



It's a Small, Small World

January 6, 2005

Late in December, while thinking about the theme for this review, the title Calm Waters seemed appropriate as the financial markets moved at a slower holiday pace. During the fourth quarter, the Dow Jones Industrial average and the NASDAQ Composite joined the S&P 500 index in rising above their 2004 consolidations, the dollar stabilized within a structural downtrend, gold paused within its bull trend and oil steadied after a two-year advance suggesting that 2004 was coming to a close with calm waters across the financial sea. Then on December 26th the strongest earthquake in forty years shook the waters off the coast of the Indonesian island of Sumatra. The quake and resulting tsunamis killed tens of thousands almost instantly in Indonesia and then swept across the Indian Ocean to eleven other countries within hours. Subsequent international relief efforts made me realize what a small world we live in. For instance, the information technology revolution of the 1990s ushered in broadband...a sort of "road" linking economies and markets around the world. As a result, innovation and the availability of information provided by global companies narrowed the gap between developed and developing economies. Investing in these companies made investors wealthy. Additionally, "Cowboy Capitalism" has been embraced by more countries across the globe transforming our global economy. In Walt Disney's words "It's a Small, Small World."

U.S. Economy

For a good part of 2004, optimists were on the wrong side of consensus and intellectual weight was thrown behind the risk of renewed contraction in the U.S. economy. Even as the Fed began raising interest rates to stem strong economic growth, it was becoming increasingly common to hear a recurring concern of robust business activity and the implied return of inflation. Starting in June, the central bank's Federal Open Market Committee increased the Fed funds rate five times last year, to 2.25% from 1%, bringing short-term rates to their highest levels in more than three years marking 2004 as the year with the most rate increases since 1994.

Despite a higher interest rate policy and continually negative media reports, President Bush's capitalist measures -- more tax incentives for work, saving, investment and risk-taking -- primed the pump for American prosperity. (Europeans derisively call these measures cowboy capitalism. The President thinks of it as free-market efficiency). In the six quarters after Bush's tax cuts, real GDP expanded at a 4.6% annual rate, much faster than the 2.5% pace of the six earlier recovery quarters. Consumer spending jumped from 2.8% to 3.9%. Business investment in new plant and equipment surged to 13.4% from only 1% before the tax cuts. Personal income jumped to a 5% growth rate, nearly double the earlier level of 2.6%. Corporate profits now stand at a record \$1.118 trillion—56% above their recession trough, 25% above the prior recovery peak of the late '90s, and at a near-record 9.5% of GDP! Broad stock market averages have jumped 60% from their lows. Home ownership is at an all-time high. U.S. household wealth stands at a record \$51 trillion.

Amidst all of this economic good news, pessimists shifted to the twin budget and trade deficits and the declining value of the dollar in the fourth quarter. A look at the budget deficits and current account positions of some major developed trade partners of the U.S. should set the record straight. There are many different routes to budget and trade deficits. A strong U.S. economy experienced in the late '90s produced four years of budget surpluses, yet the current account position deteriorated very sharply as the dollar strengthened and U.S. growth exceeded growth abroad for most of that period.

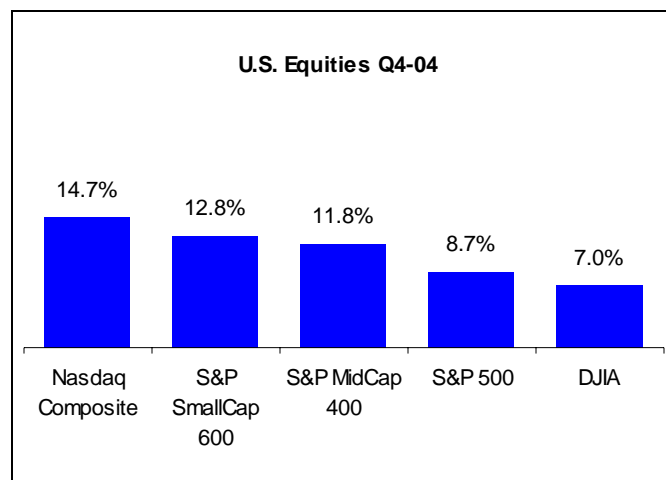
On the other hand, the budget deficits experienced in both Japan and the Euro area are widely understood to be harbingers of future liabilities and economic malaise. These budget deficits are a necessary element in triggering economic growth when a country falls into recession. Growth is the only way to escape the burdens associated with recessions. Government spending in excess of revenues is a critical factor in making sure a country is moving toward full capacity utilization and full employment. In the U.S., revenue gains are likely to continue to shrink the U.S. budget deficit as a percentage of GDP, yet unlikely to succeed in drastically improving the U.S. trade deficit unless a sharp economic underperformance versus our trading partners could be engineered. Given America's prosperity, inducing economic misery by attempting to balance the current account doesn't make sense.

Consensus global observers seem to think that the U.S. dollar is headed even lower. There are varying notions forming the basis for this belief: America's low savings rate, a dependence on cheap imports, a large budget deficit. With Japan's debt-to-GDP ratio at more than two times that of the U.S., these theories would imply a weaker yen, yet the yen is strong. Furthermore, while we have seen financial accounting problems at home with a few companies such as WorldCom and Enron, an entire country (Greece) has been reported falsifying its numbers to gain entry into the European Union. And the euro is still being revered by some currency speculators!! With Europe running tight monetary and fiscal policies to control inflation, the result is fewer euros and higher unemployment and slower growth. On the other hand, U.S. policy to grow the economy is producing more dollars, lower unemployment and an economic expansion. What option makes more sense?

Only time will tell if the concerns about budget deficits and trade imbalances have pushed the dollar down too far in the short run. The decline in the value of the dollar has been underway for three years, but has only recently been making the headlines. In fact, the decline in the dollar has placed U.S. companies on a more level playing field with foreign firms, giving U.S. firms more pricing power. Consequently, after-tax corporate economic profits as a percent of GDP were at the highest level since 1966. The key is to understand that sentiment can get extreme when the markets have been trending in one direction for an extended period.

U.S. Financial Markets

The bull market in stocks resumed during the fourth quarter and most market averages managed to hit three-year highs in the final week of 2004. What a fabulous quarter and year in Small Cap Land! Both growth and value small cap indices gained. The super-charged quarter boosted 2004 returns into the double-digit stratosphere – marking the sixth consecutive year that small beat their large cap brethren. A fortunate confluence of events began with an election result that removed the miasma of political uncertainty from the scene and finished with falling oil prices and a stronger than expected jobs report that helped extend the rally. In the stock market's version of the 80/20 rule, nearly 85% of the return for larger stocks came in the final quarter of the year (70% since October). Moreover, nearly all industry sectors advanced, reflecting good showings from the materials, energy and industrial sectors that represent a relatively large share of the value arena. Consequently value names outperformed their growth counterparts as these stocks retook leadership in the market on the back of resilience in the economic recovery. The technology-laden Nasdaq Composite



index that led the market in 2003 with a 50% gain cooled a bit as stocks like Intel Corp. declined. The winner for the fourth quarter at nearly 15%, the Nasdaq only rose 9% for 2004.

To some extent, the fact that stocks traded lower than late 2003 levels during much of last year, even as operating profits for broad indices rose roughly 20%, and nearly as much the year before, may have done much to discount the combination of slower expected profit growth and higher interest rates looking forward. Throughout this business cycle, aggregate corporate performance has been outstanding. In fact, this has been the strongest profit cycle since the 1950s. Third quarter earnings growth of nearly 17% confirmed these trends and the fourth quarter-quarter looks set to attain nearly 15% growth. The energy sector has seen the highest upward estimate revisions according to Thomson Financial. The strongest sectors for earnings growth for the year have been materials (84%), energy (46%) and technology (40%). These numbers are better than expected and demonstrate a continuation of strong corporate profitability, free cash flow and performance. Conversely the weakest sectors for the year have been telecommunications (-8%) and utilities (1%).

Initial public offerings and merger and acquisition activity surged during the fourth quarter and for most of the year. IPO issuance had its best showing since 2000 with proceeds already more than tripling to \$44 billion. The number of issues brought to market more than doubled in the year as over 230 companies priced IPOs in the U.S. This resurgence was the result of several factors, most notably the improved quality of companies. Additionally, a liberalized tax policy made equities more attractive to investors as Small Cap Land beckoned.

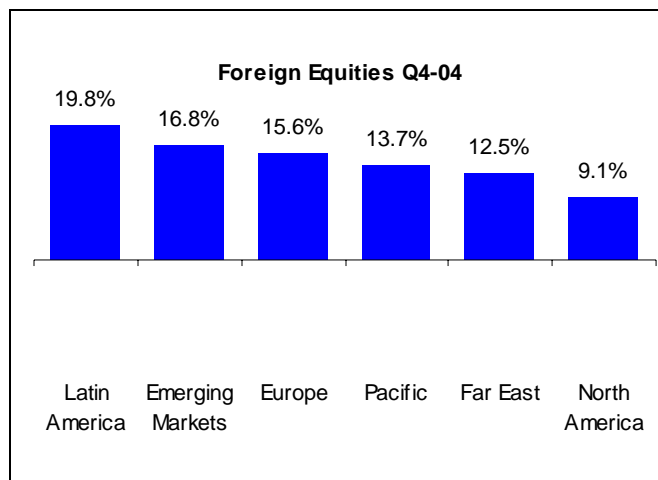
Beginning with the \$58 billion acquisition of Bank One by JP Morgan and the \$43 billion purchase of AT&T Wireless by Cingular Wireless and more recently the anticipated purchase of Guidant by Johnson & Johnson for \$24 billion and Sprint's possible bid for Nextel for up to \$35 billion, the merger landscape was covered with movement. Deals upwards of \$700 billion were announced during 2004 as corporate profits and hefty company cash balances and accessible capital markets attracted cowboy capitalists.

Fixed income markets during the fourth quarter and for most of last year, demonstrated anomalous behavior. The inverse relationship between oil prices and interest rates surprised investors who assumed that higher energy prices would automatically translate to higher bond yields. A negative correlation was firmly established: price spikes were typically accompanied by declining bond yields. For instance, when oil prices peaked at more than \$55 per barrel in October, ten-year Treasury yields declined from nearly 4.25% to less than 4.00%. Why was this happening? There are two schools of thought. One is that stable interest rates are portending slower economic growth. The argument states that higher energy prices typically equate to a "tax" on consumption that in turn slows economic growth. Given that the economy is on a path of sustainable growth, another interpretation is more persuasive. Inflation remains tame, corporate cash flows are strong, the issuance levels of corporate and government debt are improving, and the U.S. account deficit is better than expected.

Overall fixed income returns were surprisingly strong last year. The U.S. investment grade bond market returned more than 4% in 2004, a surprisingly good result considering the Fed's program of "measured" increases in interest rates. In theory, that's the way the bond market ought to work: the Fed takes away the punch bowl, inflation pressures ease, and bond investors bring long-term interest rates lower. In actuality, bond investors often overreact to Fed rate increases. In the extreme case, in 1994, the Fed raised rates aggressively but bond yields rose sharply, punishing bondholders. Unlike the case in 1994, when the core rate of inflation in the PCE deflator rose 150 basis points during the first three quarters, inflation stayed quiescent in 2004 – not bad considering the pressures coming from oil, commodities and food. In fact, from the current cycle's peak rate of 2.1% in the first quarter of 2004, the core rate of inflation backed down to less than 1% in Q3. Mortgage securities and high-grade corporates returned more than 5% last year, while high yield and emerging market sectors rewarded investors with gains of more than 12%.

Foreign Financial Markets

Led by shares of companies in Mexico, Latin America was the strongest regional performer during the fourth quarter bringing 2004 returns to nearly 40%. Record oil prices boosted the economies of oil-exporting nations. The voracious raw materials demand of Chinese industry bid up prices for metals, soy and other commodities, helping drive up South American stock markets such as Argentina (26%), Brazil (20%) and Venezuela (31%). Emerging Markets came in second for the quarter with a full year gain of 23%. Among the emerging markets, Eastern Europe was the star performer as ten of their countries joined the European Union. Hungary's BUX index jumped 55% as the price of shares in the country's largest bank, OTP, more than doubled. In the Czech Republic, the PX-50 index climbed 57%. Poland's WIG index rose 28%. A €1.8 billion sale of shares in PKO Bank Polski SA in November was the region's biggest initial public offering of the year. Other emerging market performers included India, Indonesia, Turkey and South Africa, all posting returns of better than 20% during the fourth quarter.



In 2004, European stock markets rose nearly 20% for a second straight year, driven by a rally in small- and mid-capitalization stocks. With oil prices setting records, energy stocks also boosted many indexes. During the fourth quarter, developed European equity markets enjoyed a rebound. Austria's ATX index surged 57%, making it the year's best-performing market in Western Europe. Telekom Austria, one of the largest stocks in the index, rose 42% as its net profit increased rapidly. The company also was the target of a failed takeover bid by Swisscom. Shares in oil-and-gas group OMV, another major ATX stock, surged 88%. The company spent €1.5 billion (about \$2 billion) to buy Romanian oil firm Petrom. Italy and Spain enjoyed gains of more than 20% during the quarter, while Germany, France and the United Kingdom had gains of 19%, 15%, and 12%, respectively.

Asian stock markets ended 2004 on a strong note, boosted by foreign-capital inflows, healthy economic growth, peaceful elections and the prospect of a soft landing for China's economy. Among Asian-Pacific developed countries, Australia, Singapore and Hong Kong bourses enjoyed the biggest gains, posting returns of 23%, 17% and 13%, respectively. Japan's market ended higher by nearly 15% even as its economy continued to teeter on the brink of a downturn. But in an otherwise buoyant region, stocks of Chinese companies listed in Hong Kong and on mainland exchanges fell, albeit less than 1%, as did those in one of 2003's best performers, Thailand (-4%).

Given high oil prices, Hong Kong's export of goods were somewhat dampened during the quarter that contributed to equity losses. Meanwhile, China's central bank announced a policy change that could allow for the partial transfer of financial assets out of China. These changes are significant for protecting individual property rights and promoting the progress of full convertibility of the renminbi, but investors were spooked by fears of capital outflows. In Thailand, growth forecasts were revised downward on the back of rising oil prices and weaker global demand. Moreover, the environment in Thailand remains challenging as rising militarism in the southern part of the country and outcries at the government's heavy-handed response have made Prime Minister Shinawatra's bid for re-election in 2005 questionable. His efforts since the tsunami have provided a more positive backdrop to the upcoming election.

The year 2004 also witnessed a dramatic increase in trade potential as many countries lowered tariff barriers and signed free trade agreements. Outsourcing, tarnished by the misplaced fears of lost jobs, is creating both rising productivity and new, less expensive services to consumers. Workers in India, the Philippines and Indonesia—with their fluency in English—are getting to know U.S. consumers via service calls from the U.S. routed to subsidiaries of companies in these countries. The tsunami catastrophe is also demonstrating the ability of the world to pull together during these difficult times. For investors, the surge in profits and rising corporate wealth makes smaller companies new targets for takeovers in 2005 and beyond. As the “world” grows smaller, opportunities for investors grow larger.

It's a Small World After All

It's a world of laughter
A world of tears
It's a world of hopes
And a world of fears
There's so much that we share
That it's time we're aware
It's a small world after all

There is just one moon
And one golden sun
And a smile means
Friendship to ev'ryone
Though the mountains divide
And the oceans are wide
It's a small world after all

It's a small world after all
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It's a small world after all
It's a small, small world.

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