The 2004 Stock Market: Echoes of 1994?

> The truth is that there is no investment which does not
> involve some risk and is not something of a gamble.
>
> Bernard Baruch, *My Own Story*, 1957

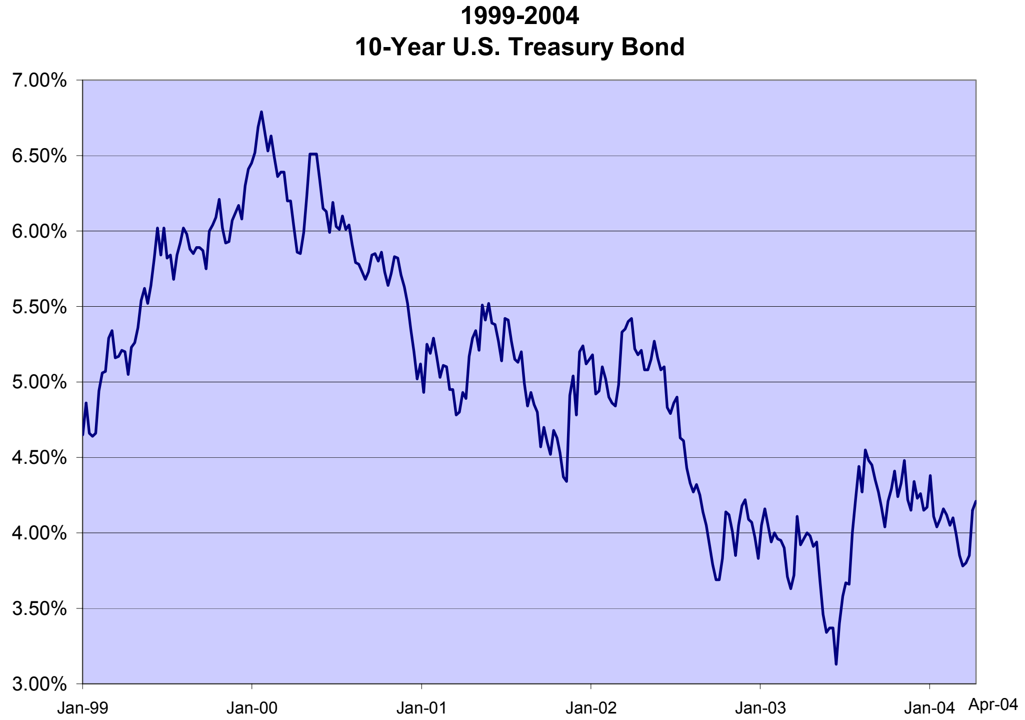
One of the key rules of seasoned investors is: Beware of a consensus. Most investors have learned the hard way (by losing money) that it is dangerous to go with the consensus view, because it usually means that investors have already placed their bets and there is little ammunition left to push the market further in the direction of the consensus. Thus, a key bullish signal for the stock market is when investment professionals are excessively bearish, and an important bearish indicator is when investors are very bullish.

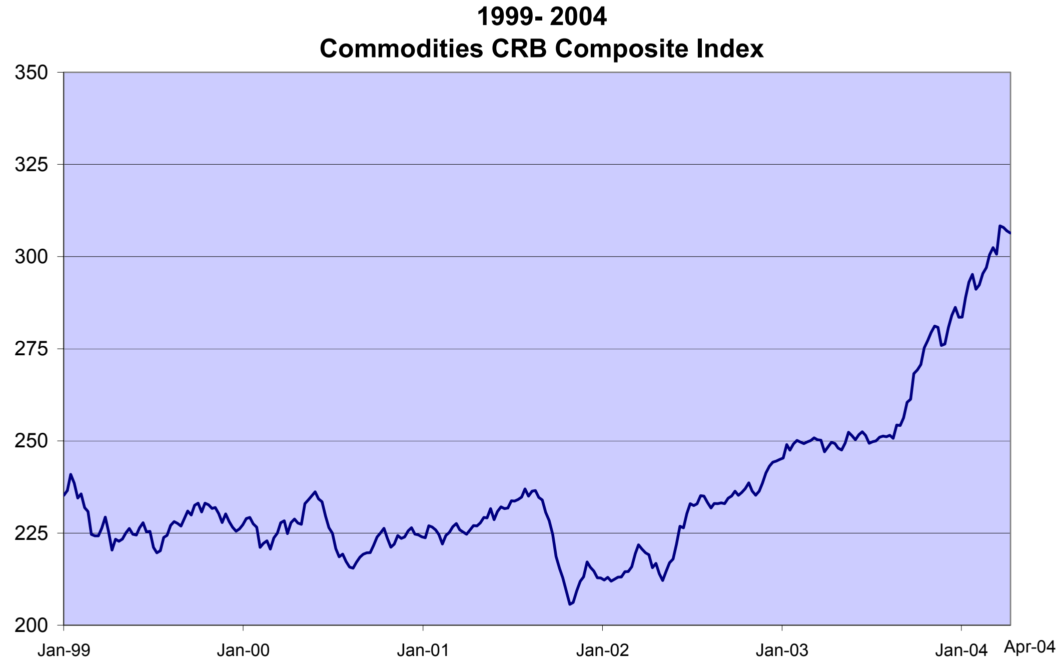
At the beginning of 2004, polls showed that most economists and professional investors believed that the stock market, driven by strong corporate earnings growth and continuing low interest rates, would perform well during the first half of the year. The consensus view was that the market would run into trouble during the second half of 2004 due to the likelihood of higher interest rates, lower tax refunds and an uncertain outcome in the presidential election in November. Instead, it appears as if we may get the exact opposite: a disappointing stock market through the first half of the year or even through the fall elections, and then, when investor expectations have been lowered and the selling is over, an unexpected stock market advance. To add to investor frustration, 2004 may well be the worst year for bonds since 1994, which reminds us of Bernard Baruch's quote above that there is some level of risk in every investment – even "risk free bonds."

During the past several years, there has been an ongoing debate by investors about the direction of the U.S. economy. The two camps lined up as follows:

Bears	**Bulls**
Deflation is the dominant theme	Inflation is coming back
Companies have no pricing power	Increasing commodity prices will cause pricing power to return
The economic recovery is weak, and job growth will be anemic	The economic recovery is strong, and job growth will accelerate
Interest rates will remain low	Interest rates will climb

This debate has been played out in the capital markets over the past year. In one camp, investors who believed that a strong recovery was underway poured money into the stock market as well as into commodities (including inflation-sensitive ones such as gold, silver, and energy). These markets climbed dramatically in 2003. On the other hand, the bears on the economy pushed interest rates on bonds down to record lows. In February 2004, with the economic recovery underway for almost two years, the 10-year U.S. Treasury bond yielded only 3.69%. This market disconnect can be seen in the charts below. The 10-year U.S. Treasury bond is a key fixed income instrument which helps determine other interest rates such as fixed mortgage rates. The CRB Composite Index is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions.





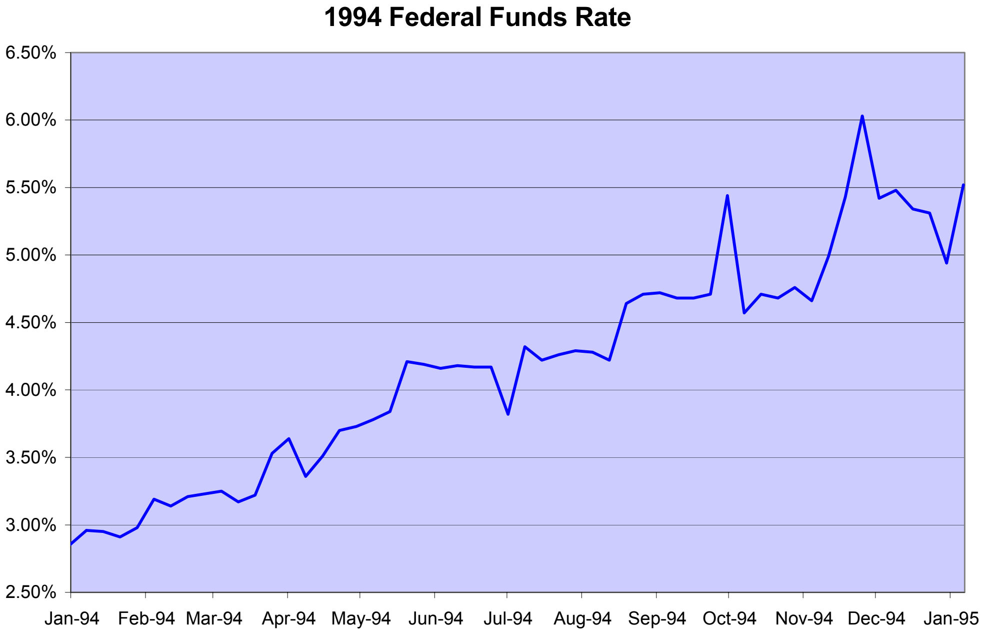
The debate ended for most investors on the morning of Friday, April 2nd. The Labor Department announced that 308,000 jobs were created in the U.S. in March. Additionally, the number of jobs created in January and February was revised upward by 87,000. Thus, more than 500,000 total jobs were created during the first quarter of 2004. Since April 2nd, there has been further evidence that the economic recovery is continuing unabated with more signs of higher inflation and strong corporate earnings. This has caused the yield on the 10-year U.S. Treasury bond to increase almost 70 basis points to 4.45%, while the stock market has dropped several percentage points.

Good Economic News Means Higher Interest Rates

The strong recovery should cause excellent corporate earnings growth this year. Estimates for 2004 operating earnings of the S&P 500 Index are $64.00 – an impressive 15.3% increase over 2003 operating earnings. This would be an all-time high – almost 10% higher than the S&P 500's operating earnings at the peak of the boom in 2000. This kind of strong growth increases the probability that interest rates will climb for the remainder of 2004. It is just a matter of time before the Federal Reserve will increase the Fed Funds rate from its current level of 1%. While some observers forecast that the Fed will wait until August, others believe that rate increases will arrive sooner. However, it is important to realize that the Federal Reserve does not usually lead the interest rate cycle with its rate hikes or cuts, but rather tends to confirm what the bond market has already done. In other words, investors in the bond market have already anticipated an increase by the Federal Reserve by raising yields on the 5-year and 10-year U.S. Treasury bonds by more than one-half of a percent. Stock market investors have already reacted during the past two weeks by marking down the prices of interest-rate sensitive sectors such as financials, preferred stocks and REITs.

1994 Déjà Vu

The action in these markets and the likelihood of a trend of higher interest rates in the midst of an election year is reminiscent of 1994. In 1994, the Federal Reserve waited too long to raise interest rates. It spent most of 1994 trying to catch up, raising the Fed Funds rate six times during the course of the year. The effect on capital markets was not positive, and surely the Fed would like to avoid a similar pattern in another election year. In spite of an 18% increase in the operating earnings of the S&P 500 Index in 1994, the total return for the S&P 500 was only 1.5%. The bond market had a terrible year, with 20- to 30-year U.S. Treasuries down over 25%. The chart below shows the trend of short term interest rates in 1994:



Near Term View

Stock market investors currently face uncertainty of three types: interest rates, the war in Iraq, and the elections in November. While recent news of strong growth in new jobs will enhance economic forecasts for income and spending, it does add to questions about the direction of interest rates and implications for inflation. The tough resistance in Iraq is a test of U.S. resolve, engendering anxiety with investors about how our engagement in Iraq will play out; and investors hate uncertainty. Finally, there is the election in November. With the nation divided on many issues, the presidential election looks as if it will be close and hard fought. If investors believe that taxes on income, capital gains and dividends will increase in 2005, this will have a negative impact on the stock market. These factors, in our view, are likely to cause the stock market to mark time, churning in a 10% band – for the S&P 500, perhaps 1080-1170. If interest rates do in fact rise throughout the year with the 10-year U.S. Treasury bond yielding 5.5% or more by year-end, the total return for bonds and various other kinds of fixed income vehicles will be negative for 2004. Remember: all investments involve some level of risk.

What to Do Now?

First of all, investors will need patience this year. If prices of stocks mark time and bond prices drop in the midst of a continuing stream of good economic news, it will be very frustrating. But this may well be the pattern in 2004 as it was ten years ago. It will be important to track the data carefully to confirm that the economic recovery is intact and likely to sustain itself for some years. If this continues to be the case, investors will want to postpone new commitments of funds to the bond market until the Federal Reserve is near the end of its string of rate increases. In both 1994 and 1999-2000, the Fed raised the Fed Funds rate six times before satisfying itself that inflation was in check.

In regard to Iraq, the administration appears committed to turning the governing process over to the Iraqis by June 30, and investors can expect stepped up attacks on coalition forces by former Saddam Hussein loyalists, renegade Shiites and foreign terrorists. If, however, the turnover of political power is accomplished on schedule, and the U.S.'s involvement is gradually reduced, one can be more sanguine about the future of a new Iraq.

On the election front, it is too early to tell how things will play out. Much depends on the situation in Iraq and the state of the economy on Election Day. It seems likely now that the election will be fought largely on the regional lines of the 2000 contest. A Bush defeat would throw into doubt the tax cuts on income, capital gains and dividends that have played a large role in providing the stock market with a strong foundation. Investors will need to pay close attention to campaign promises about taxes – especially because almost 50% of all citizens are invested in the stock market, either directly or through retirement accounts. In 1994, the stock market struggled for 11 months and then took off in December after the election, rising 35% over the next 13 months as prices caught up to earnings (and the Fed stopped raising rates).

Our word of advice for investors in 2004 is to heed the old adage: The way one makes money in the stock market is "time in the market, not timing the market."

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