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Market Commentary

Second Quarter 2004: Gaining Traction

The second quarter of 2004 was a lesson of the "be careful what you wish for" variety. For months, the most important question on investors' minds concerned the sustainability of the economic recovery. Then the economy became so strong that it raised the specter of inflation and rising interest rates. The tension between economic growth and the prospect of higher rates has held the stock market in a trading range, but we see reason to be confident that earnings growth will eventually take the upper hand, driving stocks up from current levels.

Over the past year or more, the sustainability of the economic recovery has been a nagging question. While companies were strengthening their balance sheets and enjoying heightened productivity, investors feared that once the effects of fiscal and monetary stimulus had faded, the economy and the markets would sag like a beanbag chair.

The economy's strength became undeniable in the second quarter of this year. All told, nearly one million jobs were created in March, April and May—the largest such increase since 2000.[1] Although preliminary June numbers were weak, the overall trend is an encouraging one. Coupled with earnings momentum in the corporate sector, it seems to point to a virtuous cycle of production and demand that can extend the economic cycle.

Unfortunately, the employment gains did not happen in a vacuum. Higher prices for oil and other commodities, increases in wage costs, the weakened dollar, and other factors point to increasing inflationary pressures. Cognizant of these pressures, on June 30, the Federal Reserve Board raised its overnight interest-rate target by 25 basis points, its first tightening measure in more than four years.

[1] Source: U.S. Department of Labor
[2] Source: ISI Group
[3] Source: Baseline, First Call

As we enter what is probably the beginning of a new tightening cycle, after a long period of extraordinarily stimulative monetary policy, the question of the day is, how much higher will rates go? In his June 15 testimony before the Senate Banking Committee, Fed Chairman Alan Greenspan seemed relatively sanguine that the economy would enjoy job growth and relatively modest inflation pressures. As a result, he said, the Fed could take "measured" steps to combat inflation—avoiding the sharp increases that would provide a shock to stock and bond investors alike.

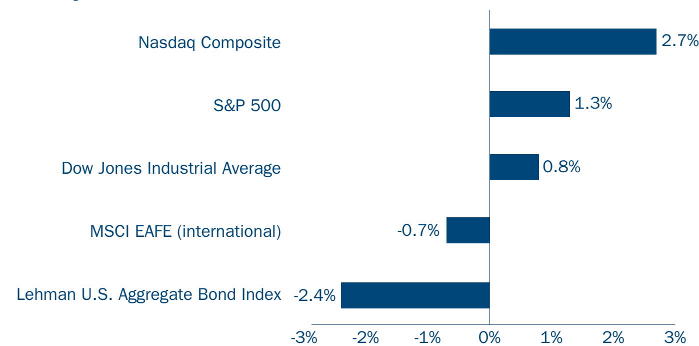
While we think that the markets will continue to experience ongoing tension between the positive effects of economic growth and the negative effects of rising interest rates, we see a number of factors that make us optimistic:

- The economy is expanding at a steady pace. Gross Domestic Product (over inflation) could surge by more than 4% in 2004, compared with 3.1% last year.[2]
- Corporate earnings have been impressive. Reported earnings in the first quarter were up some 26%—roughly twice the anticipated 10% to 15%, while second quarter earnings gains are expected to be strong as well.[3]
- The trends underlying earnings growth are formidable. Manufacturing activity is healthy; capital expenditures have increased (in part to capture a special depreciation bonus that will expire at the end of the year); and

Stocks In Suspension

FIGURE 1

Second Quarter 2004: Performance of Major Market Indices



Returns reflect price changes only, except for the bond index, which is total return. See page 4 for index descriptions.

Source: Nasdaq, Dow Jones, Standard & Poor's, Lehman Brothers

corporations are beginning to enjoy some pricing power—the positive flip side of an increase in inflation.

- Jobs are being created, and the consumer is strong. The pace of hiring has been impressive, with some 235,000 positions filled in May alone.[4] Meanwhile, personal income is rising and interest rates remain exceptionally low, albeit somewhat higher than before.
- Although the cost of energy will continue to be an issue, oil prices have already declined, and should reach equilibrium at more moderate levels. One factor to consider is that buyers (governments, corporations and individuals) have been building up their own "strategic oil reserves," to avoid paying higher prices in the future. Eventually, their hoarding goals will be reached, which will moderate demand.
- The "deflationary mindset" is fading away. A whole generation of consumers and corporate executives have gotten used to delaying purchases to save money, since goods—especially in the technology sector—seemed to get cheaper and cheaper. With prices rising, managers may begin to build larger inventories (now extremely low relative to sales), to generate better profits on those inventories when prices rise.
- The stock market is reasonably priced. As of June 18, the Standard & Poor's 500 traded at 15.5 times consensus earnings estimates for 2005.[5] Many current Wall Street analysts have not seen the power of earnings "leverage" that companies can experience in the midst of an economic expansion. In short, valuations may be lower than they actually appear.

Clearly, we continue to face real challenges. Inflationary pressures, the threat of terrorism, the price of oil (and energy in general), the budget deficit, and the uncertainty posed by the upcoming presidential election, will continue to weigh on the market. But the underlying strength of corporate America and its robust recovery suggest that stocks are likely to transcend these difficulties.

The Markets in Review

Directionless Quarter for U.S. Stocks

U.S. Stock indices stayed in neutral for much of the quarter, encouraged by strong earnings, but buffeted by inflation jitters, the Iraq situation and other concerns. No style or capitalization range stood out particularly from the others. The large-cap Standard & Poor's 500 Index finished with a 1.3% gain. The technology heavy Nasdaq generated 2.7% return, while the Dow Jones Industrial Average and the small-cap Russell 2000 rose 0.8% and 0.2%, respectively. Looking forward, it seems reasonable for many investors to have some exposure to energy, given the exceptional demand, and long-term limitations on production. At the same time, if the economy continues to surprise on the upside, it may also be prudent to

[4] Source: U.S. Department of Labor

[5] Harmonic weighted average of First Call p/e estimates for each of the companies in the S&P 500 Index. Source: Baseline, Neuberger Berman

skirt defensive stocks, focusing more on companies that stand to benefit from a robust expansion.

Rough Ride for Real Estate

Real Estate Investment Trusts suffered from interest rate fears in the second quarter, as the NAREIT Equity REIT index declined roughly 19% over a five-week span, before rebounding in late May to finish up modestly for the year to date. A strong jobs report on April 2 triggered the declines, as speculative investors appeared to exit the sector based on a fear that rising interest rates would harm REIT performance. The decline was compounded by the relatively high valuations that REITs had achieved after several quarters of standout performance.

In fact, long-term REIT performance tends to be driven by earnings growth, not interest rates. At the moment, commercial real estate is at the beginning of a cyclical recovery, which should be bolstered by a slowdown in supply growth. In a market characterized by steady GDP growth and rising long-term interest rates, we think that commercial real estate with shorter lease terms — such as hotels and apartments — stand to benefit the most. While unsettling, the quick sell-off has brought valuations back to their long-term averages, and increased dividend yields to more favorable levels.

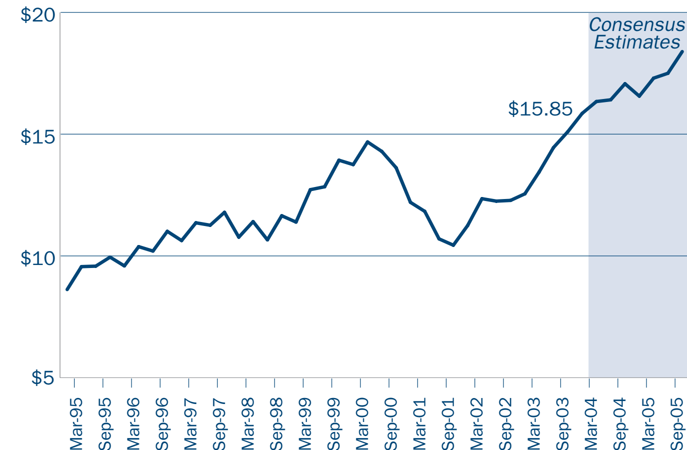
Stasis for International Stocks

International stocks treaded water during the quarter, much like their American counterparts. The MSCI EAFE index posted barely positive returns in local currency, but suffered a slight decline in dollars, reflecting modest appreciation in the greenback. Two major factors weighed on overseas markets: the high price of oil, and the engineered slowdown of the Chinese economy. The efforts of the Chinese government to put the brakes on excessive growth seem to be meeting with some success. However, this may impede the valuation of companies with heavy exposure to the country. Moreover, Japan will likely be affected, since its nascent recovery has been largely driven by exports to neighboring China. The potential for rising rates is also a concern abroad, although less in Europe than in the U.S., since the European Central Bank was more restrained in providing monetary stimulus earlier in the economic cycle.

FIGURE 2

Companies Are Enjoying Strong Earnings...

S&P 500 Quarterly Earnings Per Share (1995 – 2005)

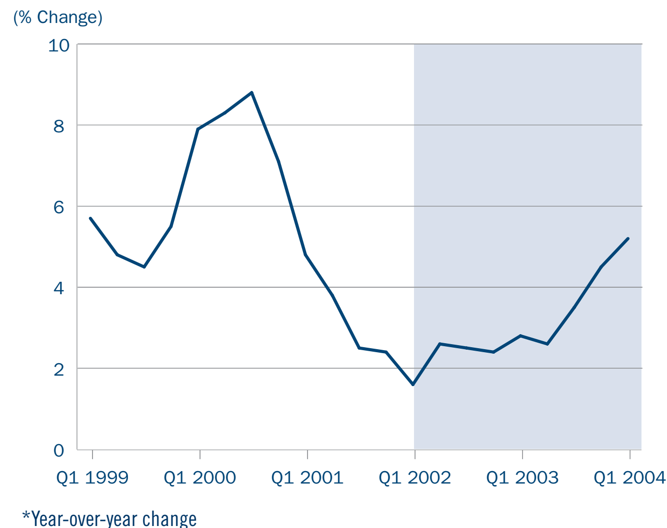


Source: Baseline. Consensus Estimates: First Call

A number of markets seem to have strong prospects, including Greece, which should benefit from this summer's Olympic Games; Spain, where consumption and real estate investment continue apace; Ireland, which is growing at a healthy clip; and Canada, whose energy companies stand to benefit from favorable supply/demand fundamentals.

Bonds Face Prospect of Rising Rates

The bond markets declined in the second quarter, as concern over inflation and the potential for rate hikes by the Federal Reserve, coupled with growing issuance by the Federal government, helped lower prices and increase rates. The past four years have proved profitable for many bond



Source: ISI Group, Bureau of Economic Analysis

investors, who enjoyed a substantial reduction in interest rates, as the Fed sought to infuse the economy with liquidity in the face of numerous financial and geopolitical concerns. In recent months, however, it appears that the economy is coming along nicely, while pressures of inflation—including high energy costs, rising labor expenditures, and a falling dollar—have been growing. This has prompted investors who previously borrowed at low short rates to invest in higher yielding assets to unwind their positions, intensifying the bond sell-off. Even after Chairman Greenspan's reassuring comments to the Senate in mid-June, it seems apparent that rates are about to enter a tightening cycle, albeit at a "measured" pace. In fact, many observers believe that Greenspan has waited too long to raise rates, such that the bond market may move without him to catch up with inflation.

As a result, a cautious approach is in order. The small spread between quality bonds and weaker credits provides little incentive to take on additional risk for the sake of higher yield. Meanwhile, Treasury Inflation Protected Securities (TIPS) have become so popular that they offer little value. Limiting duration (exposure to interest rates), concentrating on quality bonds, and emphasizing high-coupon issues (which provide more money for reinvestment should rates rise), are all sound strategies in the current environment.

High-Yield Bonds

The high-yield market suffered losses along with the rest of the bond market during the quarter. Investment outflows, coming at a time when the market was struggling to absorb an influx of new high-yield issues, contributed to the declines. Some sectors, such as airlines, were affected by high fuel costs, while others, including homebuilders, fell victim to fears of higher interest rates. Although the current environment is difficult, it bears mentioning that high-yield bonds have historically reacted favorably to improving economic conditions that tend to accompany rising interest rates, because defaults decline and the potential for upgrades increases. As with other bonds, keeping durations short helps minimize the impact of a rising rate environment, while staying diversified limits the risks associated with individual sectors and issues.

Municipal Bonds

For municipal bonds, the improving economy creates a paradox of sorts. State and local governments are finally generating more stable tax revenues, but at the same time, their bonds are facing the same pricing pressures as other fixed income instruments, anticipating potential rate increases to come. With the enormous focus on the Federal Reserve, the mostly retail investors in municipal bonds are showing relatively little interest in adding to their portfolios even after recent declines. Municipals are attractive from a valuation standpoint, with 10-year issues providing roughly 87% of Treasuries' pre-tax yield.[6] Muni bonds still provide a significant yield

[6] 10-year AAA municipal general obligation bonds versus 10-year U.S. Treasuries, as of June 18, 2004.

advantage over money market accounts. At the same time, safety seems a crucial goal at the moment. Aside from limiting duration and focusing on strong credits, managers can avoid volatile sectors such as hospitals, while emphasizing high coupons and looking for conservative issues such as pre-refunded bonds.

Keeping an Eye on the Forest

At a time when investors' attention seems to bounce from worry to worry—the Fed, Iraq, oil, employment, inflation, and back to the Fed—it makes sense to take the long view. After all, the best investment opportunities arise not when everything looks good, but when the majority of investors are fixated on fleeting concerns that will lose importance with time.

Without question, the risks in the market today are real. But investing is a probabilistic exercise, one in which risks should be weighed in relation to the potential rewards they provide. As money managers, we run the numbers every day, looking for the best risk/reward tradeoffs we can find for our clients. Leaving the short-term myopia to other investors, we rely on fundamental research and the perspective gained by years of experience to guide our decisions.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance.

The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials, including stocks that trade on the New York Stock Exchange.

The Nasdaq Composite Index is a broad-based capitalization-weighted index of all Nasdaq National Market & Small Cap stocks. The index was developed with a base level of 100 as of February 5, 1971.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000® Index. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

The NAREIT (National Association of Real Estate Investment Trusts) Equity REIT Index is a capitalization-weighted index based upon the last closing price of the month for all tax-qualified REITs listed on the NYSE, Amex and Nasdaq. Only common shares issued by each REIT are included in the index.

The Lehman Brothers U.S. Aggregate Index represents securities that are U.S. domestic, taxable, and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Lehman Brothers U.S. Corporate High Yield Index covers the universe of fixed-rate, non-investment-grade debt. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, and 144-As are also included.

Please note that indices do not take into account any fees and expenses of the individual securities that they track, and individuals cannot invest directly in any index.

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