



Outlook for 2004 – Front-end Loaded

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At the beginning of 2004, a few things are clear:

First, the capture of Saddam Hussein likely means that the situation in Iraq will slowly improve and thereby lessen one source of tension.

Second, 2004 is an election year in the United States. Typically, equity markets rise in election years. This year looks to repeat that pattern for a number of reasons. Fiscal stimulus of the economy in the form of continued tax cuts and low interest rates should ensure that there is a high degree of liquidity in the economy. Though the Fed may jiggle with the money supply periodically, in the absence of inflation, it is committed to maintaining consumer spending and keeping the cost of capital low. With interest rates still under 4.5% for the 10-year Treasury note, stocks of high-growth companies should return more to investors than fixed-income securities.

Third, the U.S. economic recovery is in the process of strengthening and broadening: businesses are responding positively to an acceleration in demand that began in the second quarter of 2003. The resulting pickup in production, employment and capital spending moved the economic recovery toward a sustainable growth path. Monetary and fiscal stimulus will lift aggregate demand in 2004 because the Federal Reserve remains accommodative, with the lowest federal funds rate since the early 1960s. Tax cuts will also affect the first half of 2004 by bolstering consumer income.

Fourth, corporations are spending again. Estimates for 2004 are for 10% growth in capital spending as opposed to less than 5% in 2003. Profits are expected to grow more than 10% in 2004 and a larger portion of these gains are likely to come from top-line growth and wider margins. The rise in profits and cash flows, along with lower costs of capital, are key factors driving capital spending. We've been saying that consumer spending and government spending can only sustain growth for so long. Corporate capital spending has been the missing element, and it has clearly been picking up again. This should be a significant positive for the economy in 2004.

Key risks to economic and financial market performance in 2004

Although risks abound, they are less obvious than the pending Iraq war that faced us in early 2003. Key risks include the negative economic and financial fallout of a disorderly, sharp decline in the foreign exchange value of the dollar, a resurgence of protectionism, or an extended disruption caused by terrorism.

The U.S. dollar declined throughout 2003, but foreign exchange markets remained orderly, and the dollar's retreat had no noticeable impact on interest rates or inflationary expectations. A sharp, disorderly decline in the dollar could send tremors through financial markets with negative economic fallout. A significant fall in the dollar that contributes to a rise in interest rates and a fall in the stock market could dampen durable goods consumption and business investment. However, we don't expect such events to occur.

U.S. exports are projected to resume healthy growth, following several flat years. Two potential obstacles to expanding trade are faltering global economies and protectionist initiatives. The probability of a renewed global slump is low: the economies of Canada, Mexico and the U.S.'s other meaningful trading partners in the Americas are picking up, Japan's 2003 recovery looks sustainable for 2004, China will continue to grow rapidly, growth in other Asian nations is accelerating, and Europe is predicted to recover modestly. The recent threat of retaliation in

response to U.S. steel tariffs and trade sanctions with China illustrates the potential downside of anti-trade measures.

Terrorism also registers as a significant negative macroeconomic risk. Despite continuing threats, we believe we are making significant progress in the war against terrorism.

What to expect for the financial markets

As 2004 begins, higher cash and futures prices for many industrial commodities suggest that higher inflation lies ahead. However, measures of consumer prices still do not reflect this trend; in November, for example, the PCE deflator ex food and energy was unchanged and May was the last time it increased more than 0.1%. As demand picks up in 2004, more pricing power should accrue to businesses, but global competition, excess capacity and productivity gains should all continue to be at work. These forces will hold inflation below 2.0% for 2004.

Corporate profits may finally start to hit on all cylinders in 2004. Stronger demand and lower taxes should add to the positive of improving margins. Although a stronger economy may drive up some business costs, such as wages and raw materials, better pricing power, operating leverage and the ongoing benefits of productivity will likely give margins another healthy boost. Technology will also play an important role in rising productivity.

The unexpectedly large rise in the stock market in 2003 that was supported by positive fundamentals – a sharp increase in operating profits, low inflation and interest rates, and an accommodative monetary policy – represented a rebound from depressed levels. Returns from stocks in the 10% range appear feasible in 2004, well ahead of inflation and better than the anticipated returns from bonds. We also believe that stock market returns will be “front-end” loaded and occur in the first half of the year. Market leadership in 2004 will likely shift from the turnaround issues that posted outsized returns in 2003 to more substantial companies with solid long-term prospects. While the combination of productivity-driven profit gains and an accommodative monetary policy with a negative real Federal funds rate is ideal for an appreciating stock market, a judicious rate hike would not unhinge valuations.

If the economy achieves the healthy growth we expect this year, the Fed may begin boosting interest rates modestly – but not until the second half of the year. Further, we don’t see a serious worsening of inflation, or aggressive tightening by the Fed, coming before 2005. Increases in interest rates should be relatively modest – on the order of a 90-day T-bill rate of 1.5% versus the current rate of 0.9%. The ten-year Treasury could add about 75 basis points and rise to 5.0%. These expectations substantiate our view that returns from Treasuries will be negligible over the coming 12 months. Once again in 2004, we expect that including select corporates and high yield instruments in fixed-income portfolios will enhance returns.

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