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Economy appears to be in midcycle slowdown

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Managing Your Money is a regular feature in which members of the Times Investing Panel answer personal finance questions from readers. The answers to these questions are general in scope and do not apply to all situations.

Q: The U.S. economy has definitely slowed over the past several months. Do you think there is now a risk of recession?

A: It now appears that the economy is experiencing a midcycle slowdown, much like the slowdowns experienced in 1986 and 1995.

Each of these slowdowns was preceded by Fed rate increases directed at some excess building in the economy or financial markets. In each case, the stock market reacted to the economic slowdown before the economy actually slowed.

After 17 consecutive rate increases, the Fed looks to be on hold for the foreseeable future. Higher short-term rates should accomplish two goals: stop excess speculation in real estate and slow economic growth enough to keep inflation in check.

The reason the Fed will not cut rates soon is that the Fed wants to guard the gains that it has made on the inflation front and establish credibility for the Ben Bernanke era.

A cut in interest rates would be conducive to stronger growth, something that the economy does not yet need because a small buildup of economic slack is necessary to fully wring inflation from the system.

One important factor contributing to a slower economy is the adjustment the real estate market is currently undergoing.

In November, new housing starts dropped nearly 20 percent from a year ago. Moreover, the build up in unsold new homes shows no signs of abating, suggesting we have not yet hit bottom.

A survey of economists showed the consensus expectation is for GDP growth of 2.5 percent this year. In recent speeches, members of the Federal Reserve Board have stated that the Fed believes a weak housing market will reduce economic growth by 1 percent in 2007.

One important question is whether the downturn in the housing market will spill over to the consumer sector. We think the U.S. economy is sturdy, not fragile.

In the second half of this year, we expect a resumption of growth and a moderating rate of inflation. The Fed will most likely keep short-term interest rates at the current 5.25 percent level. If inflation stays within an acceptable range, the Fed should not deem it necessary to hike rates again.

Q: It seems like everyone is talking about global warming and the need to reduce energy emissions. Is there a safe way to invest in renewable or nonpolluting energy companies?

A: The answer is yes. We believe the United States, and many other industrialized, and even underdeveloped countries are poised to attempt to reduce the level of greenhouse gases produced.

The world is now ready for next-generation clean power technologies. It may be an understatement to say our goal should also be to reduce our dependence on Middle Eastern imported oil.

Regarding clean-power technologies, we believe there will be multiple key markets developing over the next several years in which investors will want to participate.

There are companies involved in: solar-photovoltaic technology, efficient lighting, hybrid and electric vehicles, the hydrogen economy, and fuel cells -- auto, stationary and portable.

Unfortunately, there are two problems with investing in these technologies: One, a company like General Electric will be involved in many aspects of these technologies, but this will only account for a very small percentage of their business.

In other words, the bigger players in these new industries will not be a “pure-play” on the new technology.

Second, most of the pure plays are small, unknown companies; small unknown companies pose a high risk-return trade-off. If these small companies run into any problems, then stock prices could plummet.

The best way to participate in this evolving industry is through Exchange Traded Funds (ETF) or Mutual Funds. This way you benefit from an exciting new industry without the risk of trying to pick one or two individual stocks.

A good ETF is the Powershares Wilder Clean Energy Portfolio (PBW). It sells for around \$17.15 per share and is currently about 30 percent below its May 2006 high.