



Economic & Market Review and Outlook

October 1, 2004

The stock market appears to have been stuck in the doldrums, so to speak. The real doldrums, as you might know, refer to the calm—sometimes non-existent—prevailing winds that affect areas immediately around the equator. While that environment might sound idyllic to land-locked northerners, those interested in doing things like trimming the sails aren't excited about the doldrums: sailors struggle to, well, sail when the wind doesn't blow. Bordering the doldrums on both the north and the south are the stronger trade winds, so named because of the favorable travel environment they provided for merchant mariners long ago.

Looking back over the third quarter, we see that the S&P 500 declined very slightly—not creating real discomfort, just an annoying lack of progress. This performance is right in line with the typical 3rd quarter performance in recent history. The good news from history is that equity returns in the coming four months have tended to offer trade wind-like opportunities for growth. In other words, we may not need much of a catalyst; we might do well by just maintaining discipline and hanging in there until the recovering economy and clarity on certain key uncertainties—notably the election and progress in Iraq—allow us to move into this more favorable environment.

The Economy

- GDP growth for the second quarter was revised upward to an annual rate of 3.3% which, while down slightly from the 4.5% rate during the first quarter, still represents a healthy expansionary pace.
- Unemployment has broken its plateau at 5.6% and appears to be headed lower still. It currently stands at 5.4%.
- The GDP price deflator (a measure of inflation closely watched by Fed Chairman Alan Greenspan) continues to exhibit a very benign inflationary trend. The Fed's response has been to raise short-term interest rates at a “measured” pace.

- Consumer confidence remains strong, having moderated just slightly during a seasonally difficult period for retailers.

Outlook: Global GDP appears to be on its way to a roughly 5% growth rate during 2005. Areas with particularly good prospects for growth include Asia (excluding Japan), sub-Saharan Africa, and Latin America—geographic regions where large U.S. companies have significant operations. European and Japanese expansions may well be tepid or flat, while the leading U.S. economic indicators are pointing toward expansion in the neighborhood of 3.5% here at home.

Global security issues continue to be the biggest drag on expansion. Iraq, of course, remains an obvious concern particularly for the affect that the conflict has on crude oil prices; the industrial, transportation, and basic materials sectors may well have the most at risk in this environment. Russia's own issues with Chechnya and the related school massacre in Beslan have given birth to an unhealthy consolidation of power in Moscow—not particularly helpful for capitalist development in the world's largest emerging market economy.

On the other hand, the world-wide free trade movement continues to lower barriers, allowing countries to exploit their comparative advantages. Technological advances have produced dramatic productivity increases for western workers over the last decade, and should likewise benefit global economies when security issues subside.

Stock Market

- The stock market gave up ground during the third quarter. The S&P 500 index is up 1.5% year-to-date, leading both the NASDAQ (-5.0%) and the Dow Jones Industrial Average (-2.1%).
- Not surprisingly, with oil prices as high as they've been, the energy sector is the top performing group year-to-date. Utility stocks have also done well.



- The health care and technology sectors have been the weakest, as government regulatory and cyclical pressures, respectively, have depressed stock prices.

Outlook: “The sun don’t shine on the same dog’s [back] every day, but, mister, you ain’t seen a ray of light since you got here” (Opal Fleener to Coach Norman Dale in the movie *Hoosiers*). Ms. Fleener’s delicate observation might well be true of pharmaceutical stocks today. It seems that despite generally increasing profits and valuations below those in the broader market, drug companies cannot gain traction. Some of the pressure is no doubt attributable to suspicions that a Kerry presidency might yield greater health care regulation—whether that fear is justifiable is another matter.

More significant is the unsettled nature of the national debate about the re-importation of drugs from Canada and other countries. Is it fair for U.S. consumers to bear a higher cost for drugs than their neighbors to the north? Aren’t pharmaceutical companies entitled to make a profit which, in part, gets rolled back into the research and development of new drugs? Are the drugs I might buy from a Canadian pharmacy subject to the same scrutiny and safety checks as those in American stores? The implications from answers to these questions are enormous, and they create a perfect fermenting environment for that old foe of equity price appreciation: uncertainty.

Historically the fear of the unknown has been more harmful to equity prices than bad news that is known. Free markets tend to work out these types of conundrums over time. In the meanwhile, sticking to a disciplined strategy of identifying good values within a broadly diversified portfolio has no second.

Bond Market

- The Fed funds rate now stands at 1.75%, after three successive 25 basis point hikes.
- Contrary to consensus (and our) expectations, the third quarter saw fixed income yields generally decline, as investors bought bonds in response to, according to Mr. Greenspan, a “soft patch” in the economic recovery, exacerbated by foreign central bank purchases resulting from currency intervention strategies.
- Accordingly, holders of long-dated bonds have enjoyed the highest returns.
- Truer to our view, the yield curve has flattened year-to-date, with short-term interest rates rising and long-term rates holding steady.

Outlook: Our position during this low interest rate environment has been that since we feel the next major move in rates will be up, we prefer to keep portfolio weighted average durations under 5 years. As we’ve noted before, when interest rates do rise, we’ll then have the opportunity to re-invest proceeds at more attractive levels. Interest rates have not yet embarked on a sustained rising trend, and when they have periodically declined, superior returns could have been had by owning longer bonds.

However, there are some benefits to owning bonds that accrue to investors regardless of duration. For instance, returns to portfolios with long or short-term bonds tend to be less volatile than those of all-stock portfolios. As well, long bonds offer no advantage over short bonds when it comes to the reliability of a portfolio’s income stream—that’s a matter of credit quality, not duration. In our opinion, at current yield levels, the short-term appreciation benefit to holders of long bonds has been and continues to be insufficient to outweigh the risk of price depreciation as rates move higher.

DJIA 10,080.70 S&P 500 1,114.58 10 Yr. US Treasury 4.14%