



Investment Insights

Kevin Kennedy

Second Half Preview

It's hard to believe that time is moving so fast, but we're already in the second half of 2004. With recent concerns in the stock and bond markets making investors feel unsettled and nervous, let's take a look at the issues on the horizon for the remainder of the year that could impact your investments.

Terrorism

Since the September 11th attack back in 2001, terrorism and the potential for further incidents has dominated the headlines. The Office for Homeland Security, with their seemingly weekly alerts, has ensured that the fear factor has not diminished much in the three years since that terrible day. Just the uncertainty alone could impact things like the consumer's willingness to spend money, and company's ability to conduct business unhindered by such concerns. This might weigh on the economy, and hamper the fledgling recovery we've seen over the past year and a half.

There are four very public and symbolic events on the horizon for the remainder of the year: the Olympics, the Democratic and Republican conventions, and the US elections. All four of these events are considered "high-profile" targets for terrorists, and financial markets are already on edge as these events approach.

The Elections

On November 2nd, voters will go to the polls, and the Presidential election is, by most accounts, a toss-up right now. Although feelings are mixed as to which political party would be most beneficial to the economy and the financial markets, one thing is for sure: the markets don't like uncertainty. Unless the picture clears up in coming months, many market participants may decide to sit pat until the outcome is known. As a result, markets may tread water, idling until the future is more certain.

For businesses, the elections are an important time also. With the potential for changes in tax policy, foreign affairs, and new legislation governing business operation, many companies are closely watching the polls to see what impact these elections might have on their operations. Again, with the unclear picture we currently have, the result might be that businesses hold off on making major decisions about hiring, expanding, and purchasing goods until their future is clearer. This, too, could have a negative impact on the economy in the second half of the year.

Interest Rates and Inflation

The Federal Reserve reversed their long-standing policy of stimulating the economy through low interest rates when they raised the Fed Funds rate by ¼% in June. This was the first rate hike in four years. At his testimony before Congress in late July, Fed Chairman Alan Greenspan suggested that the pace of interest rate hikes may accelerate if economic and inflation data continues to be strong.

Although we are still at a historically low level on interest rates, a trend of rising rates has a negative impact on everything from stocks and bonds to home prices. Expectations about the level of interest rates have changed dramatically in the financial markets over the past few months, and this has contributed to the lackluster performance we've seen since April of this year. At this time, the markets have factored in future measured increases in the Fed Funds rate, but if that pace is faster and greater than expected, it could weigh further on stock, bond, and home prices.

I've outlined three major issues the markets are watching closely right now, and all three have potentially negative ramifications on the markets in the short term. Before you get too discouraged, and put all of your money into a tin can in the backyard, let me emphasize the positives that are currently being somewhat forgotten.

Fundamentally, we're in very good shape. We are now in the second year of what has been by most measures a successful economic recovery. After the sharp slowdown in 2000-2001, the economy has posted strong results, and that trend is expected to continue. A strong economy leads to higher corporate earnings, which boosts the stock market, and more prosperity in the country, which leads to increased confidence and spending. The economy is much like a 100-ton oil tanker: it's very hard to reverse direction in a short period of time. The momentum we've built from the dark days of the recession may abate slightly, but fundamentally, the wind is at our backs now.

Another positive is the structural change in business and investing that was brought about by the historical bear market we experienced in 2000-2001. Dramatic, fundamental changes typically only happen during periods of extreme stress and discontent, and we certainly experienced that through the decline in stock prices, corporate scandals, mutual fund industry scandals, and the bursting of the dot-com bubble. The Crash of 1929 brought about reforms like the formation of the Securities and Exchange Commission, which put in place rules and regulations policing the investing world that had previously been non-existent and leveled the playing field for all investors. This crash has brought about reforms in areas like tax law, corporate governance, and investor education that may never have happened had conditions been less severe. Going forward, these changes will provide a better environment for all investors to participate fairly and equally in the financial markets.

As is always the case, there is much on the horizon investors should monitor. Knowing what events and issues impact the markets and the economy make everyone able to better understand the short-term gyrations of their investments. If you are unsure of how these events might impact your personal situation, sit down with your financial advisor and review your portfolio now. Be proactive, not reactive. Act logically, not emotionally. Take action today to achieve confidence and peace-of-mind that your financial future is on track.

Kevin Kennedy is president of Kevin Kennedy, LLC, a registered investment advisor firm in Alameda. Reach him at 510-748-1898 or Kevin@KevinKennedyLLC.com. Stocks, bonds, and mutual funds involve risk, including loss of principal. Past performance is no guarantee of future results.