

September 30, 2005

### **Hurricanes Revisited**

In our letter to you this time last year, we discussed the impact that the rash of hurricanes we had just experienced would have on the energy supply, the economy, and the capital markets. It is quite amazing how relevant that same letter is exactly one year later. The two recent hurricanes that caused so much devastation in the Gulf Region have also caused tremendous uncertainty in the energy markets as well as the economy as a whole. At the risk of repeating much of what we said a year ago, we will discuss the impact of recent events on the economy as well as the stock and bond markets.

The Federal Reserve recently raised short-term interest rates for the 11<sup>th</sup> consecutive time. The Fed feels that any economic slowdown due to the hurricanes will be temporary and they need to stay focused on the inflation threat. It remains to be seen what the combination of higher oil prices and higher interest rates will have on economic growth. For the first time in this interest rate cycle, the decision to raise interest rates was not unanimous, with some feeling that the Fed should put the rate increases on hold until the economic damage from the storms was determined. We feel it is too early to forecast this damage with any degree of accuracy, but it is safe to say that there will be a slowing of the economy due to the storms.

From the behavior of the bond market, investors seem to be discounting the inflation threat as evidenced by a very flat yield curve, or virtually no difference between short-term and long-term interest rates. If the Fed over shoots their interest rate increases and causes a recession, look for the yield curve to invert, or short-term rates being higher than long-term rates. We tend to view this as more likely than not. Alan Greenspan has made it very clear during his tenure that they would rather suffer through a recession than to suffer inflation. Because of this we have been gradually increasing the duration of our bond portfolios as we feel we will see a rally in the bond market in the next six months.

Stocks, in general, do not perform well in a flat or inverted yield curve environment. While a late year rally in stocks like we had last year would not surprise us, to see a sustained upward move we will need to see a break in energy prices and a rebuilding effort in the Gulf that does not cause inflation. We continue to be fairly defensive in our stock portfolios.

**Wabash Capital**