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# First Quarter 2004: Two Steps Forward, One Step Back

*The first quarter of 2004 provided a classic example of the stock market's volatile nature. Following an extraordinary year, equities continued their surge early in the quarter as the economic recovery appeared to gain strength. But in March the market suddenly reversed direction on fears about employment weakness and a potential resurgence in worldwide terrorism. Although fundamentals supporting the equity market remain solid, it appears that stock selection will assume greater importance after the widespread early gains of this bull market.*

Last year, stock investors had to make one crucial decision: *Are you in or out?* Gains were recorded across the board, with more speculative stocks—particularly in the technology and small-cap areas—generating the strongest results. 2004 began with the same trend in place, although the storyline was changing. Previous laggards, including cyclical and defensive stocks, asserted themselves.

Late in the quarter, the plot changed yet again. A Labor Department employment report showed that a mere 21,000 jobs were created in February, far less than previous months. The stock market dropped, as investors worried that meager hiring would sap demand and stall the recovery. (On April 2, the Labor Department reported that non-farm payrolls jumped by 308,000 in March—a far more encouraging figure.) Compounding investor anxiety, the Madrid bombings of March 11—and their effect on the subsequent Spanish elections—reminded everyone that terrorism is still a destabilizing force in the world. Finally, the increasingly combative presidential election race here at home offered none of the certainty the market craves, and, in spite of a resurgence at quarter-end, the market lost most of its earlier gains.

However, with so many eyes on the negatives, it bears mentioning that underlying fundamentals are what drive stock performance in the long run. As we look at conditions today, there are many factors in place that suggest continued gains in the economy and, potentially, the stock market as well.

- The economy is growing. Gross Domestic Product is expected to surge by 4% or more in 2004, compared with 3.1% last year.[1]

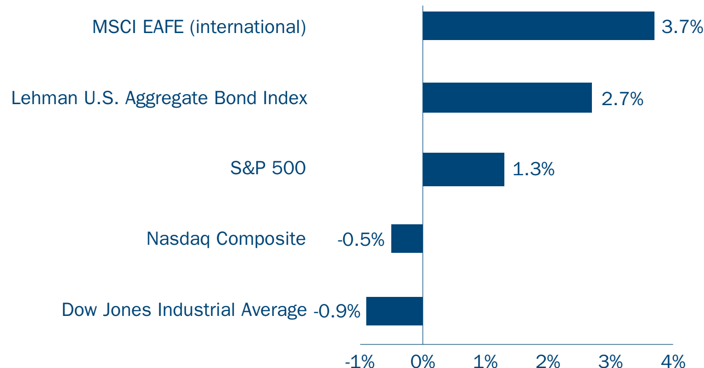
[1] Source: ISI Group

- Manufacturing activity is increasing. The Institute for Supply Management's figure for March was slightly down from January, but at 62.5 (compared with a neutral reading of 50), figures are strongly in expansion mode—in spite of employment woes.
- Interest rates remain remarkably low. During the quarter, the Federal Reserve Board decided to keep its targeted short-term lending rate at a 40-year low of 1%, and may delay any increases to ensure that the recovery remains on track. Corporations have made effective use of low rates to improve their balance sheets, while consumers have refinanced their mortgages, freeing up cash for other purchases. While the refinancing boom may be nearing a close, these lower payments continue to help homeowners.
- Higher tax refunds should stimulate spending. As a result of last year's federal tax reform, refunds to individuals are expected to rise 23% this year.[2] The impact may be concentrated within the next few months, since taxpayers may have delayed filing the more complicated forms, and many people may have failed to recalibrate their tax withholdings in 2003, creating larger refunds in 2004.[3]
- Corporate earnings are strong. Companies in the Standard & Poor's 500 are expected to grow earnings per share by 10% in 2004, based on consensus top-down forecasts.[4] In fact, these figures may be on the conservative side, due to the extraordinary level of productivity driving profits. In addition, Wall Street analysts are now careful to avoid appearing overoptimistic. To illustrate, one company recently issued a range of possible earnings results, only to find that all the analysts covering the stock picked the lowest, more easily attainable number.
- The stock market overall appears reasonably priced. As of March 18, the Standard & Poor's 500 traded at 17.9 times bottom-up estimates for 2004.[5] However, this number includes speculative stocks with little or no earnings that skew results. If you exclude 82 information technology stocks, the S&P's p/e is 16.9.

Of course there are a number of areas of concern. Aside from the anemic employment data, the price of oil is on the rise; the federal budget deficit has reached enormous proportions; and the balance of trade has shown only moderate improvement even as the dollar has declined. There are also legitimate questions about how long the economic expansion can last as the effects of fiscal and monetary stimulus wane.

**Stocks Take a Breather** FIGURE 1

First Quarter 2004: Performance of Major Market Indices




Returns reflect price changes only, except for the bond index, which is total return. Past performance is no guarantee of future results. See page 4 for index descriptions.

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

The negative factors weighing on the market are serious enough to create a powerful tug of war between buyers and sellers, as evidenced by tremendous volatility in March. However, we maintain that even with the gains of the past year, a dispassionate analysis suggests that the stock market remains healthy.

## The Markets in Review

### *A Jittery Quarter for Domestic Stocks*

U.S. stock indices finished roughly flat to modestly positive for the first quarter, beset by negative news and profit taking in March. Investors engineered a sector rotation during the quarter, shifting away from the tech stocks and other high flyers that proved so rewarding in 2003. Small-capitalization stocks generated stronger results than large-caps, aided by a resurgence in late March, while the value style of investing prevailed over growth in the market's shift to a more defensive psychology. For the quarter, the bellwether Standard & Poor's 500 rose 1.3%, while the Nasdaq eased –0.5%, and the Dow Jones Industrial average declined 0.9%. In contrast, the small-cap Russell 2000 rose 6%.

### *Real Estate*

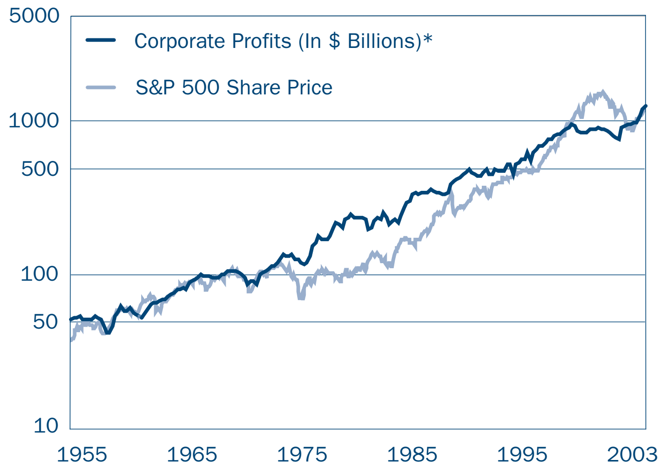
Real Estate Investment Trusts continued their trend of strong returns, bolstered by growing evidence of a bottom in commercial real estate, an attractive dividend yield, and healthy demand by investors. Many companies reported modest occupancy improvements, with growing expectations for 2004. This trend probably reflects the

[2] Source: ISI Group
[3] Source: Lehman Brothers
[4] Based on a survery of analysts' forecasts for the entire S&P 500 Index. Source: Bloomberg
[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

## Tighter Link Between Profits and Stock Prices

FIGURE 2

The bear market's price declines, combined with recent earnings gains have brought profits and stock prices back into line.




*National Income and Product Accounts, seasonally adjusted annualized rate.
Source: Robert Barbera, Hoenig; Bureau of Economic Analysis, U.S. Department of Commerce, Standard & Poor's

overall improvement in economic growth, which has filtered down to demand for commercial real estate space.

Among the primary beneficiaries were owners of industrial properties, hotels, self-storage facilities and retail properties. At the same time, a slowdown in the rate of new construction suggests only modest increases in supply, helping overall fundamentals. With a 5.7% average dividend yield at the start of the year, real estate investment trusts continued to provide an attractive income stream. Including potential capital appreciation, we anticipate that the sector could produce a respectable 10-12% return for the year.

### *International Stocks*

International markets managed modest gains during the quarter, affected by concerns about overall economic growth and the political impact of March's terrorist bombings in Madrid. Asia-Pacific markets such as Japan, Taiwan and South Korea put in good performances, while continental Europe in general did not perform as well as the more peripheral markets of Scandinavia. Foreign consumers have stayed relatively resilient, buoyed by low interest rates, which continue to fuel housing markets worldwide, and benefit companies in the consumer durable sector that participate in repair, maintenance, renovation and other housing-related activities.

The weak dollar—which fell some 15% versus other currencies last year—continued to concern policymakers overseas.[6] However, foreign companies with U.S.-based costs stand to benefit from the weakness, as do U.S. investors with unhedged foreign exposure. That said, we think that the dollar has reached a level approximating "fair" value, and may not move much lower from here. Among the markets that appear particularly attractive are Ireland, with its solid economic growth, healthy finances, and strong housing market, and Canada, whose energy companies stand to benefit from high oil prices and strong supply/demand fundamentals. We continue to remain skeptical about the recent economic resurgence of Japan, an export-dominated country that still needs to undertake meaningful institutional reforms before returning to long-lasting health.

Despite strong results in 2003, international stocks continue to trade at a discount compared with their U.S. counterparts. As global companies continue to post strong numbers, we anticipate that this gap will narrow.

### *Ninth Inning Surprise for Bonds*

During the first quarter, the fixed-income markets extended their long winning streak, as yields continued to decline, pushing up prices. Bond investors have experienced heady times over the last four years, with the Lehman U.S. Aggregate Bond Index generating a 38.9% cumulative return through 2003.[7] However, as the economy has grown increasingly robust, the dollar has fallen, and energy costs have soared, many observers have expected a rise in interest rates that would hurt bonds. In the first quarter, any such rollback was postponed. Relatively weak employment and benign statements from Federal Reserve Chairman Alan Greenspan suggested that Fed rate increases might be delayed to give the economy more protection. As a result, fixed-income securities enjoyed a strong quarter, particularly those with greater interest rate sensitivity.

Still, risk is high. While rate hikes have been delayed, the impetus for the Fed to act will probably intensify. Strong economic growth, increases in energy costs, the weak dollar, the growing federal budget deficit and alarmingly high trade deficit all suggest a danger of higher inflation. Given the relatively small spread between quality bonds and weaker credits, it makes little sense to aim for higher yield with increased risk. As a result, a defensive posture seems

[6] Federal Reserve U.S. Trade Weighted Major Currencies Dollar Index
[7] Through December 31, 2003. Source: Lehman Brothers

appropriate. Limiting duration (exposure to interest rates), sticking to quality bonds, and emphasizing high-coupon issues (which provide more money for reinvestment should rates rise), are all prudent strategies at the moment.

### *High-Yield Bonds*

After posting record total returns in 2003, high-yield bonds experienced a more temperate first quarter. In contrast to last year, the market this quarter favored higher-quality credits. And while issuance remained strong, there was less demand for speculative "fringe" deals—perhaps a sign of a less frothy market moving forward. Although high-yield bonds are lower rated, an emphasis on better quality high-yield bonds seems an appropriate strategy at a delicate point in the market cycle. As with other bonds, limiting duration at a time when yields are at historic lows also appears prudent.

### *Municipal Bonds*

Municipal bond fundamentals improved during the quarter. State and local governments experienced better tax revenue flows due to the improving economy, easing budgetary pressures. Although demand for municipal bonds remains strong, an anticipated $15 billion in California deficit bonds may weigh on the market moving forward. Municipals are attractive from a valuation standpoint, with long-maturity munis providing roughly 94% of Treasuries' pre-tax yield.[8]

At the same time, a cautious approach is appropriate at the current juncture: 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.

### *Sorting Through the Signals*

At any particular time, trying to "read" the stock market can be a confusing and anxiety-inducing experience. Especially during periods of crisis, alarmist news stories and near-term fears have a way of crowding out reasoned analysis. Yet these times of market uncertainty can produce excellent investment opportunities.

As professional money managers, our job is to sort through the conflicting signals and make investment decisions based on our own fundamental research and our best judgment. Setbacks do occur, an important reminder that the road to financial security is never a straight line. But in the long term, we believe that a diversified portfolio, managed with a highly disciplined approach, is the best way for investors to reach their financial goals.

[8] As of March 25, 2004, 20-Year AAA Muni G.O.'s were yielding 94% of the 30-year U.S. Treasury. Source: Bloomberg

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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