Commentary - 2nd Quarter 2004

"Exciting" is not an appropriate word to describe the stock market in the first half of 2004. The stock market continues to digest last year's impressive gains while the bond market adjusts to the reality of a growing economy and interest rates heading higher. The S&P 500 gained 1.75% in the quarter for a year-to-date gain of 3.58%. The bond market experienced one of its worst quarters since the 1980's after successive strong employment reports triggered worries that the Federal Reserve would have to be more aggressive in their move to boost interest rates. Considering the rise in interest rates from early April to late June of over 1.0%, the stock market held up relatively well. Let's look at the conflicting forces that are keeping the stock market in a narrow trading range.

Corporate earnings are coming in strong this year. With the economy growing at approximately 4.0%, corporations are finally enjoying top-line revenue growth. Because they instituted numerous expense reductions during the economic slowdown, their earnings have expanded more rapidly than revenues in most cases. Unfortunately, the earnings increases we are seeing now were discounted into stock prices with the price gains we saw last year. Today investors are trying to figure out if the earnings gains can continue, albeit at a slower rate. Corporations are experiencing higher costs for energy, health care, and many commodities. It is difficult to pass these cost increases through to consumers, but we think companies will have some ability to raise prices over the next few years as monetary policy remains accommodative and the dollar continues to weaken. Disregarding an unforeseen event, we expect the economy will continue to grow strongly over the remainder of 2004 and into 2005. Corporate earnings may not grow as fast as they have over the last year, but they should increase nicely. We think positive earnings growth will eventually overcome investor angst about rising interest rates, Iraq, election season, energy prices, growth in China, the government's fiscal deficit, a weak dollar, inflation, corporate governance issues, the trade deficit, global warming, and any other excuse journalists can find. In other words, we think the stock market is taking a breather before starting up again.

The economy may have taken a breather in June also. The employment report for June was

weaker than expected. Wal-Mart and Target, among other retailers, reported slower than expected sales in June. GM and Ford saw slower sales in June. This perceived slowdown has taken some of the pressure off of the Fed to aggressively raise interest rates. Two year Treasuries have fallen from a high yield of 2.90% in late June to around 2.60%. After last week's Fed meeting that resulted in an increase of twenty-five basis points in the Fed funds rate, the Fed's "measured" approach to raising interest rates was reinforced. Market interest rates, as determined by the bond market, have increased much more rapidly than the Fed's "measured" pace. This leads us to believe that the Fed is deliberately falling behind. After last year's worries about deflation and the experience that Japan has endured with falling prices over the last decade, the Fed may be taking the approach that faster growth and higher inflation are desirable. Another factor that favors that argument is our debt situation. Between the fiscal deficit and our low savings rate, the U.S. has become the world's largest debtor nation. We depend on foreign investment to sustain our high rate of consumption. Many foreign countries intentionally keep their currencies artificially weak against the dollar in order to promote exports to the U.S. This managed trade policy results in their central banks accumulating huge dollar reserves. The only place they can invest these massive dollar reserves is in U.S. government bonds. Essentially, they are loaning us money to continue purchasing their manufactured goods. What better way to repay them than with depreciated dollars. We think the only choice the Fed has is to run an accommodative monetary policy, keeping interest rates lower than they normally would be and allowing the dollar to fall in value versus most foreign currencies as inflation increases. In the short term, an easy money policy should result in a strong economy and a higher stock market. Eventually it will lead to unacceptable inflation and sharply higher interest rates. Everything goes in cycles. We have seen long term interest rates fall from almost 16% in the early 1980's to slightly over 3% last year. Inflation fell from double digit rates in the 1980's to concerns about deflation last year. The bond market outperformed the stock market for the last five years. Now it is time for the cycle to turn in the other direction with higher inflation, higher interest rates, and better stock performance.