December 2003

DHJ&A
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Fearless Forecast

As we approach the end of the year, it is appropriate to sit back from the day-to-day noise of the market, take a deep breath, and come up with a reasoned view of where we are. From that point we can try to come up with a view of where we will be twelve months from now.

Where are we now? We are in the fourth inning of an economic recovery. Although a recovery would probably have happened anyway, led by a turnaround in capital spending, it has been accelerated by tax cuts, deficit spending and significant monetary stimulus from the Fed.

Capital spending declined rapidly during the recession as many companies realized that they had over-expanded capacity in the late nineties. By the end of 2001, a lot of that over-capacity had been shut down or sold off. A more normal level of capital spending might have ensued in 2002, but the September 11, 2001 attacks and the buildup to the Iraq war made planning very difficult, so most companies continued to keep spending to the minimum. This year, with the help of government stimulus, confidence has improved and corporations have begun to increase capital spending to catch up to rising consumer demand.

Improving capacity utilization has led to tremendous productivity improvements in the economy and, as always, dramatically better than expected earnings coming out of the recession. This is what has driven stock prices up. It is also why the market leadership has been concentrated more in the technology, manufacturing, and cyclical areas of the market since the bottom last March.

Interest rates have bottomed for the cycle. The Fed is no longer pumping liquidity into the system. Confidence has returned to the point that the next change in Fed policy will be to try to slow things down a bit. This becomes even more probable given the significant decline in the dollar versus other major currencies.

Where will we be by December 2004? We will be in the eighth inning of the recovery, having experienced several more quarters of above trend-line GDP growth. Earnings will have continued to dramatically surprise on the upside. S&P 500 earnings will be running at an annualized rate of $60 per S&P share by the summer of next year, exceeding the high levels of the late nineties for the first time.

By next summer the Fed, faced with a strong economy and ongoing weakness in the dollar, will have started to become less accommodative and will likely begin to raise short term rates. The yield curve will flatten, anticipating slower economic growth six to nine months later.

When we write this letter next year, we will likely be talking about peak cycle earnings, profit margin compression, higher interest rates, and slower economic growth in 2005 versus 2004.

What does this mean to the markets? Near term, the stock market has more room on the upside. Earnings reports for the more cyclical industries should continue to come in above expectations. However, in the second half of the year financials, which contribute more than 30% of the earnings of the S&P 500, will suffer margin compression as the spread between short-term and long-term rates diminishes. It will be tougher for these companies to book better than expected results.

At the same time, the price/earnings ratios of the S&P 500 will likely begin to compress later next year as it becomes clear that earnings growth will slow in 2005. So, by year-end 2004, the S&P might reasonably sell at 18 times earnings of $60 to $70. This computes to about 1200, or a gain of about 13% from today.

Bonds could have a tough first half, as investors anticipate Fed rate hikes. But once short rates begin to rise, the longer end of the yield curve could begin to do better. So, we would guess that the 10 year Treasury might finish next year at about 5%, or some 75 basis points higher than today. This would put the total return on that issue at about zero for the year. Corporates, especially lower quality ones, could do materially worse as the market anticipates slower growth and less liquidity in 2005.

Of course it is possible that "external" events, such as the war on terror, the elections, etc., could change this scenario. However, given where we are now, we believe this represents the most likely case.

Best Wishes for a happy and peaceful 2004.

-Robert C. Davis CFA
December 10, 2003

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

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