**Whither Thou Goest?** The scripture poses this question in a religious setting. It can easily be applied in a variety of secular settings, especially the marketplace. The marketplace is asking the question in this way: *Where are interest rates going?*

Since the beginning of this year interest rates, as measured by the 30 year U S Treasury bond, have risen roughly 1%. Translated into price terms, the bond has fallen about 10%. This change is not unprecedented, but it is a major downward move, especially when stocks are up more than 6% through April 30, as measured by the S&P 500. *So, the buyer of the average stock is roughly 16% ahead of a buyer of a 30 year Treasury bond since the beginning of this year.*

Given this major discrepancy in returns it seems only appropriate to ask the question, where are interest rates going? *Our answer is, we don’t know.* What we do know is rising interest rates and rising stock prices are somewhat like stretching a rubber band or participating in a tug of war. At some point one side or the other has to give in or the band or the rope breaks.

**One of the main factors driving interest rates is fear of inflation.** The old rule of thumb is long term interest rates should be about 3% above the rate of inflation. So, if inflation were running at 3%, the long Treasury bond should be 6%. Inflation, as measured by the Consumer Price Index, has been running less than 3%, but now the long bond is 7%. *Therefore, one can only conclude that the bond market fears that inflation will be rising above 3%. This fear may not be justified.*

**As was recently reported, economic growth beat expectations in the first quarter of this year.** However, the 2.8% reported rate (subject to future revision) was not one that would necessarily drive inflation higher. Commodities, such as energy and grain have moved up sharply in price. Grain harvests depend heavily on the weather (which can change), and energy prices not only depend on supply and demand but also on politics. *Turning on the spigots in Iraq could alter the supply dramatically. This is of specific interest given that energy futures prices have turned down recently.*

**Labor prices are the most important factor influencing inflation.** They provide about a 2/3 weighting. Although the jobs market seems to be getting tighter, there still seems to be only moderate upward pressure on wage rates. *So, the argument for higher inflation has some credence, but also is flawed.* In turn, the argument for higher interest rates must be considered. There are good counter arguments however, that do not support such a happening.
The direction of interest rates does influence the markets. The direction changed at the beginning of 1996. We don’t see a sound rationale for sharply higher interest rates caused by rising inflation. In fact, rates still could move back down this year after going upward through the 7% barrier. To some extent, political gridlock has directly contributed to the uncertainty in the marketplace.

The budget battle between parties has been disruptive. Lack of agreement has resulted in a failure to raise the debt ceiling to accommodate March government financing needs. This has caused a log-jam in financing the government debt. Delay in March financings moved them into April, doubling up financings for that month. This has been followed by regular quarterly needs brought to market in early May. All in all, $95 billion in Treasury notes have been sold in 31 days. This is somewhat akin to having a tiger eating an elephant whole. We must remember that the financial markets are delicate and do react to financing surges; we just don’t have smooth, steady funding flows coming out of the government. This kind of congestion tends to disrupt the markets.

The future direction of the financial markets is unknown to us, and those who try to forecast the markets are often wrong. Abrupt changes in market factors such as interest rates cause some market participants to react quickly by making major changes in their holdings. We think of such moves as being more speculative in nature if they are not supported by sound economic fundamentals. We prefer to make changes based on those fundamentals. It is our judgment that if these fundamentals remain in place, there is every reason to expect slow economic growth and reasonable inflation.

Our strategy for account management has essentially gone unchanged. As we have indicated in prior newsletters, most of our accounts are balanced, meaning they have both a bond and a stock component. We continue to stagger our bond maturities over a 10 year period.

As for stocks we continue to diversify according to industry and individual issues. Technology, finance and health care remain over weighted sectors. Slight increases have been made in our energy holdings while slight decreases have been made in our health care holdings, the latter on a price basis. Energy stocks we have been using have growth or restructuring characteristics and do not represent commodity surrogates.

We will continue to monitor the direction of interest rates and signs of increasing inflation. Unless we view changes in basic fundamentals, we will continue to implement our current strategy.

Referrals They are the life-blood for this and any other service-oriented business. Please keep us in mind when uncovering potential investment management opportunities. Our experience, flexibility and strong performance record could be a benefit to those who wish to work with us. Thank you.