Go Figure!

April 8, 2005

Well, at least the first quarter is over. There we were, at the end of last year rejoicing in our double-digit equity returns for the past two years and anticipating a decent start to 2005. Most signs pointed to solid months ahead – optimism prevailed. And then, the first three weeks of January saw investors take profits despite little change in the underlying fundamentals of companies. Most equity indices ended down in January followed by a February when equity and fixed-income markets rebounded and the 10-year Treasury bond yield declined to 4.38% all in the face of inflation fears driven by rising oil prices. By the end of March, oil prices had risen nearly 30% – a mini-bubble – as traders feared supply shortages even as inventories were growing. Go Figure! The disconnect between investors and solid fundamentals continues to be a challenge to navigate in the short-term, but we believe that all of the elements are in place for a continued global economic expansion and corporate profit growth that will remain in the double-digits for 2005.

The U.S. Economy

Over the past month, oil prices have set new records, commodity prices have surged and bond yields have risen significantly. Nevertheless, financial conditions still point to a pace of global expansion that exceeds the norm. On March 21st, the lead editorial in the Wall Street Journal answered the perennial question on monetary policy (Is Fed policy too accommodative?) in the affirmative. Such questioning was common during the 1970s and 1980s when inflation was lurking at every turn but in recent years, concerns about deflation or disinflation have actually been more common. We are, after all, only 21 months removed from a time when the Fed was seriously worried about deflation – indeed, a time when the 10-year Treasury bond yield dipped to a 45-year low of 3.10%.

During the first quarter, the Federal Reserve raised the target rate for short-term federal funds twice – by 0.25% on February 2nd and by 0.25% on March 22nd – bringing the rate up to 2.75%. This latter rate increase represents the seventh such increase since last June. The Fed believes that the economy is getting better and no longer needs the stimulus of low interest rates. Policymakers also want to make sure that inflation does not get out of control as the economy strengthens. Moreover, the Fed now believes that pricing power has increased allowing businesses to pass along rising costs to consumers.

Large businesses continued to focus on productivity and technology rather than on hiring. Productivity has slowed from its torrid growth pace of 4% between 2000 and 2004, but it should still average 2.5% or more this year. This average is significantly higher than the 1.5% average for the previous thirty years. While hiring is lagging at big corporations, small businesses that don't show up in the payroll survey are growing quickly and hiring. Moreover, small business bankruptcies declined steadily in 2004 and small business optimism as measured by the National Federation of Independent Business is at its highest level since 1999.

Corporations are healthier as witnessed by the fact that company balance sheets have become flush with cash (nearly $800 billion for non-financial companies at the end of 2004, compared to $350 billion at the end of 2000), while workers have seen relatively flat wages (although that doesn't reflect rising health care benefits). The aggregate picture is that people still find the labor market challenging, even as corporations are growing earnings anywhere from 8% to 20% annually.

Despite widespread concern about imbalances, the global economy appears less vulnerable to shocks than those in the media would like to portray. Unless oil prices rise significantly from current levels, the downside threat from the latest spike should gradually wane. The traditional business cycle remains relatively free of bottlenecks – as the combination of rising free trade and global productivity minimize price increases that are driven by supply shortfalls. Above all, price stability and low inflation expectations reduce the need for policy restraint and foster low bond yields that promote economic activity.

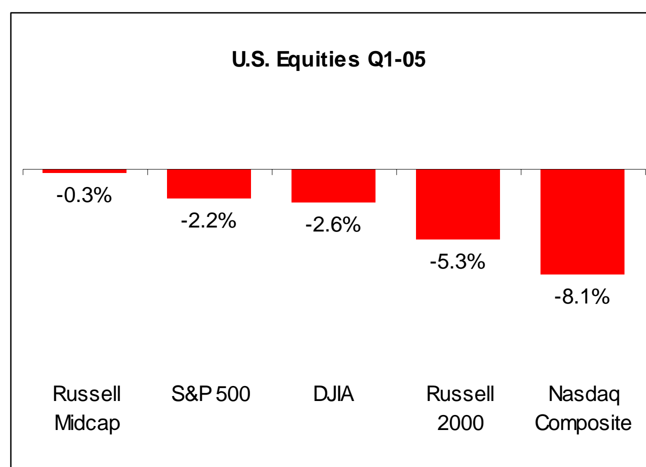
The strong rebound from the mild recession of 2001 is increasing the likelihood that U.S. economic growth will slow somewhat from the pace of 2004. Our view of the economy still looks for continued non-inflationary prosperity, with 2% inflation and slightly less than 4% growth for 2005. The Federal Reserve is likely to raise the target rate to 4% by year-end taking interest rates back to normal levels – in an historical context.

In the euro area, European Central Bank (ECB) statements point to higher rates this year demonstrating a commitment to keeping inflation under control, but the prospective rate cycle over several years is likely to prove very mild. Europe continues to be among the more affluent parts of the world and the less developed economies of Eastern Europe are growing rapidly on the back of easy fiscal policy and decreasing regulation. Unfortunately, Europe continues to be faced with an aging population and substantial costs associated with unemployment and social services resulting in slower growth.

The Japanese economy appears to be expanding at a pace that is closer to Japan's lower long-term trend. Close links with emerging Asia – especially China – have been providing key economic support along with improved profitability and strength in corporate balance sheets. The renewed expansion is likely to remain modest given continued weakness in the financial system and fiscal tightening by the government. In Japan, "quantitative easing" probably will persist beyond 2005 amid lingering deflation.

China has become the "growth" factor in the global economy. China is growing at nearly 9% per year according to official figures. Not only is China's production of goods keeping U.S. and global inflation low, but China as a consumer is reinvigorating global multinationals. The recently concluded National People's Congress (NPC) annual meeting highlighted policymakers' two major concerns in the Chinese economy – an investment rebound and surging inflation. The government is likely to adopt a combination of policies this year to manage these risks.

U.S. Financial Markets



After an outstanding gain in 2004's fourth quarter, the U.S. stock market suffered losses in the first quarter of 2005 as higher energy costs, fears of inflation and higher interest rates spooked investors. For the first quarter, the Dow Jones Industrial Average fell 2.6% while the broader Standard & Poor's 500-stock index declined 2.2%. The Nasdaq Composite index closed down 8.1% for the quarter as investors continued to punish technology companies. For the second quarter in a row, large cap stocks outperformed their smaller cap brethren as witnessed by the 5.3% decline in the Russell 2000 index compared to the 1.9% fall in the Russell 1000 index. Mid-capitalization stocks came first in the style race with the Russell Midcap index closing down a marginal 0.30%.

On the brighter side, twelve-month returns through March were still positive, although just barely for the Nasdaq Composite (0.8%). The S&P 500 index 12-month return of 6.7% was just about double that of the Dow Jones Industrial Average. Roughly half of the S&P 500 index's 12-month return has come from energy stocks, which have been far and away the leading market sector for several years. Big gains among value heavyweights such as ExxonMobil, ConocoPhillips, and ChevronTexaco help to explain why value stocks outperformed growth during the period. Over the past 12 months, the S&P 500 energy sector has returned 50% (climbing to 8% of the benchmark's market value from under 6% 12 months ago), while the rest of the S&P 500 has a return of just 3%.

During the first quarter, oil and gas products firms, including refinery firm Valero Energy, led the way. Drillers and more-diversified exploration-and-production companies also did well. Utilities, another sector sensitive to energy prices, came in a distant second with more than a 4% gain. Within that group, the formerly distressed Texas Utilities had stellar returns. Most of the remaining sectors finished out the first quarter in negative territory with the exception of materials and consumer staples that posted marginal gains. Financials stocks closed down nearly 7% as regulatory and Congressional scrutiny of Fannie Mae sparked concerns in the investment community. Although some asset managers and investment banks posted respectable gains, higher interest rates dampened returns for banks overall.

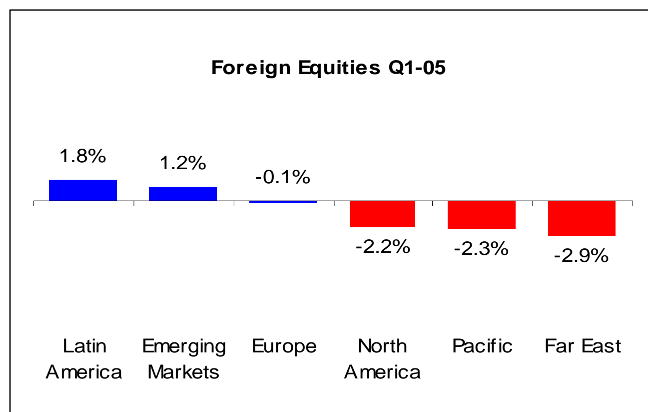
Bearishness seems to have become fashionable given the stock market's slide year-to-date amidst inflation fears and the Fed's possible reaction, not to mention disappointing earnings growth, geopolitics, and elevated energy prices. Yet last year wasn't much different. In the first half of 2004, oil prices jumped almost 30%. In addition, 10-year Treasury yields jumped from 4.2% to almost 4.9% in the five months following a January/February bond market rally. Furthermore, earnings growth was expected to slow. Now undue pessimism is on investors' shoulders despite the fact that bulging balance sheets and a massive buildup of private equity capital – some have estimated that there is as much as $1 trillion of takeover/corporate buyout firepower on the sidelines – could trigger a stock market rally at any time. Some companies are buying others (Chevron-Texaco and Unocal), while others are using the leveraged buyout approach (SunGard Data), and still others are using Dutch tenders to shrink their share count and boost the stock price (OfficeMax). Moreover, companies are continuing to lift their dividend payouts.

Investors shouldn't be too quick to write off the prospects for this year. Indeed, 2005's stock sell-off is the third such setback in three years, and each of the prior two declines saw healthy returns over the subsequent three quarters (33% for 2003 and 9% for 2004). Corporate earnings trends remain positive, and the coming increase in interest rates is not expected to be so steep as to produce a big erosion in price/earnings multiples.

The broad tone in the bond market was decidedly negative for the first quarter. Not only did short-term rates continue to rise, but long-term rates finally broke out of a 4.0%- 4.4% trading range after confounding policymakers. The yield on the 10-year Treasury fell below 4.0% on February 9th and has since risen to an eight-month high. The sell-off continues to be fueled by inflation fears as energy prices remain high, trade and budget deficit worries persist, and further dollar weakness generates concerns about the attractiveness of dollar-denominated debt to foreign investors. Beyond a one-year maturity, there was virtually no refuge for bond investors as most sectors declined enough in March to put them in the red for the entire first quarter. Mortgages offered the slightest positive performance for the quarter while the corporate sector had its worst relative performance since the stock market bottom in October 2002 – losing 62 basis points relative to Treasury bonds for the quarter (93 basis points for the month of March). The widening of spreads on corporate bonds was due in large part to worries about General Motors' proximity to junk bond classification following the company's forecast of a first-quarter loss and disappointing profit prospects for all of 2005.

Foreign Financial Markets

With interest rates relatively low worldwide and global economic growth projected at around 3.6% for 2005, foreign equity markets got off to a respectable start only to take a breather late in the quarter. In 2004, foreign equity markets benefited from a weaker U.S. dollar, but the rebound during the first three months of 2005 made it difficult to eke out gains. In the developed markets, Europe was the winner with the MSCI Europe index losing just 0.1%. The MSCI Far East index was the worst performer, down 2.9%, as stocks in Hong Kong declined 4.7%.



Emerging markets in Asia and Latin America that are benefiting from the recent boom in oil and other commodity prices did particularly well during the first three months of 2005. The MSCI Latin America index rose 1.8% while the MSCI Emerging Markets index gained 1.2%. During the first quarter, emerging market equities were up as much as 8% but experienced a turn in March. After enjoying record net inflows of cash in February – roughly $4.6 billion – mutual funds that invest in these markets had big outflows by the end of the quarter.

European markets enjoyed some of the better returns of the quarter. London's FTSE 100 index rose 1.7% as mining companies BHP Billiton and Rio Tinto rose to new 52-week highs. Frankfurt's Xetra DAX index advanced 2.2% while Paris had a 6.5% rise in the CAC-40 for the quarter. Countries recently admitted to the European Union that took steps to adopt the euro saw their local stock bourses gain handsomely. The MSCI Eastern Europe index rose 5.6% as Hungary and the Czech Republic posted gains of more than 11%.

Developed Asian stock markets were volatile during the quarter but Japanese and Singapore equities managed to finish up 1.6% and 1.8%, respectively. Electronics giant Sony Corp., one of Japan's most famous exporters, may have made the biggest splash when it named a Welsh-born American to lead the company. But for many global investors, the focus in Japan remained on companies tied to the domestic economy. One popular area was real estate, where demand for stocks reflected signs that Japan's long-slumping property market may be turning around. The government recently reported that residential prices in central Tokyo rose in 2004 for the first time in 17 years. Profits for non-financial companies also looked to be up strongly for the fiscal year that ended in March.

During the first quarter, emerging market equities experienced a global flight from riskier assets. The sell-off was primarily in emerging-market bonds but spread to stocks with high valuations and exposure to rising interest rates. South Korea, though off its highs for the quarter, was one of the better performers. The Kospi index advanced 10.6%, led by steelmakers such as Posco. Brazilian equities as measured by the MSCI Brazil index rose just 4.2% as rising Brazilian bond yields erased earlier stock-market gains.

It is unlikely that emerging markets will continue to experience the sort of widespread sell-off that plagued these markets in 1997 and 1998 following a round of currency devaluations and climaxing with Russia's debt default. The economies generally look stronger and, as commodity producers, will again benefit if the recent price slump turns around.

Conclusions

The global economic expansion remains on track despite higher oil prices and investors' obsession with potentially higher inflation. Domestically, "hard-core" inflation remains near zero. Euro-zone inflation will likely remain within the 'acceptable" levels while inflation in emerging Asia may surprise on the upside. Nevertheless, global inflation remains at 40+ year lows.

Domestic equity and fixed income markets face a period of slower profit gains and rising interest rates. For example, most analysts project S&P 500 earnings per share to rise by around 8% in 2005, down from an estimated 20% gain in 2004. Increased corporate cash and potential merger/acquisition activity may allow some companies to increase earnings per share beyond these averages.

U.S. corporate bond spreads over Treasuries have been below the norms since the early 1990s suggesting that there is little relative or absolute opportunity in the U.S. fixed income market. High margins, improved balance sheets and low defaults will tend to underpin corporate bonds, but yields are likely to rise in line with or more than Treasuries indicating that equities continue to be the investment choice for investors.

Without a doubt, there are market challenges. There always will be. Back in early 2000, it seemed easy: buy anything with the suffix dot-com. Similar concerns are now being voiced about real estate investments. Another round of corporate scandals have emerged with such blue chip names as American International Group and Warren Buffet in the headlines. And we haven't said anything about the uncertainty of renewed terrorism.

Regular readers of our quarterly reviews are familiar with our focus on opportunities rather than on risks. We look at hundreds of companies – small and large – that are adapting to the world as it is changing. An important point to make is that good companies are dynamic – they change as the environment changes. Management makes decisions based on the events taking place around them and innovates and/or alters their profile based on these changes. The best of these companies are both flexible and adaptable as they consistently find ways to reinvent themselves in order to grow. It is our responsibility to evaluate these companies to determine the best opportunities for growth. Utilizing our thematic framework for investing, we have been able to provide our clients with market-beating returns in the past. While the past is no guarantee of the future, we remain committed to staying on top of the pack.

Quote for Thought: "It is a mistake to try to look too far ahead. The chain of destiny can only be grasped one link at a time". *Sir Winston Churchill*

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