

Commentary - 1st Quarter 2004

Equity markets took a breather in the first quarter. After reaching new highs early in the quarter, they sold off on disappointing news regarding the employment situation and terrorist worries. The S&P 500 ended the quarter with a slight gain while the Dow Jones Industrials ended with a slight loss. Our expectations of higher interest rates were proven wrong as the weak jobs market led to a dramatic drop in rates in early March, so bond indices reported gains for the quarter. However, that drop in interest rates was reversed on April 2nd, when we finally received good news of a pick-up in hiring. With the recent positive jobs report, most economic prognosticators are now expecting the economy to experience 4.0% growth for the remainder of the year. If employment continues strengthening, the political future of President Bush should be enhanced, which the stock market will like because that means the dividend and capital gains tax cuts will remain in effect.

We are glad that the stock market experienced a reality check in the first quarter. After last year's strong rebound, we were worried that valuations were becoming extended. As we stated in last quarter's letter, risk premiums collapsed in the second half of 2003. Unprofitable tech stocks, junk bonds, and other high risk sectors led the market's rise last year. We are expecting the market to return to more normal conditions with the higher probability of interest rates increasing. Higher quality stocks should outperform riskier stocks and credit spreads should increase as the timing nears of Federal Reserve interest rate increases. Large capitalization stocks should begin outperforming small company stocks as the economic recovery matures. We are focusing on companies with stronger balance sheets in our equity-oriented strategies because weaker companies benefit to a greater degree from easy money conditions. The Fed will lean toward tightening later this year and negative real interest rates, where the inflation rate is higher than the Fed Funds rate, will disappear.

Our positive outlook for the stock markets is still intact. We expect corporate earnings to meet or exceed expectations because the economy is performing well. And for once, the United States is not the only country experiencing positive growth prospects. Asian coun-

tries are benefiting from strong Chinese demand and even Japan may be rebounding. India is another emerging economy that is experiencing strong growth. Europe may support global growth, though it will be contributed by the developing Eastern European economies rather than the stagnant Western European countries. As global growth becomes more balanced, foreign currencies that have gained versus the dollar over the last year should maintain their improved position. The dollar has returned to levels where it traded in 1998 versus other currencies. When the dollar began its ascent in 1998, our manufacturing sector fell off a cliff because they could not compete with foreign manufacturers that enjoyed lower labor costs and a weak currency. We are now back to more of a level playing field where domestic producers can vie for global business again.