December 2004

Where We Are

Santa Claus brought Wall Street a present again this year. Investors in U.S. equities have enjoyed a vigorous rally since October. Somewhat surprisingly, Santa was good to bondholders as well as bond prices have remained firm. Barring unforeseen headlines, both bonds and stocks will finish with a respectable positive return for calendar year 2004.

It was certainly a noisy year. The Presidential elections went about as anticipated, as the Democrats had a good showing, but not enough to unseat the incumbent. The war in Afghanistan went well, but the war in Iraq continues to challenge our national resolve. We made it through another year without a terrorist attack in this country.

The economy is doing okay. Corporate profit margins have never been higher, and there are signs that employment is trending up. Oil prices spiked during the year to the mid $50 per barrel but have recently come back to earth at close to $40 today. The dollar remained weak all year in spite of the efforts of the Federal Reserve as it has raised short-term rates several times throughout the year. The bond market seemed to reflect all this noise the best. With all this sound and fury, the Ten-year Treasury bond fooled all the pundits and will end the year at about 4.25%; the level it was when the year began.

No doubt 2005 will have its share of noise. In order not to get too caught up in it, I suggest we get back to basics as we review the outlook for bonds and stocks in the New Year. Over the short run, Sentiment dominates the markets. In the intermediate term Monetary factors set the tone, and Valuation is more useful over longer periods.

Currently, Sentiment is in a very different position for stocks, compared with bonds. The recent rally in stocks has the market quite extended. Investors Intelligence reports 61% Bulls and only 20% Bears among investment advisors. This hardly represents a "wall of worry" for the stock market to climb. It seems likely that some correction of this overbought situation will occur after the seasonally strong period passes in mid-January. Bonds, on the other hand show lots of skepticism. The Stone & McCarthy survey of bond fund managers show them positioning their portfolios with durations significantly below their benchmark indices. They've been that way all year, expecting long-term rates to rise. With most professionals already short, I wouldn't expect long-term rates to increase much in the short run.

Over the intermediate term, say six months out, bonds may have a tougher time. The Federal Reserve is intent on raising short-term rates further. Today, the spread between the yields of the two-year Treasury note and the ten-year Treasury bond is 125 bps. Historically, the average spread is 95 bps. As the Fed nudges rates up from this point, investors will find it harder to justify the higher risk associated with longer term bonds. Higher short-term rates will probably push longer term rates up with them until there are signs of a slowing economy. Bond prices are likely to be lower six months out.

Stock averages like the S&P 500 may also not make much headway in the first half of the year as rates rise. Close to 25% of the S&P 500 is in financial service stocks and considerably more of S&P 500 profits come from that sector. A flattening yield curve and higher overall rates are usually not good for the profits of financials as their interest margins get squeezed. The industrial sectors should continue to show good earnings as capacity utilization expands. Higher rates are not necessarily bad for industrial stocks and they should do fine. The mix should favor Growth stocks versus Value for the first time in many years.

As for the longer term, Valuation of both bonds and stocks are neutral in our work. The recent tendency for companies to raise dividends should continue as the current administration supports lower relative taxes on dividends. Increased dividends should support higher stock prices over the long run.

In summary, 2005 looks like it will be a year in which bond investors will find it hard to earn the coupon on a total return basis. Stocks should do about what they have done in 2004, but the mix will likely shift away from the Value sectors dominated by financials, and reward more economically sensitive Growth stocks.

Best Wishes for a peaceful and prosperous New Year!

Robert C. Davis, CFA
December 29, 2004

A copy of our Form ADV, Part II is available upon request.

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