the character of commodity trading," he said. "[The new entrants] are not trading on valuations, they are playing off the price of crude. It's a fact of life. There is a lot of hot money out there and these traders need to put their money somewhere."

The price behaviour of energy majors offers a fine

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Crude Mentality continued

example of the herd instinct in action. The Amex oil index, the widely followed gauge for the group, showed particularly choppy performance during the second half of 2005, with the index zigzagging to the tune of rising and falling crude prices. The latter, in turn, appeared highly sensitive to the latest weather forecasts for the northeastern US. On October 20, for example, the index shed 4.7 percent, but bounced back 6.1 percent in the next three days following a $2 drop and then a rise in crude prices.

Those movements also underscore the extent to which shares in oil majors can now be driven by the short-term performance needs of hedge fund managers. In both November and December, the Amex suffered sell-offs towards the end of the month even though oil prices were relatively unchanged. One possible explanation is month-end selling by hedge fund managers.

Not all of the sector's volatility could be blamed on fickle trend-traders. There have also been strong underlying reasons for volatility in the crude price.

Stephen Gengaro, energy analyst at Jefferies & Co, said factors such as an oil strike in Venezuela, had combined with strong energy demand growth from China and India to rattle crude prices. Momentum traders, he said, only added to the volatility.

Although the consensus is that the short-term direction of the energy sector will continue to be set by hedge funds and other fast money, most strategists appeared to take the hand-in-hand movements of energy shares and commodity prices with a pinch of salt.

But they need to be aware that one-night stands often end with a hangover and regrets. ■

The Economic and Market Environment

In Sum: Despite continued concerns from the Middle East, North Korea, and South America, global economies have remained resilient. Domestically, employment numbers remain strong. The focus is now on new Fed Chief Bernanke and his plans for interest rates and inflation. President Bush presented his budget for 2007. Congress is currently reviewing the budget proposal, with continued deficits remaining a widespread concern. Corporate earnings for the final quarter of 2005 improved, with stock buybacks continuing to surge.

Geo-political: U.S. officials hope to reduce the numbers of U.S. troops in Iraq this year, if the Iraqi government is able to assume more security responsibilities. Recent elections of the Hamas party in Palestine are disconcerting. The U.S. and European Union have threatened to cut off aid to any government run by Hamas unless the group renounces violence and abandons its commitment to Israel's destruction. Hamas has made conflicting statements as to whether or not they would seek additional funds from Iran. Iran has defied increasing international calls for restraint by restarting their nuclear programs.

Economic: Recent Employment growth numbers demonstrate that the five-year economic expansion is continuing in the first part of 2006. The automobile industry continues to struggle, but consumer spending overall has remained strong. Inflationary pressures and a slower real estate market in some areas could signal slower economic growth in the later part of 2006.

Monetary: At Greenspan's final meeting, the Federal Reserve Board raised short term interest rates to 4.5% from 4.25%. The focus is now on whether or not new Fed Chief Bernanke will continue to raise rates. Robust employment growth and increasing inflationary pressures imply the Fed could raise rates again soon.

Fiscal Policy: President Bush sent a proposed budget to Congress calling for increased research into alternative sources of energy as well as additional spending on defense and security. The proposed budget does not include any changes to the current tax code, but calls for making some current cuts permanent. If the President's budget is approved in its current form (unlikely) the planned deficit would be $354 billion in fiscal year 2007, down from the current year's projected $423 billion shortfall. This does not account for the bulk of continued spending to fund the war in Iraq.

Equity markets: Earnings reports for the last quarter of 2005 have been improving with energy continuing to lead the overall market. Retail sales numbers came in ahead of expectations with retailers across the board reporting a better than expected holiday season, which continued into

January. New stock buybacks continue to surge. TrimTabs Investment Research estimates actual stock buybacks will average $1.94 billion daily in the current quarter up from $1.86 billion daily last quarter.

Fixed income markets: Demand for longer term fixed income has been keeping interest rates low. Rates remain similar across maturities with some short-term bonds yielding slightly more than their long-term counterparts.

Bernanke, Interest Rates and the Economy

Written by: Christopher J. Kress, CFA

On February 1, 2006, Ben Bernanke began his role as chairman of the Federal Reserve, replacing Alan Greenspan who presided over the central bank for the past 18-½ years. While Bernanke's previous experience as both a Princeton economics professor and advisor to the Bush administration should prove beneficial in this new role, it remains to be seen if Bernanke has what it takes to successfully handle the job during these precarious times.

By way of review, the Federal Reserve was founded in 1913 to foster a sound banking system and implement a monetary policy that "promotes the objectives of maximum employment, stable prices, and moderate long-term interest rates". Of course, this is easier said than done.

The Fed's principal tool for implementing monetary policy is the federal funds rate. The federal funds rate is the interest rate that banks charge other banks on balances held at the Federal Reserve on an overnight basis. This rate also influences the level of interest that banks and other financial institutions charge corporations and individuals when loaning money.

When banks lower the cost of capital, this generally leads to a higher level of economic activity as businesses are more likely to make capital investments and individuals are more inclined to spend on goods and services such as cars, homes, vacations, etc. Of course, the reverse is also true. That is, businesses and investors alike tend to reign in their spending when the cost of capital is too high. Thus, monetary policy can play a significant role in determining future economic activity.

In pursuit of maximum employment, the Federal Reserve has a natural desire to foster an environment that stimulates economic growth. Left unrestrained, however, a strong economic climate can lead to inflationary pressures.

Conversely, if inflation appears to be getting out of control, the Federal Reserve may wish to slow down the growth of the economy to relieve this pressure. However, when the economy slows down, unemployment increases.

Maintaining a healthy growth in the economy without too much inflation is complicated by the fact that there are a number of exogenous factors that can impact employment, inflation and interest rates of which the Federal Reserve has little or no control. Moreover, there can be lags by as much as 12 to 18 months between the times that the Federal Reserve attempts to exert its influence by a change in monetary policy and when the change is actually felt in the market place.

So, where do we stand today? To answer that question, it may be helpful to take a look at our past. Over the past 20 years, the U.S. economy has generally been in a growth mode with only two brief recessions, the last of which occurred in 2001. To minimize the length of this recession, Greenspan began a series of reductions in the federal funds rate such that the level fell from 6.5% during the latter part of 2000 to as low as 1.0 percent in June of 2003. Then, beginning in the middle of 2004, the Federal Reserve began a systematic increase in the federal funds rate, raising this benchmark by 0.25 percent during each of its Federal Open Market Committee meetings, including the most recent meeting, which took place on January 31 of this year. With the federal funds rate now at 4.5% and the prime rate at most financial institutions at 7.5%, the question is what will Bernanke do next?

On the one hand, there are signs that inflation is returning to the market place, due partly to the impact of high oil and natural gas prices. While energy prices may moderate from current levels it is likely that the price of oil and natural gas will remain substantially greater than what we have been accustomed to during most of the economic expansion that began in the early 1980's. Higher energy prices are not only increasing our cost of transportation, it is also increasing the cost of production for many of the goods and services that we consume.

Bernanke, Interest Rates and the Economy continued

Anecdotally, many of the companies that we follow are suggesting that the market place is more accommodating of higher prices than they have been in the recent past. Keep in mind that moderate inflation is actually viewed as a sign of a healthy economy and in fact, there is no evidence yet to suggest that inflation is out of control. But clearly, the signs are present that inflationary pressures are building in the economy. Such concerns would argue for further rate increase.

On the other hand, a continued increase in interest rates is likely to strain the consumer and put a crimp in our economic growth. For example, a sector of our economy that is very much at risk is the housing market as rising real estate values have increased home construction, enhanced the purchasing power of homeowners and stimulated the purchase of a broad range of home related products and services. With signs that the housing market is beginning to cool, the ripple effect to our economy could be significant.

A continued increase in interest rates could negatively impact the purchasing power of consumers in other ways, as well. For example, many financial institutions have recently increased the minimum monthly credit card balance due, from 2% of the outstanding balance to 4%. Many homeowners are also exposed to adjustable rate debt, most notably with their primary mortgage or equity line of credit. Once again, as interest rates rise, their monthly mortgage payment increases as well. For consumers on a tight budget, this added expense could have a negative impact on future spending.

If the Federal Reserve becomes concerned about the future of our economy, one would expect that they would reverse their course and in fact, lower rates in the future.

There is yet another phenomena that is worth discussing; the inverted yield curve. Simply put, an inverted yield curve exists when short interest rates are higher than longer-term rates. For example, on February 12, 2006, Bloomberg quoted the yield on a 6-month Treasury bill at 4.69% whereas a 10-year Treasury bond carried a yield of 4.59%.

Many believe that an inverted yield curve foreshadows a slowing economy and possibly, a recession. In fact, while an inverted yield curve has not always led to a recession, every recession in modern times has been preceded by an inverted curve. This then begs the question, why does the Federal Reserve need to increase interest rates when a recession may be in the offing?

As the year progresses, we will be paying close attention to economic indicators and company fundamentals, trying to discern whether our current economic expansion can be extended or if a recession is right around the corner. At the moment, we do not see evidence of a recession but we must remain vigilant, nonetheless.

We must also pay close attention to the future actions of the Federal Reserve. At the moment, it is a reasonable bet that increases in the federal funds rate are coming to an end. What may be more telling is the explanation that the Federal Reserve provides at the time that they no longer increase the rate. A decision to hold the federal funds rate stable following a pattern of consecutive increases may reflect confidence that the tandem goals of moderate economic growth and moderate inflation has been realized or it may suggest that they overshot the mark.

Per our portfolios, our strategy remains the same. We feel that investors should only be invested in equities if they have a multi-year time horizon and can accept the volatility that is inherent in owning common stock. Moreover, we continue to believe that equities offer investors a superior total return than fixed income investors over a market cycle.

Our bond portfolios, for the most part, are relatively short in duration, taking advantage of the current interest rate environment. In time, it is reasonable to assume that short rates will trend lower and long rates will either stay flat or rise moderately. As this occurs, it is likely that we will begin to lengthen the maturities of our bond portfolios, all else being equal. ■

Several of the companies we have invested in for our clients have recently become the subject of class action lawsuits. Our clients receive forms to participate in the lawsuit and a majority can be filed online. To find out if the forms can be filed online, go to www.gardencitygroup.com/cases/index. If the company is listed, we can file online on your behalf and you do not need to forward the paperwork to us. We understand not everyone is web enabled and, of course, are delighted to continue taking your calls and accept any class action paperwork sent to us.

Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.

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