



A Standoff Between the Bulls & the Bears

July 1, 2004

At the close of the second quarter, U.S. stock and bond markets are stuck in trading ranges. After getting a modest lift from reminiscences on Reagan-era optimism, the equity markets settled back into their five-month trading range. So far this year, the volatility of the S&P 500's weekly returns has been running under 10% annualized, the lowest since 1996. Stock prices have managed a modest bounce off May's lows (5% for the S&P 500 and the Dow, 6% for Nasdaq), but investors haven't been able to muster enough enthusiasm to propel stocks back to first-quarter highs. After an unequivocal retreat in April and early May, the bond market has been on hold for more than a month. Given all the unanswered questions in the investment environment, the equity market seems to be mired in a standoff between the bulls and the bears, without any clear catalysts to move things one way or another.

For the most part, stock prices have ignored the generally positive economic reports released during June. As far as the stock and bond markets are concerned, a 25 basis-point increase in short-term interest rates was pretty much a "fed accompli". Yet positive economic news and a Fed tightening aren't enough to stop investors from worrying about inflation. Should higher inflation prove to be a more stubborn problem than the market anticipates, investors will continue to give short shrift to strong earnings and other evidence of improved economic conditions.

The uncertain direction of oil prices, over which policymakers have little control, is also helping to keep investors on the fence. Although off their highs, oil prices haven't moved down enough to instill confidence that the peak is truly behind us. The volatile situation in Iraq and the Middle East generally adds to the indecision, and not just because of its potential effects on oil supply. Moreover, there are still more than four months of uncertainty before the U.S. presidential election; the latest polls favor President Bush, which in theory ought to be a short-term plus for the market, but the margin is far from decisive.

Amid all of this uncertainty, there is one sure thing: the stock market won't stay in a trading range forever. It's the timing and direction of the breakout that are problematic. Certainly the issues contributing to the pause aren't going away soon. On the other hand, pointing to a more imminent breakout – and a positive one – is the fact that the June-October period in presidential election years has generally been a good one for the stock market. Another, more fundamental, reason to expect a market breakout to the upside: corporate profits and profit expectations have been trending higher through this pause in the bull market. First Call numbers are showing that second quarter S&P 500 earnings will climb more than 20%. Moreover, the market's P/E multiple has declined suggesting more appropriate valuation levels that will bode well for stocks as long as profits keep improving. As a reminder, corporate margins have been outstanding and are now at 35-year highs.

With our most likely case forecast still calling for healthy economic growth, moderate inflation and higher profits, we continue to look for positive returns from equities over the next 12 months. A moderate rise in interest rates is expected to limit returns from fixed-income investments but not inhibit equities.

U.S. Economy

The most recent report showing a mild 0.2% increase in May's core consumer price index relieved investors in early June. The early transfer of sovereignty from the U.S. to Prime Minister Iyad Allawi and other Iraqi leadership also gave stocks a boost, but it wasn't enough to make a lasting impression on traders as the second quarter was ending. For the most part, stock prices have also ignored the generally positive economic reports released during June. The high point of these favorable data was a 1.0% increase in consumer spending for May, the biggest gain since October 2001, when zero-percent financing moved a record number of cars off showroom floors. May also saw a record level of home sales. Following 2003's fight with the (real or imaginary) forces of deflation, the Fed has been targeting a 2% or so level of inflation – in other words, a rate of inflation where consumers and producers would be reasonably comfortable. Having hit this 2% target during the first quarter, the core PCE price deflator ratcheted up to a 2.5% inflation reading in the latest three months, a level that is probably still acceptable to Fed policy makers but just barely so and not for any protracted period.

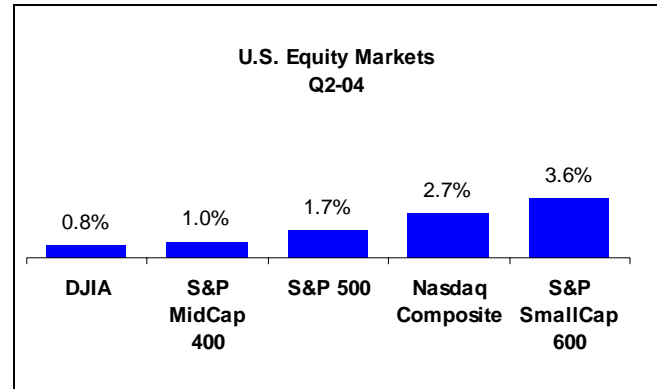
While output got a boost from a weather-induced jump in utility output, manufacturing production increased by a solid 0.9%. The Index of Leading Economic Indicators suggested that healthy growth will continue, with its 0.5% gain for May and a recent trend that the Conference Board sees as signaling a "continuation of this relatively strong [5.0%-5.5%] rate of economic growth in the near term." Despite higher mortgage rates, building permits were at a new high for this cycle in May, and housing starts were close to their recent high.

Yet there are factors mitigating the inflation implications of the economy's upward sloping track. The report on May industrial production showed manufacturing capacity utilization at 76.4%, up about four percentage points from its 2003 low but about the same amount below its average of the last 30 years, an output gap that serves as a limitation on businesses' ability to raise prices. The recent report on May producer prices showed the core inflation rate for finished goods running at a larger-than-expected 0.3% (3.6% annual rate). But further back in the pipeline, prices for crude materials ex-food and energy have retreated for two months in a row, confirming signals seen in other commodity price indicators. China's voracious appetite for industrial commodities is beginning to decline.

Few forecasters would go so far as to predict that the U.S. economy will grow as fast as that of China or India, but a case can still be made for above-average economic growth in the years ahead. After a couple of decades of disappointing results, labor productivity in non-financial corporations has increased at a robust 3.7% annual rate since 1995. (The recent experience is nearly twice the 1.9% rate averaged over the prior four decades). The development of the Internet and its integration into business may have produced a one-off fillip in the productivity rate that will be difficult to replicate. But as important has been the change in mindset among business managers to push the envelope on productivity as a better way to boost profit margins; this pursuit of productivity is unlikely to go away any time soon. As a result, we believe it is reasonable to expect above-average growth in output per hour ahead. The nation can even strive for productivity growth on the order of 3% per year, roughly the average since 1958 not counting the 1973-93 period (when it was 1.5%), which would make possible the utopian combination of above-average GDP growth, moderate new job opportunities, and modest inflation.

U.S. Financial Markets

The second quarter was a choppy period as equity markets tried to assess the combined effects of higher oil prices, tension in Iraq, higher interest rates, the profit cycle, and investor sentiment. In early May, it seemed as if every asset class declined: U.S. equities, U.S. bonds, global equities and bonds, commodities, and even gold. It was as though no one could figure out what direction the global economy was heading, and in the absence of conviction, there was a retreat to cash. The result was very volatile markets in Asia, and see-sawing in the U.S. and Europe. At the end of it all, however, most equities markets were down only a bit, and overall about where they were in January. For the latest three-month period, the Dow Jones Industrial Average rose 0.8%, to 10435.48. It now is 302.22 points short of February's three-year high of 10737.70 and almost unchanged, down 18.44 points, for the year to date. The Standard & Poor's 500-stock index ended the quarter at 1140.84, up 1.7%. The technology-heavy Nasdaq rose 2.7% to 2047.79.



Large-cap stocks pulled ahead in 2004's second quarter but failed to outperform smaller cap stocks. The S&P SmallCap 600 gained 3.6% while the S&P MidCap 400 rose 0.9%. With investors in a cautious mood, neither growth stocks nor value issues took a decisive lead during the quarter, although growth stocks generally fared a bit better. The S&P Barra Value index rose 0.8% while the S&P Barra Growth index gained 2.7% for the three-month period.

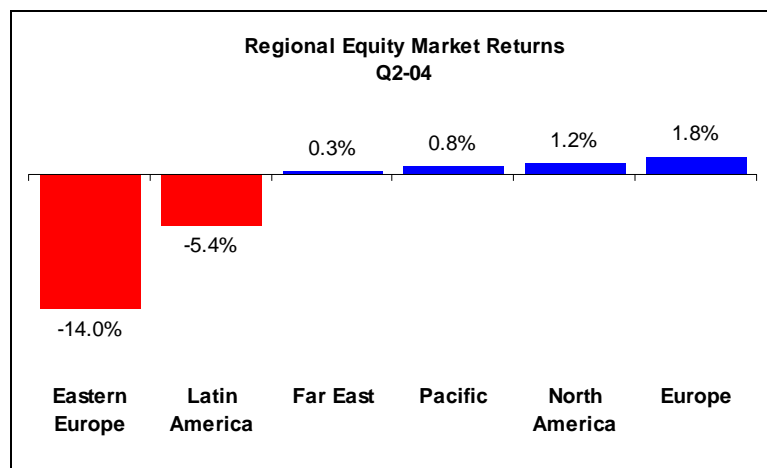
The majority of the S&P 500 sectors posted gains for the second quarter. The spike in oil and gas prices has been bad news for consumers filling up at the pump, but great news for the energy sector, which gained 12% for the quarter. Even though smaller exploration and production and services names surged the most because they're more leveraged to commodity prices, the big integrated oil companies such as ExxonMobil, BP, Total, and Royal Dutch Petroleum, still enjoyed double-digit stock gains for the quarter.

The industrial sector was the second-best performer for the quarter, posting a 6% gain as the strong economic recovery boosted Boeing by 24%, 3M by nearly 10% and Honeywell International by 8%. Transportation stocks such as Burlington Northern Santa Fe, Southwest Airlines, and Canadian National Railway also posted solid gains. The information technology sector brought up the rear, posting a gain of less than 1% for the quarter as heavy-weights Microsoft, Adobe Systems, and Check Point Software Technologies had single-digit gains. Database software maker Oracle drifted lower for the quarter due to skepticism about its plans to buy PeopleSoft while Texas Instruments, EMC, Applied Materials and International Game Technology posted losses and weighed down the sector's returns for the quarter.

Aggregate S&P 500 earnings are forecast to grow at 15% - 18% this year, and somewhere around 10% next year. We believe that corporate accounting is cleaner than in the past, and corporate cash flows have never been as strong. Many of the growth companies we follow will have 15% - 25% earnings growth annually between 2004 and 2006. The potential return on equities is substantially greater because companies can grow earnings, whereas bond yields are fixed. The 10-year note yielding 6% will provide less return during the same time frame, especially if inflation rises. Of course, all investors have to assess their own asset allocation, and determine the mix of fixed-income, growth equities, value equities, real estate, and other available instruments to meet their financial objectives. But we are confident that equities offer substantial upside potential as we enter a new period of multi-year global economic expansion. The fundamental fact is that the equity markets ultimately reflect the profit growth of the underlying companies.

Foreign Financial Markets

During the second quarter, foreign stock markets gave back their first quarter gains. Oil prices set records, raising the specter of inflation and threatening global growth. Terrorism fears, in the Middle East as well as in the West, kept traders edgy and made many investors more risk averse. Additionally, the Federal Reserve's announcement that it would raise rates coupled with fears that the Chinese government would be unable to slow the economy -- or even worse, would slow it down too much -- weighed on stock markets across the globe, and especially on emerging markets. European equities were the best performers as the MSCI Europe index gained 1.8%. Pacific stocks that include Japan were up less than 1% while Far Eastern equities gained a scant 0.3%. Many emerging equity markets declined during the second quarter. Rising U.S. interest rates were a big culprit, hitting especially hard highly indebted countries such as Brazil and Turkey. The main indexes in those nations fell 7% and 11%, respectively, for the quarter. India was down 12% on the back of the surprise win by Sonia Ghandi of India's Congress party that sparked concerns that the ruling coalition would slow or even reverse recent market overhauls. Eastern European emerging markets that were up 25% in the first quarter were down 14% after Russian equities declined 21% over continued fears about the Russian government's suit against oil giant Yukos for tax evasion. Investors worried that other companies might come under attack from the Kremlin.



The European Union welcomed 10 new countries on May 1st, the group's largest expansion ever, bringing the total number of member nations to 25. Austria, with a central European location that makes it one of the biggest beneficiaries of this new pool of cheaper labor and consumers, saw its stock market rise 7%. While the European economy continues to show less life than economies in Asia and the U.S., European stocks held their own during the second quarter. The Paris CAC-40 index was up 3%, while

the London FTSE-100 index rose 2%. Frankfurt's Xetra DAX index advanced 5%. During the second quarter, the Bank of England raised interest rates as the economy continued to show signs of strength. Investors on the Continent were disappointed that the European Central Bank failed to cut its interest rates, as many economists predicted. The quarter ended with investors questioning the region's catalyst for growth and stock market returns.

Asian stocks performed poorly during the second quarter, with the benchmark indexes in South Korea, Taiwan, and China all falling more than 10%. Tokyo's Nikkei Stock Average, which rose 1.2% for the quarter, was among the better performers globally. Japan's economy in the January-through-March quarter expanded at a 6.1% annualized rate, faster than the initial estimates of 5.6%. The Organization for Economic Cooperation and Development recently said Japan's long period of falling prices could end next year. While in the past, investors looked to Japan's world-class exporters, such as Sony Corp. or Toyota Motor Corp., the market has been led higher this year by domestic-oriented companies such as Tokyu Department Store Co. and Takashimaya Co., another retail chain. Both stocks are ahead more than 60% for the year.

Despite expectations for higher interest rates, corporate fundamentals in Europe are excellent. Earnings this year in Europe are expected to rise more than 25% from year-ago levels. The improvement could be even more robust for Japanese company earnings as operating margins have reached post-bubble highs.

Conclusion

A Pew Research poll of people in 44 countries found Americans to be the most positive about their ability to control their own destiny. This can-do attitude among Americans, supported by and reflected in the nation's world-class economic performance over the decades, was personified in Ronald Reagan. Without question, the 40th U.S. President's brand of individual liberty and rugged optimism struck a chord with citizens – native-born and immigrant alike. Under our system of free-enterprise capitalism, there is no lack of examples of good ideas and products percolating their way to the top, producing ample rewards to inventors and investors in the process. Odd as it may sound, U.S. investors can even take encouragement from the stock market's performance in the aftermath of the 1929-32 market crash. As bad as it was, that awful bear market was over in 34 months, setting the stage for what is now SEVEN decades of returns from equities averaging 12.5% annually (through two more bubbles, 1971-72 and 1998-99, no less).

We are looking at a domestic economy that will see some of the strongest economic growth in a decade and record corporate profits. We are looking at a global economy that is growing in every region and that is no longer as dependent on the United States for that growth. China is emerging as a consumer of global goods and commodities, and its expansion is sparking increased activity in Japan, Korea, and Australia. India is showing signs of being the next China. All of this is unfolding in a relatively low inflationary environment, at least by the standards of the past half century.

Many people have been trying to come up with the exact historical parallel to the current market and economic environment. As oil prices have risen, there have been the requisite comparisons to 1974, but today, there are no gas lines; there is no oil embargo; and even with oil at \$36 a barrel, if oil prices had risen as fast as inflation over the past two decades, the price today should have been more than \$90 a barrel. As the prospect of interest rate increases grows, there have been requisite comparisons to 1994, when the Fed began a sharp tightening cycle. The problem is that the present is never exactly like the past and making investment decisions based on facile parallels is not a good recipe. The world and our economy have changed dramatically since 1974 and since 1994 as well. Historical patterns are a vital guide, but no amount of trolling through past examples can replace fundamental analysis of what companies are doing today.

We do not believe that the robust global economic picture is being adequately reflected in the equity markets. The ever larger share of national income going to corporations, especially in a globalized world where U.S. domiciled companies repatriate profits made abroad, is shaping up to be a significant social issue in the years ahead. In purely market terms, however, the trend suggests that investors ought to follow the profits — and that means investing in those companies that are generating them at above average rates. In any long-term perspective of the U.S. economy and stock market, history is on the side of the optimist.

A Thought: “Small opportunities are often the beginning of great enterprises.” *Demosthenes*

Diane V. Nugent, *President*
Victoria Capital Management, Inc.
4101 Main Street, Suite C
Hilton Head Island, SC 29926

Tel: 843-342-3044
diane@victoriacapitalus.com