

## The Tonge Telegraph

### May 2005

#### Keeping An Eye Out

One wonderful thing about April showers is that eventually May comes and the flowers burst forth. Clearly, April was a stormy month for the markets. The good news is that spring is in the air. The economy, erratic to be sure, is nevertheless in a warming trend, just as surely as the weather is moving from the snows of winter to the heat of summer.

As the U.S. economy slowly strengthens, the stock markets will from time to time get ahead of or fall behind what would be considered a fair value in the current circumstances, and for a number of reasons. One is the guesstimate of what the situation will be six months down the road. Another is the anxiety that drives people to buy into the stock markets at the top because they don't want to miss out and to sell at the bottom because they're so frustrated. A third and perhaps most powerful factor in today's markets is the presence of hedge funds. Hedge funds exist only to trade the market, not to invest in the market. Their trading activity tends to exaggerate swings past fair market value on both the up side and the down side.

The current scene may be no cause for jubilation, but it could be worse. The economy moves fitfully forward, corporations are earning money, and consumers continue to spend it. We call none of these three factors robust, but we note that they're on the positive rather than the negative side. That is, the economy is growing at a slow rate albeit with increased inflation, and corporations are earning money if not at the growth rates we saw last year. The consumer is still spending money but confidence has dropped recently, in part because the higher cost of fuel is taking a toll on discretionary dollars.

As I've said in past newsletters, we can only know what is. The markets enjoyed a nice run from last August through the first quarter of this year. They overran their fair market value somewhat, but not by a huge amount. They have taken a breather over the last two months and sold off to a level I would call slightly below equilibrium. We don't know where the markets or the economy may go, but we are well aware of the possibilities. A market that is selling off is very susceptible to bad news, particularly the unexpected type.

Thus, I'm being very cautious and defensive of the portfolios at this time. I'm watching positions carefully and selling those that are performing poorly. When the situation improves, as I expect it will, there will be plenty of good opportunities to reinvest the money. Meanwhile, I prefer to have some money safe on the sidelines earning a nominal interest rate in the money market fund.

Whatever may surprise us on the evening news this month, we can be sure that outside the window there will be the welcome and dependable change from the white of winter to the colors of spring and the sounds of summer.