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2004 Q&A

February 10, 2004

As at the beginning of 2003, Dave, Clara, and Bill gathered to recapitulate the year passed and sketch some scenarios about the future. The highlights of that discussion, presented in a Q&A format, follow:

Q: A year ago you (Avalon) posited 2003 would feel a lot better than 2002. You also said that investor perceptions were too gloomy given the improving economic numbers, especially corporate profits and capital spending. I didn't believe it at the time, but that analysis proved correct. Seems as if the only investors left behind in 2003 were the ones who played it "too" safe. After such strong gains, is there anything left for investors in 2004?

A: After 9/11, it was essential to recognize that rigorous monetary and fiscal measures were being taken to engineer a recovery in the stock market and the overall economy. The effects of the stimulus were expected to take hold in 2002. We positioned the portfolios accordingly; however, it wasn't until 2003 that investors began to believe again, resulting in broad-based gains across the markets. Every asset class[1] rose by double-digits save for cash and treasury bonds, which were all but unchanged.

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With the exception of tepid job creation, the economic numbers were strong in tandem with the market. From a historical market perspective, given the amount of fiscal stimulus injected, the results were as expected. Looking ahead, we expect the economy (and the markets) to continue "under their own steam" in 2004 even as monetary and fiscal stimulus fades.

Q: O.K., so you are saying that last year the government pulled out all the stops to reflate the economy and succeeded, but what ammunition do they have left?

A: Last year the Federal Reserve made sure that there was plenty of easy money around. Equity valuations were already attractive, cheap even, in the period just before the Iraq War and around the time of the SARS epidemic. The stimulus came at just the time a lot of investors were starting to panic. Now with a strong pick-up in economic growth, coupled with high productivity and few current signs of inflation, both the US and global economies have substantial momentum as we enter 2004.

Q: That all sounds good for now, but once employment picks up and when inflation moves higher, won't the Federal Reserve have to raise rates and thereby spook the markets?

A: First, we believe that the Fed is unlikely to short-circuit the recovery by raising interest rates in an election year. There are no real signs of inflation, and in spite of an increasing deficit, neither spending cuts nor tax increases are likely this year. This should create problems in the long run, but in the short run, the market isn't paying attention. Second, there are typically two stages to a market recovery. In the first stage, investors start to anticipate the recovery at the same time the Fed stimulates with easy money. In the second stage, the recovery is evident in both economic growth and profits. Historically, the Fed has already begun to raise rates while the second stage is progressing and the markets continue to move higher as profits recover.

We are already in a profit recovery and probably on the verge of a rate increase later in the 2004, but the stock market doesn't usually react in a sustained way until the second or third increase. In other words, we believe that the rally is maturing, but it isn't over.

Q: You've hinted at some long run negatives that could surround the budget deficit. What else is on the horizon that I should be aware of?

A: We are closely monitoring the price of oil. U.S. crude levels are at the lowest since the autumn of 1975. Inventories are down almost 10% versus a year ago. The current price per barrel is around $35.00. Our apprehension is the possibility of a $40 or more price tag by the end of the year. Worldwide demand continues to increase while production lags[2]. The boom in China has created enormous demand for many of the world's commodities, oil among them. Oil consumption in China is growing 30% per year. Meanwhile, China already wrestles with a deficit of about 2 million barrels per day[3]. Higher oil prices imply a powerful negative for consumer sentiment. Retail sales growth could slow way down as inflation begins to accelerate, forcing the Federal Reserve to raise interest rates. After years of importing deflation from China, we might start to import inflation as their demand for commodities rises with their growth. Rising inflation would impede a healthy environment for bond and stock markets (with the exception of energy and resource-related issues).

The weakness in the U.S. Dollar bears watching as a contributor to both higher inflation and higher interest rates. Since November, 2000, the U.S. Dollar has fallen 33% against the Euro[4]. If the rate of decline accelerates, because of low interest rates and ever-increasing budget AND trade deficits, foreign investors could panic over holding dollars, forcing the Fed to shore up the dollar with higher interest rates.

2004 is a Presidential Election Year. For investors, the good news is that the current administration continues to do everything it can to stimulate the economy. The scary news is that the bias to stimulate may evaporate following the election. We believe that the longer-term issues will need to be addressed by the new or returning administration and the Fed will no longer be constrained from raising interest rates because of election year politics.

Q: Last year your investment strategy was designed to capture the reflation opportunity. You were overweight in equities, both U.S. and international, and you invested in high-yield corporate bonds instead of treasury bonds and cash. Will you stick to this strategy now that the rally has moved into the second stage?

A: Overall our asset allocation models still favor equities over bonds, but there are differences in the recommended composition when compared to a year ago. Then the models were very overweight anything related to tech and biotech and were tilted toward a more concentrated portfolio that emphasized high-beta and growth over value. That began to change last year and we adjusted portfolios accordingly. We took profits on some of our high-flier tech stocks and put that cash back into high-quality, dividend-paying stocks like drugs, telecom service, and energy.

We have begun to sell a little of the high yield funds. They were stellar performers in 2003, but much of the value relative to treasury bonds has been extracted. We expect to cut back further throughout 2004 and wait for an opportunity to invest in treasuries later in the year when we expect interest rates will be higher. A yield of 5% on the 10-year treasury would be an attractive rate given our current outlook for the economy and inflation.

We continue to recommend Asia for international equity investors. We would use pullbacks in those markets to add to positions. China is probably a secular story. It will be volatile, but prices could be much higher over the next five to ten years. International stocks have underperformed the U.S. for a decade, creating attractive relative valuations in both stocks and currencies. We think last year's outperformance by international markets was only the beginning of a trend to narrow the performance differential that occurred throughout the 90's.

Q: You forgot to mention REITS. You didn't have a big allocation there last year and yet they did even better than the S&P500. Any thoughts?

A: The results for REITs in 2003 were a surprise. Key factors driving returns were heavy fund flows from individuals and institutions seeking higher yields. The powerful rebound in equities in combination with emerging strength in the economic cycle boosted the prospects for a recovery in lagging property sectors like office, apartment, industrial and lodging. Conspicuously absent from the reasons for the strong returns in 2003 were the underlying fundamentals. Office vacancies continued to rise, apartment rents fell, and profits were generally lackluster. Still, rising momentum pushed the asset class to one of its best years ever.

What's next? Because much of the strength over the full cycle came from retail properties, opportunities for new investment remain in the office, apartment, and lodging areas, where fundamentals are only just beginning to improve. Despite our concerns that this asset class is getting pricey, our technical models continue to point toward higher prices. Still, the trend is advanced, which requires vigilance, especially as valuations are getting stretched.

Q: I think that covers it for now. You will let us know if you are making any big changes.

A: As always.

Footnotes:

1 US Stocks, International Stocks, REITs, and Natural Resources, based upon unmanaged index returns.
2 Eia.doe.gov
3 BCAresearch.com
4 BCAresearch.com

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