NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Hot Economy, Cool Market (for now)

Current Economy

United States Economy

The addition of 308,000 workers to March payrolls was the last piece of the U.S. economic puzzle to snap into place. Job creation is a necessity for the sustainability of the current economic expansion. Before the March employment report many market watchers fretted that the economy could be running out of steam. With this growth in employment, household income can remain firm as the benefits of tax cuts and the refinancing frenzy fade. The bottom line is that real consumer spending should continue to expand at a solid pace in 2004 and beyond.

This economy is firing on all cylinders. The consumer, who led the recovery, was joined in the fourth quarter of 2003 by double-digit growth in capital investment, 20% growth in export volume and record levels of housing construction and sales. Retail sales rose 1.8% this March over February, a far greater increase than expected and the biggest jump in a year. The stage is set for 4%-5% real growth in 2004, and 4% in 2005.[1] Contemporaneously, the U.S. economy may be enjoying the highest rates of growth in productivity, cash flow and corporate profits with the lowest inflation and interest rates in about 50 years. Chairman Greenspan could not have engineered a more ideal economic environment.

Unfortunately, bubbling below the surface, March also saw total consumer prices as measured by the CPI rise by 0.5%. Although the March CPI is susceptible to seasonal jumps (weather-related factors), this jump implies that inflation has stabilized as it prepares to turn higher. Worries about increasing inflation rates coupled with robust job growth numbers signaled to market watchers that the Fed can be expected to begin raising rates.

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In response, the 10-year Treasury note plummeted over 5% in four weeks, to yield 4.46% (comparable to last Fall's highs), when rate watcher's last feared that the economy was too hot for such low rates. Even as we believe inflation has bottomed with long-term interest rates, we do not expect it to pick up significantly in 2004. Productivity increases, surplus global supply capacity and a strengthening dollar should mute inflationary pressures near-term. Fed Chairman Greenspan recently told a Senate banking panel that "firms are slowly regaining pricing power but I expect few inflation worries. The inflationary pressures will be reasonably well-contained so long as productivity is moving at a reasonably good clip and unit labor costs are still going down." We look for inflation in the 2.5% range this year versus 2.2% last year. In 2005 inflation may approach 3.4%, a significant uptick, but still relatively low by historical standards.[2] We further anticipate that interest rates will begin rising this year as the economy shifts gears from a stimulus-induced expansion to a profit-induced expansion. Rising interest rates have less impact on an economy that is generating momentum from profit growth than only from Fed stimulus and low interest rates.

World Economy

The global economy is in the early stages of a renewed and synchronized expansion. Worldwide economic growth should average in the 4%-4.5% range for the next several years, around 4% for mature industrial nations in 2004. The range would be higher but Western Europe is expected to grow only about 2%. Europe is hampered by low population growth, structural, monetary and fiscal problems and inadequate labor reform in Germany and France. In developing economies, overall growth could rise from 4.4% in 2003 to 5.6% in 2004. Despite a projected slowdown in China's growth to 8% this year, the Far East should grow 6.3%. Latin American will trail with a projected 4% growth rate.[3]

Investment Outlook

United States Investment Outlook

Corporate profits are on a roll. After growing some 17% in 2003, the numbers look to be over 30% in 2004 and likely 15-20% in 2005.[4] Hopefully earnings will provide a good tailwind for equities against the headwinds of terrorism, occupation, rising inflation and interest rates. For now, we think political and economic headwinds will mute the upside potential of the equity market near-term.

The "headwind factors" definitely stomped on the first quarter of this year. The equity rally that started in March 2003 continued into the first two months of 2004. Then the terrorist attack in Spain, concerns about inflation and interest rate hikes, and Iraq doubts caused the markets to give back most of its gains since the beginning of 2004. On April 18, 2004, the newly elected Prime Minister of Spain ordered the withdrawal of Spanish troops from Iraq. This fulfilled his campaign pledge to a nation recovering from deadly terrorist bombings. Reportedly, Al-Quaida militants said the bombings were reprisals for Spain's support of the Iraq invasion and occupation. The situation in Iraq is deteriorating. U.S.-lead Coalition forces are fighting on two fronts, battling a Shiite inspired uprising in southern Iraq and Sunni insurgents in Fulluja, and scurrying to meet a June 30 deadline to turn over Iraqi sovereignty to Iraqi leaders. Finally in the midst of this, Israel killed Hamas leader Sheik Ahmed Yassin in a rocket attack, and for the first time Palestinian's terrorists groups threatened the U.S. with revenge attacks.[5]

The Federal Reserve, Inflation and Interest Rates

What about the Fed and short-term rates? Despite the price plunge in long maturity bonds, Fed officials are trying to cool fears about a rate increase. Recently Fed President Broaddus said that rates would eventually have to rise if the recovery continued, but "we are still some distance from that." Fed Gov. Bernanke and San Francisco Fed President Robert Parry made similar statements. In the midst of these assurances, Chairman Greenspan declared victory over deflation. "Threats of deflation that were a significant concern last year by all indications are no longer an issue," he told a Senate banking panel on April 20, 2004.[6] These hints suggest a rate increase could come as early as August if the economy continues to charge ahead. However, as we explained in our "2004Q&A" (You can review this article on our web site at www.avaloncapital.com .) only after a series of rate hikes by the Fed does the market feel a drag. Normally the first hike is seen as the result of stronger earnings, a check on inflation and a weak dollar, which can offset a negative effect on the stock market.

Facing down the headwinds, we do expect the rally to resume in the second half of 2004. We believe that earnings growth will prevail over ever-present anxieties. Finally, this is an election year! Ned Davis of Ned Davis Research has analyzed past election year stock market results. His findings (based on monthly Dow returns since 1900) suggest that the market will begin to improve sometime after Memorial Day. Posting gains upwards of 10% in the second half, as it has 81% of the time in election years since 1900.[7] Of course, "the markets' historical numbers cannot predict the future."

Asset Allocation

U.S. Stock and Bonds

Our asset allocation still favors equities over bonds. In the last two months we raised some cash, which we plan to hold until the current correction abates, probably within the next two months. The cash came from the domestic stock and bond portion of the portfolio. We pared back high tech, biotech and finance positions. When we add back to the U.S. equity portfolio it will be to high tech, industrial, cyclical and health care issues. When we add back to the bond holdings in the portfolio, it will be using U.S. Treasuries. Later this year or early next year, we anticipate seeing a 10-yr treasury note yielding 5% which we would use as a first entry point for buying.

International

We added to Japan in the first quarter, increasing our over-weighting to international and to the Asian region specifically. Stock valuations are very attractive when compared to the U.S. Currently, major international markets trade at a discount to their expected earnings growth over the next year, while the U.S. trades at a premium. We think this disparity will narrow and eventually disappear in the coming years. After a decade of underperformance to the U.S., international stocks began outperforming in 2003 and continue to do so in 2004. Over the last ten years, international stocks have returned a meager 4% per year, lagging the 11% annualized return for the U.S. Historically, these returns have performed in line with each other, leaving lots of headroom for international to play catch up.

Over the last 15 years among international markets the main laggard had been Japan. Then in 2004, Japan began to lead the pack. In the first quarter the Nikkei 225 rose 10%, the S&P500 advanced 1.29%. Japan's "second section," (the equivalent of our Nasdaq) rose 31%, the Nasdaq lost .46%. This performance is attributable to the most meaningful improvement in Japanese fundamentals in 14 years. The Nikkei now trades at 18 times current earnings, but profits are forecast to grow 32% next year. The long ailing financial and real estate sector are leading the advance, a good indication that this time the upturn is for real and sustainable. Until now, these sectors had held back any Japanese economic advance.[8]

Natural Resources and Energy

We continue to overweight natural resource and energy. The long-term outlook for oil prices is excellent for investors. Dr. Marc Faber, a respected and long-time Far East investment observer, makes a robust case for higher oil prices on the basis of demand from the Asian region alone. The entire region, containing 3.6 billion people (56% of the world's population) and the world's fastest growing economies (China, India and Vietnam), only consumes 20 million barrels of oil per day. This is less than the U.S. consumes with 285 million people! It is unlikely current oil producers will be able to accommodate a doubling of Asian oil demand, 35 to 50 million barrels of oil per day, within the next ten years without significant price increases.[9] Shorter-term, OPEC agreed at its Vienna meeting to cut output by one million barrels per day, starting April 1.

Real Estate

We continue to underweight REITS. They were hit quite hard during the recent correction, even so we think it is too early to increase the allocation.

In summary, the world economy, including the United States, is in a strong expansion. Albeit bottoming, inflation and interest rates remain low by historical standards. While the markets, except for Japan, have paused from their 2003 advance, we expect the advance to resume.

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Other than as footnoted below, the research underlying this article represents Avalon Capital Management's proprietary research activities.

Footnotes:
1 Cass Research Associates
2 Cass Research Associates
3 Cass Research Associates
4 Cass Research Associates
5 Msnbc.msn.com
6 Investors.com
7 Barronís
8 Cass Research Associates
9 Ameinfo.com

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