

Market Commentary

Tug of War

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Stock market performance during the first quarter of 2004 can best be described as an economic and geopolitical tug of war. Both vying to push the market up or down.

2004 began on an upbeat note after unexpectedly strong market performance in 2003. Stocks surged in January based on good news on the earnings and economic fronts and no unexpected occurrences in the geopolitical area. However things became decidedly more unsettled in February and March with disappointing employment reports, hints the economy might not be doing as well as expected, the Madrid terrorist bombings, continued turmoil in Iraq, and the assassination of a Hamas leader further complicating the situation in the Middle East. By the end of the quarter the January gains had largely been eliminated by the turbulence in February and March. With the market essentially unchanged over the past three months, it seems appropriate to review both forces to assess their relative merits.

On the positive side we see three major factors which argue for continued stock price appreciation: low interest rates, continued signs of economic growth, and strong earnings reports.

The best argument for stocks continues to be what might be called "what's the choice?" With money funds yielding less than 1% and the ten-year Treasury at less than 3.7%, it doesn't take much convincing to buy stocks with dividends which are taxed at much more favorable rates than taxable fixed income securities (tax frees offer even more dismal low yields).

Most economists expect the economy to grow between 4% and 4.5% this year after surprisingly strong performance in 2003. Productivity continues to allow businesses to keep costs under control (which also results in slow growth in employment), and there are signs of renewed spending on capital equipment.

Finally, earnings remain good, with the number of negative pre-announcements of earnings lower than average (when earnings are on track companies tend not to make announcements before they are released).

On the negative side there is continued weakness in job growth, many stock

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valuations are excessive by most standards, and the continued threat of terrorism.

The only economic measure that continues to be much weaker than expected is employment growth. If unemployment doesn't go down and job growth increase, it means the consumer, the driving force behind two-thirds of economic activity in the United States, will not have money to spend to fuel economic growth. Lack of job growth also tends to have a depressing effect on consumer confidence. This is a negative for the economy, although it is a positive in terms of the continuation of low interest rates, which make stocks attractive.

Few would argue that stocks as measured by price earnings ratios are cheap at this point. How expensive they are relative to historical standards is a matter of debate, but many aren't a great bargain. The primary reason for owning stocks is their potential returns relative to other liquid investments (one of the positives mentioned above). High market valuations make stocks vulnerable to unexpected bad news. This brings us to the third and final major negative.

It is in many ways easier to assess the risks of weak job growth and high stock market valuations than it is to determine the market impact of potential terrorist actions. While the threat of terrorism is something we have lived with since September 11 (and in reality before that), the impact is impossible to gauge. Based on what happened after the Madrid bombings, it is clear the market would go down in response to other acts of terrorism. How much and for how long is a matter of conjecture. It is equally clear, however, that there is little investors can do to protect themselves from this. If, in light of geopolitical concerns like terrorism, one had exited the stock market in early 2003, the cost in terms of foregone investment returns would have been in excess of 20%. This is a steep price to pay for protection.

Our view at this time is that it continues to make sense to be invested in stocks, but return expectations should be modest and volatility a fact of life.

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