



## July '06 – Where are the Markets Heading?

Due to the uncertainty in the world stock markets, I have had many people ask, what I think will happen in the near to intermediate term (one to six months). Being that my crystal ball is “in-the-shop” I don’t know what will actually happen but I do recognize a fragile market environment when I see one. From my perch, if the market gets bad news regarding inflation data or 2<sup>nd</sup> quarter earnings/3<sup>rd</sup> quarter earnings guidance from corporate America in the next several weeks, the market could head sharply lower. I just don’t see the risk equating to the potential reward to be in investors favor. Here’s why.

**Inflation is accelerating**, which could threaten corporate profitability. Core CPI\* in May was 2.4%...above the 1-2% Fed “comfort zone”. And the CRB\* Raw Materials index is at the highest level in 25 years. With potential supply disruptions for commodities from the unstable countries that provide much of the world’s raw materials, commodity prices will most likely remain elevated for the foreseeable future. In the past, this has pushed inflation higher. If the inflation data continues to show increases, the Fed could continue to raise rates past the current Fed Funds rate of 5.25%, and this has been one of the main headwinds for the markets in recent months.

**Corporate Profitability** has been at all-time highs in 2005-06. With the likelihood of slowing economic growth and higher inflation cost pressures on companies, it will make year-over-year comparisons tough to top. The double digit earnings growth we have seen in recent years could easily slow to single digits, even if companies continue to do well. The stock market is a forward looking indicator - generally looking out 6-9 months - and if Wall Street sees future profit growth slowing, this could be a major negative for the markets.

**Higher Volatility** has been seen in recent weeks. Larger one day swings in the markets performance is a major change in the character of the market when compared to the last two years. In the past, rising volatility has almost always been associated with declining markets.

Is the correction we have seen in the world markets that began on 5/11/06 just that – a simple correction? Or, is it the start of a bear market? It is this writer’s assessment, we have just completed the 1<sup>st</sup> leg down of a deep correction/bear market. I say completed because the markets were oversold and an oversold bounce could occur at any time. On the other hand, markets can and have stayed oversold for long periods in the past so the bounce may or may not occur. When will this second leg down begin? Your guess is as good as mine but it could be when/if corporate profit and economic growth forecasts are cut from current levels or if the Fed raises interest rates too far.

Have a great day,

Dave

\* CPI – Consumer Price Index; CRB – Commodity Research Bureau

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