



# DAVID R. KERN

ASSET MANAGEMENT

Dynamic Asset Allocation Strategies

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## 3rd Quarter 2004 Newsletter

### Oil's Impact on the Economy

Besides the election in November, oil is a big factor in today's market. The price of oil has hit record highs on the New York Mercantile Exchange, rising about 50% from the beginning of the year. High oil prices are important because gasoline, diesel, and heating oil are made from crude oil. While oil is hitting nominal new highs, it is well short of the inflation-adjusted record. "When inflation is figured in, oil would have to top \$81.30 per barrel to surpass the \$39.00 that U.S. refiners were paying in 1981, according to the U.S. Energy Information Administration."<sup>i</sup> While there is no consensus on the effect of higher oil prices, if prices remain high, those costs will work their way into the system and have the effect of slowing economic growth and possibly increasing the inflation rate. "White House economic advisor Gregory Maniki said at a conference in Philadelphia that oil prices would have to rise another \$20 to \$30 to slice 1% from the U.S. gross domestic product."<sup>ii</sup> Gene Epstein, a regular economic commentator in *Barron's*, paints a different picture. Without the jump in gasoline prices we've already seen, consumer spending would be up about 3% instead of 1%, and second quarter GDP growth would have been 4½% instead of 3%. That much growth would definitely have resulted in some additional hiring by business. This could create a problem for the Federal Reserve, as they have been raising interest rates to cool the economy just when the economy is showing signs it could use additional stimulus.

Higher oil prices may not be as temporary as in the past when oil prices have spiked, only to fall back. "As demand for oil increases, OPEC and

other oil-producing countries increase their production to its absolute limit, but oil prices continue to rise. Among other factors, OPEC had not foreseen the emergence of China as a world economic power. China is importing 20% more (oil) this year than last."<sup>iii</sup> The longer energy prices remain high, the more likely they are to affect world economies.

This is just one of the many factors that have clouded the economic, international, and political concerns this year, keeping the stock market from going anywhere and leaving investors scratching their heads about many asset classes. For example, 10- and 30-year Treasury Note prices (government bonds) were expected to decline over a long period with the Fed's indication in April, and then twice since, that they feel the economy is strong and interest rates should rise, causing bond prices to drop. The bond market sold off in anticipation of this, but has since rallied, bringing interest rates back down, even as the Fed raised the short-term lending rate to banks. There is speculation that money flowing into oil-producing countries is finding its way back into relatively safe government bonds. Increased demand for bonds keeps long-term interest rates low, and makes home mortgages more affordable.

<sup>i</sup> *USA Today*, Section B, Wednesday, October 6, 2004.

<sup>ii</sup> *USA Today*, Section B, Wednesday, October 6, 2004.

<sup>iii</sup> *Sy Harding Street Smart Report*, "Higher Oil Prices Already Make a Difference," 10/8/04.

A current copy of our disclosure brochure (Form ADV – Part II) is available upon request. Please call Lisa Everson in our office at 260-637-1019 if you would like to receive a copy.

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### **ADVANTAGE FINANCIAL PLANNING, INC.**

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**David R. Kern, Registered Principal**

## New Sector Rotation Strategies

While the broad stock market indexes have been in a fairly narrow trading range all year, many sectors have done relatively well. We feel it is an opportune time to introduce some new sector rotation strategies. In addition to Precious Metals and Real Estate, which we consider separate asset classes, we will also include Basic Material, Energy, Utilities, Biotechnology, and Internet asset classes. These new strategies will provide broader diversification of our programs in all risk levels. They also have the effect of decreasing exposure to Precious Metals and Real Estate when those sectors are not performing well.

Sectors related to natural resources and raw materials were primarily strongest for the most recent quarter. These additional sectors will help increase our exposure to “hard assets,” in addition to the Precious Metals system included in our programs.

While my view for the next three months is very optimistic, I feel our expanded approach that targets certain sectors has the potential to provide superior performance, as opposed to focusing on the broad market indexes. Our research and review efforts for monitoring and updating our management systems are ongoing to provide strategies that will apply to any market condition, in a wide variety of sectors and asset classes.

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## Sideways Market Indexes

October 10, 2004 marked the start of the third year of a bull market in the broad market indexes that began October 10, 2002. While the indexes rose briskly initially, they pulled back in March of 2003, and then took off again. This year, they peaked in January and have been in a sideways (neither up nor down) to downward trading range for the remainder of the year. This phase of the market, going sideways in a 6 to 10% trading range, is one of the longest pauses in a bull market in the last 100 years. The only one that was longer took place in 1947.

The final quarter in 2004 includes the months of November and December. These months have historically seen inflows of retirement monies from pension and profit sharing plans, which can run into January and February. This strong

seasonal period may provide an opportunity, especially after the election, for the stock market to make some gains.

According to John Kosar of Branco Research, “Since 1970, the strongest months for stocks have been November and December. The month of October has historically kicked off a period of strength in the S&P 500 Index that carries into January of the following year.”<sup>iv</sup>

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<sup>iv</sup> E.S. Browning, *The Wall Street Journal*, Money & Investing, “Hope for Stocks: The ‘Usual’ 4<sup>th</sup>-Quarter Rally,” 10/11/04.

## Crystal Ball-Gazing

Byron Wien, a well-regarded strategist at the Morgan Stanley brokerage house, indicated that he feels stocks could surprise on the up-side. “The Presidential elections will be decided soon, eliminating a big uncertainty, possible falling oil prices once things stabilize after the hurricanes, and continued economic growth, accommodated by a gradual rise in interest rates” are the reasons he feels stocks have a good chance over the next few months.

In spite of all the negatives about the economy, corporate earnings are still strong from monetary stimulus over the last couple of years. One of the best models for assessing equity valuations – whether stocks are expensive or cheap in historic terms – is the Federal Reserve model, which focuses on the market’s earnings yield to assess fair value. This model compares equity returns to bond market alternatives. Equity earnings yields compared to bond yields show that stocks are very reasonably valued in today’s market. From an earnings yield perspective, stocks are priced at the most attractive levels we’ve seen since the beginning of the bull market in 1982. According to the Fed model, they may be as much as 20% undervalued at this point. This is true of international equities as well, based on historical valuations. Along with reasonable valuations, corporate earnings are maintaining their double-digit momentum and appear to be stronger now than they’ve been through most of the 1990s. Valuations and earnings are important offsets to high energy costs and rising interest rates in the big picture.