

## Report From The Portfolio Manager

September 2005

Eric M. Kobren, Portfolio Manager ■ Rusty Vanneman, Co-Portfolio Manager



Eric M. Kobren

## Katrina, Energy Prices, and Greenspan

Clearly, the most important impact of Hurricane Katrina is on the lives of those on the Gulf Coast that bore the brunt of its destruction. Our sympathies go out to all those affected by this terrible storm, including the families and friends of those in its path, many of whom still do not know the fate of their loved ones. We have clients across the country, including New Orleans (some who even rode out the storm), and we recognize that many lives have been significantly impacted.

Beyond the human tragedy, Katrina will affect us all in a variety of ways, from its impact on economic growth, to the prices we pay for gas at the pump and food in the stores. It may even affect Federal Reserve policy. In an attempt to be fairly concise, we will try to address these various effects in a question and answer format. *Please recognize that the current economic and market environment is quite fluid and parts of the following report could get dated relatively quickly.*

Please also remember that the heart of what we do when building client portfolios is about process — matching an appropriate relative risk level to a specific client's circumstances — and not about our current economic or market outlook. Nonetheless, we can appreciate the fair question of what we are currently thinking and doing regarding client portfolios given the rather significant recent news.

## How Big Was Katrina? ■ ■ ■ ■ ■

Big, very big. Estimates of the total costs from Katrina range anywhere from \$50b to a stunning \$200b, over what is expected to be a three or four year process. To put that into perspective, Hurricane Andrew in 1992, the worst previous storm, cost just under \$20b in today's dollars. In short, this likely to be the biggest single natural disaster to ever hit the U.S. in terms of sheer direct economic impact (even larger than the \$32b cost of 9/11).

While the impacts of natural disasters are usually localized, because of its impact on a large portion of this country's energy industry, Katrina is quite different. Repeating numbers that have been oft-stated in the financial press of late, the Gulf of Mexico provides around 30% of our oil production and 10% of all the crude oil consumed in the U.S. In addition, almost half of our refining capacity is located along the Gulf's shores.

As of this writing, while some pipelines have begun operating again at reduced capacity, roughly three-quarters of the region's natural gas production, and over 90% of its oil output, are still shut down. This impact on the energy industry amplifies the potential impact of Katrina on the national economy.

Continued ...

How Much Will It Impact U.S. Economic Growth? ■ ■ ■ ■ ■

While Katrina is the biggest storm to date, the chart below, which examines the last five hurricanes before Katrina, shows their economic impact has been fairly modest. We do recognize that this is an extremely oversimplified situation, covering only five storms and assuming no other factors were relevant except for the hurricane in question. Nonetheless, it does provide a clue that a devastating hurricane does not necessarily knock the economy into a recession.

For the second quarter of this year, GDP grew 3.3%, just slightly below the long-term average of 3.5% real GDP growth. Prior to Katrina, expectations for third quarter GDP were running close to 4.5%. In its wake, some economists have shaved expectations for near-term GDP by 0.5%, but others are talking about how the rebuilding effort will actually increase GDP.

Impact of Recent Hurricanes on GDP (average of last five storms)	
Period	GDP
2 quarters before storm	3.6%
1 quarter before storm	2.7%
<b>Quarter of the storm</b>	<b>3.4%</b>
1 quarter after storm	2.9%
2 quarters after storm	2.2%
3 quarters after storm	3.1%

Source: JP Morgan

Our view is that since Katrina was bigger than past storms, and given its impact on the energy sector, there will be a net reduction in near-term GDP, but not enough to drop it significantly below the long-term average of 3.5%. Of course, as mentioned earlier, this is a fluid situation which will require close watching.

How Will That Impact Corporate Earnings? ■ ■ ■ ■ ■

Our guess is that there is some bad news and some good news in the answer. We could see a repeat of what many savvy corporate financial officers did after 9/11, when they used the impact of the event as an excuse to lower earnings and expectations in the immediate quarter. If so, stocks may initially suffer as market participants attempt to adjust to the new lowered expectations. Of course, once all the “bad news” has been dumped into the third quarter earnings numbers, the fourth quarter should have an easier time. This offers a strong possibility of a re-acceleration of earnings growth later this year.

What About Energy Prices, And Will Katrina Push Them Even Higher? ■ ■ ■ ■ ■

Higher energy prices are not a positive. That said, the situation isn’t as bad as the headlines suggest, at least not yet. For starters, today’s high prices are the result of strong genuine economic demand, not artificial supply constraints. The economy, for the most part, appears to have enough positive momentum to absorb the higher prices. In addition, while the nominal levels of energy prices are setting new records, in real terms (after inflation), current prices are still below the early 1981 peak of around \$40, which represents an oil price well over \$90 in today's dollars.

Continued ...

Something else to think about is that as a percentage of disposable income, energy has declined from 8% in the early 1980s to the less than 5% today. A study from Cambridge Energy Research Associates, suggests that oil futures would have to rise to, and stay above, \$75 a barrel for roughly three years to have the same economic impact as the oil shock of the early 1980s.

President Bush's decision to tap the Strategic Petroleum Reserve should take some pressure off prices, at least on crude oil. In fact, while prices surged to \$70 a barrel in anticipation of Katrina's impact, since then prices have retreated nearly \$4 a barrel. And with so much refining capacity damaged, the demand for crude in this country should go down in the short-term.

The problem with a lack of refining capacity (or the pipelines to get crude to refineries that are operating) is that it puts upward pressure on the prices of the primary products we actually get from crude oil — namely gasoline and heating oil. In that sense, Katrina will likely result in even higher energy costs.

Still, sentiment on the energy complex is quite bullish. Looking at the positions of mutual fund and hedge fund managers, overweights abound. It seems to us that the level and volatility of prices may be amplified by this speculative interest. While this doesn't mean that prices can't continue to rise, it is important to remember that markets are cyclical and even in long-term up-trends, they can have deep corrections. At the very least, this extreme in speculative interest suggests a potential imbalance and a more-than-decent probability that prices could fall in the near- to intermediate-term.

What do we think the Federal Reserve will do? ■ ■ ■ ■ ■

Quite frankly, heading into the weekend before Katrina, while most of the major headlines concerned energy prices, we were more interested in the comments made by Federal Reserve Chairman, Alan Greenspan. In brief, he expressed his concern over the housing market and how speculation may be continuing to push home prices higher. The market was fairly swift in coming to the (correct in our view) conclusion that the Fed would continue to raise short-term interest rates longer (and higher) than previously anticipated.

Now, however, given Katrina, the market has had to reassess that likelihood and then some. While it had been taken as a given that we would see rate hikes in September, November and December, as of now, the market is basically putting the odds at about 70% that the Fed will stop here, with no increases after September.

The argument for the Fed to keep raising rates, however, remains intact: rising inflationary pressures — particularly from energy prices, Greenspan's specific concerns about an "asset bubble" in housing, and the desire by the Fed (and Greenspan) to be seen as a steady hand true to their role as — first and foremost — an inflation fighter.

Continued ...

The arguments for pausing right now, however, make this a fair debate. Arguably, if the Fed was in a neutral mode — rather than in the midst of an unfinished tightening cycle — it would be fair to assume that its response to an event as significant as Katrina would be to cut rates to supply liquidity. Remember that the Fed cut rates in 1996 when a large snowstorm shut down the Northeast (and at that time, core inflation was at 3% — now it is only around 2%).

While it is unlikely to cut rates here (though at least one economist has suggested that as a possibility), the Fed may simply want to hold off on further hikes until it can get a better picture of the impact of Katrina, but that really won't be known until after the next FOMC meeting on September 20th.

Moreover, some of the economic data of the last week, particularly in manufacturing, strongly hinted that the economy was already slowing *before* Katrina, so they may not wish to risk exacerbating the situation. And, even though energy prices are indeed high, they have not yet significantly raised core inflation.

We still believe the Fed will boost rates again in September. But if they don't, we expect them to signal that this is only a pause (citing some of the reasons above) and that they remain committed to removing "accommodation" (i.e. raising rates) to keep inflation in check. This is important because one of the factors keeping long-term bond yields low has been the Fed's continued effort to take the air out of rising inflationary pressures. If the Fed announced they were "done," and inflationary pressures continued to increase, then the longer-term interest rates would begin to rise.

#### What About The Stock Market? ■ ■ ■ ■ ■

A review of our Five Factor Equity Model (available on our website) actually yields a bit of an improved outlook for stocks since last month.

In recent weeks, investor sentiment on stocks has soured. Katrina, energy prices, and Greenspan's comments have all weighed on investors, but so have weaker prices themselves. As we have mentioned in the past, chasing past performance generally impairs future investment performance. Thus, we see this bearish sentiment as a positive for the market. *Note that sentiment can change quickly, and the market is surging today, the first day back from the long Labor Day weekend.*

With the softness in the market over the past few weeks, valuations have improved a bit, though they still remain above historical averages (i.e. stocks are not cheap).

On the earnings front, the overall picture for the last two years, and so far into this one, reveals a strong economy and strong corporate profitability. Economic momentum is positive. Dampening this view, however, is the potential that earnings in the 3rd quarter could be quite dismal as we described earlier.

Continued ...

Also as we discussed above, interest rates remain uncertain. No one knows what the Fed will do for the rest of the year regarding short-term rates. But right now, we know that in an absolute sense they are still quite low and accommodative. In addition, longer-term rates have actually dropped recently. These are both stock market positives. The negatives still include the possibility of an inverted yield curve (i.e. where short rates are actually higher than long rates) which has historically signaled a recession. However, those concerns have decreased a bit over the past week.

Liquidity is basically a catch-all phrase for the amount of money available to buy stocks (and other things). The liquidity backdrop had been deteriorating in recent months, driven by such factors as a contracting money supply and rising short-term interest rates. It is a reasonable guess though, that liquidity will improve as the government responds to help the individuals and businesses who have suffered from Katrina.

In summary, we are, like many others, quite concerned about the potential economic impact of Katrina, something we can't fully measure for weeks, or more likely, months ahead. Needless to say, we still endorse our core philosophy of building all-weather, diversified portfolios that maintain an appropriate amount of stock market exposure given each investor's unique situation.

On the margin, however, we are a bit more positive on the stock market heading into the month of September, a bit more negative on the outlook for long-term interest rates, and not encouraging the initiation of any fresh commodity market (and energy in particular) exposure.

Sincerely,



Eric M. Kobren  
President  
Portfolio Manager



Rusty Vanneman, CFA  
Director of Research  
Co-Portfolio Manager

This report was produced by Kobren Insight Management (KIM) and although all data was gathered from sources believed to be reliable, it cannot be guaranteed. This report should not be considered investment advice and the opinion of KIM can change at any time.