

Interest-Rate Roulette: A Game of Many Dangers

By J. ALEX TARQUINIO

WHEN it comes to interest rates, some investors seem to think that they can have their cake and eat it, too. They want rate cuts — and they want a vibrant economy this year.

But a growing chorus of Wall Street strategists is warning that it is extremely unlikely that both will occur. So the strategists are advising investors to proceed with caution on both the equity and the fixed-income sides of their portfolios.

To be sure, the bond markets have already priced in a rate cut of 0.50 percent by year-end, and it seems that stock investors are counting on rate cuts, too. Lately, stocks have rallied whenever investors have believed that the Federal Reserve may cut interest rates, and fallen back whenever they have worried that it won't.

That pattern has come to the fore in recent weeks. On Wednesday, for example, when the Federal Reserve chairman, Ben S. Bernanke, testified before both houses of Congress, the stock market fell sharply.

In response to questions about the Fed's intentions, Mr. Bernanke stressed that inflation remained the Fed's chief concern. That evidently disappointed investors, who had sent stocks soaring the previous week on the apparent assumption that the Fed was moving closer to cutting interest rates.

David Greenlaw, the chief United States fixed-income economist at Morgan Stanley, said investors should avoid a "knee-jerk response" to Fed statements.

"We're getting a bit closer to the point where a rate cut becomes a legitimate possibility, but I don't think we're there yet," he said.

He predicted that core inflation — which excludes volatile energy and food prices — could ease somewhat later this year, but that rising food prices might keep the broader measure of inflation above the Fed's comfort zone. He said that would make it hard for the Fed to cut rates.

On the brighter side, Mr. Greenlaw said, cuts may not even be necessary. He says he foresees stronger domestic growth in the second half of the year because he thinks that "the powerful headwind" from sluggish residential construction will abate. Residential construction has been in such a decline since the second quarter of 2006 that it has trimmed about 1 percent from overall economic growth over the last 12 months, Mr. Greenlaw said, but he expects the home-

building industry to stabilize later this year.

Over all, he estimated, the economy will grow about 2 percent, annualized, in the first two quarters this year; and 3 percent, annualized, in the last two quarters.

If the Fed does not cut rates this year, he said, then bonds are now too expensive. On the other hand, he said, if the Fed does cut rates, two-year Treasury bonds will probably benefit more than longer-term ones.

John T. Donohue, the chief investment officer in the fixed-income group at JPMorgan Asset Management, is also optimistic that the domestic economy will perk up later this year. "Clearly, the biggest question mark is the housing market," he said. "We all know that the subprime market is in dire straits, but that's still a small part of the mortgage market." He said that about 20 percent of mortgages last year were made to borrowers with shaky credit — loans that are generally referred to as subprime.

But despite the tremors in the housing market, Mr. Donohue said he thought that the Fed would have the latitude to cut rates only if unemployment rose closer to 5 percent from its current 4.5 percent. "We essentially have full employment now, and the consumer is holding up very well," he said.

Mr. Donohue said two types of bonds could perform well in the current environment.

First, he recommended Treasury inflation-protected securities or TIPS; the Treasury adjusts the bonds' principal based on changes in the Consumer Price Index. Mr. Donohue said TIPS could outperform ordinary Treasuries if the Fed cut interest rates while inflation was still a concern. "In that case, the Fed would be tapping the growth accelerator," he said, "which could create inflationary pressures down the road."

He also suggested buying foreign bonds, particularly those denominated in euros. He said that any interest rate cuts in the United States could further depress the dollar, which fell against many currencies last year. Individual investors might want to buy into a mutual fund that invests in European bonds but does so without hedging the currency risk. A bond fund's prospectus should indicate whether the fund manager is allowed to hedge currencies.

Henry H. McVey, the chief United States investment strategist at Morgan Stanley, also said that bonds were pricey now. He has long recommended that individual in-

vestors put 65 percent of their overall portfolio into stocks. But in January, he raised the recommended cash position to 10 percent from 5 percent, while reducing the bond allocation to 25 percent from 30 percent. "We think that cash looks good relative to bonds now," he said.

Financial stocks have often done well when the Fed cuts rates. But this time around, Mr. McVey said, he would be wary of financial stocks like those of regional banks, which could be sensitive to any fallout from the subprime mortgage debacle. On the other hand, he said, stockbrokers and investment managers could benefit from rate cuts.

Standard & Poor's recommends an allocation of 60 percent stocks, 25 percent bonds and 15 percent cash. It predicts one rate cut of 0.25 percent this year. Sam Stovall, S.&P.'s chief investment strategist, said he would expect further rate cuts in 2008.

Once the Fed does begin cutting rates, he predicted, the dollar will weaken, which would benefit large-capitalization stocks more than small caps. Many large American companies earn a substantial portion of their profits abroad.

Mr. Stovall said industrial stocks tended to do well soon after the Fed begins cutting rates. For example, in the first six months

after every initial rate cut since 1945, the industrial stocks within the S.&P. 500 outperformed the index as a whole 80 percent of the time. During those initial six months, the industrial stocks rose 17 percent, on average, while the index gained 10 percent.

But Mr. Stovall did not recommend another sector that has typically fared well after rate cuts: companies that rely on consumer discretionary spending. These stocks have risen 18 percent, on average, in the first six months after an initial rate cut. But they have outperformed the stock index only half of the time. Moreover, he said, these stocks are expensive now. The consumer discretionary stocks in the S.&P. 500 have an average price-to-earnings ratio of 19.5, compared with 15 for the index as a whole.

Richard Bernstein, the chief United States strategist at Merrill Lynch, said he thought that the Fed did not have the latitude to "pre-emptively" cut interest rates to ward off a slowdown in the economy. "That would unleash unbridled credit creation," he said, "because we are in a unique period of nonbank lending" by private equity firms and hedge funds.

"If I am right, and the Fed's hands are tied, then investor expectations of what the Fed will do are going to fluctuate all year," he said. In that case, he recommended a handful of conservative investment strategies that generally work well in volatile markets.

First, he said, investors should emphasize high-quality assets — whether stocks or bonds — from large issuers with good credit. Then, among domestic stocks, he favored conservative sectors like health care and consumer staples. Among foreign stocks, he said developed countries generally outperformed emerging markets during volatile periods. He also said that stocks with relatively high dividend yields can help cushion broad swings in the markets. He is also recommending a relatively high cash stake — 20 percent — for investors' portfolios now, along with 50 percent in equities and 30 percent in bonds.

He says that all of these conservative strategies should work well if the Fed does not cut rates this year, or if it cuts rates because the economy is sputtering seriously. But if the Fed cut rates to ward off an economic slowdown, he says, riskier assets around the globe will probably trump the conservative strategies he outlined.

The Fed may be hesitant to cut rates, Mr. Bernstein said, partly "because risk taking in the financial markets might go wild." □

A wrong guess on the Fed's next move can hurt your portfolio.

Growth After Rate Cuts

Average sector performances for the six months after the Federal Reserve began cutting interest rates.

S. & P. 500 SECTOR	AVERAGE PERCENTAGE CHANGE
Information technology	20.7%
Consumer discretionary	18.3
Industrials	16.9
Consumer staples	14.1
S. & P. 500 Growth Group	11.8
Energy	11.6
Health care	11.1
Materials	11.0
Financial	10.4
S. & P. 500 Value Group	7.7
Utilities	7.3
Telecommunications services	3.8

For rate-cut periods from 1945 to 2001.

Source: Standard & Poor's

The New York Times