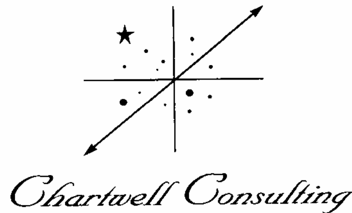

CHARTWELL REVIEW

July 2004 **SECOND QUARTER 2004** *Volume XI, Issue No.2*

"Pushmi-Pullyu"

Those of you intimately familiar with the Classics (*children's* Classics) will recognize our title this quarter as the name of Dr. Doolittle's two-headed llama. Although seemingly blessed with perfect foresight and hindsight (the dream of every institutional investor!), the poor animal was simply incapable of making any real forward progress. As soon as one end started north, the other end had to head south. If one end turned right, the other end would do the same, and the whole beast would find itself walking in circles.

We can't think of a better metaphor for capital markets during the second quarter, which weren't able to sustain any momentum. The results (see tables at right) were very modest equity returns and very poor fixed income results. Further, there was just enough monthly volatility to get you whipsawed, as both stocks and bonds experienced intra-quarter rallies and declines.

One event this quarter sticks out as epitomizing current half-empty attitudes. In the days leading up to the Federal Reserve's June 30th meeting, most market talk was about how "virulent inflation" and an "overheating economy" was forcing the Fed to start aggressively raising the Fed Fund's target. A 25bps increase (which is what occurred) would be just the tip of a large iceberg. Fast forward ***two days***, to the July 2nd Labor Dept. report that June payroll employment rose by 112,000 persons, compared to "fears" the figure would prove to be 300,000 (more jobs = bad? Go figure). By that afternoon, long-term bonds had rallied, stocks had fallen, and market talk was questioning whether the Fed had "acted too quickly" on June 30th, and would "choke off a slowing economy". A classic Pushmi-Pullyu.

Table 1. Index Benchmarks

Market Index	**Q2 2004**	**1Yr**	**Trailing Returns *** **3Yr**	**5Yr**	**10 Yr**
S&P 500	1.7	19.1	(0.7)	(2.2)	11.8
U.S. Large-cap Stocks	1.4	16.3	(2.4)	(4.1)	11.5
U.S. Mid-cap Stocks	1.5	29.4	6.4	6.5	13.5
U.S. Small-cap Stocks	0.5	33.4	6.2	6.6	10.9
International Stocks	0.2	32.5	4.5	0.7	4.7
T-bills (3 month)	0.2	1.0	1.6	3.1	4.2
1-3 Year Treasuries	(1.0)	0.5	3.9	5.1	5.7
Aggregate Bonds	(2.4)	0.3	6.4	7.0	7.4
High Yield Bonds	(1.2)	9.7	9.7	5.2	7.5
Global Bonds, ½ hedged	(2.4)	3.2	9.5	7.1	7.5
CPI, **annualized**	**4.9**	3.2	2.2	2.7	2.5

* Annualized trailing returns for periods ending 6/30/04.

Table 2. Average Fund Returns

Fund Category	**Q2 2004**	**1Yr**	**Trailing Returns *** **3Yr**	**5Yr**	**10Yr**
U.S. Large-cap	1.2	18.4	(1.3)	(1.5)	10.5
U.S. Mid-cap	1.3	25.5	2.5	5.1	12.3
U.S. Small-cap	0.7	32.2	6.6	9.9	12.7
International Lg. Cap	0.7	29.8	3.4	1.8	6.0
International Sm. Cap	(0.2)	44.6	13.7	9.3	9.7
Emerg. Mkt. Equity	(8.9)	33.2	12.0	4.9	1.9
Balanced/Hybrid	(0.4)	11.6	2.5	2.5	8.8
General Bond	(2.5)	0.4	5.9	6.4	6.9
Government Bond	(2.1)	(0.2)	5.2	6.0	6.4
High Yield Bond	(0.6)	9.8	7.8	3.7	5.9
Hedge Fund Index	*(1.4)*	*12.3*	*6.9*	*9.4*	*11.1*

* Annualized trailing returns for periods ending 6/30/04.
Source of fund's data: Morningstar; Hennessee

Is Our Economic Growth Self-Sustaining?

We began the second quarter with less positive economic momentum than during the prior six months. The first quarter's GDP growth rate of 3.9% was lower that for the 4th quarter, and much lower than last year's 3rd quarter (8.3%). This is a bit ironic, because the 2nd quarter's first major economic "event", a favorable April 2nd report on March employment, set market strategists abuzz with visions of a super-heated economic growth environment – and the inflation which can come with it.

As Table 3 reflects, the most positive contributors to first quarter GDP growth were a 7.5% annualized increase in exports, following 20% and 10% annualized growth the prior two quarters, and a modest 5.3% increase in business spending (primarily for IT equipment and software), following 11% and 13% annualized growth the prior two quarters. Personal consumption spending, which always accounts for the lion's share of GDP, increased at a solid 3.8% annualized rate (its median quarterly increase over the last 4 years has been 2.9%). On the negative side, imports shot up another 10%, after a very sharp 16% rise the prior quarter. Also, rising business inventories and increased government spending (particularly defense spending) accounted for one-third of the quarter's growth, and neither of these can be viewed as unambiguous positives.

Table 3. Contributions to First Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**2.64%**	**3.8%**
Fixed Investment	**0.78**	**5.0**
(- by Businesses	*0.54*	*5.3)*
(- by Consumers	*0.24*	*4.6)*
Chg. in Inventories	**0.65**	**na**
Exports	**0.72**	**7.5**
Imports	**(1.43)**	**10.4**
Government Spending	**0.54**	**3.0**
Real GDP Growth	**3.9%**	

Consumer spending – was buoyed by 7% higher real spending on *nondurable* goods. Durable goods spending declined in real terms. Consumption growth was facilitated by a surprising jump in real disposable personal income, due to rising personal income and *falling* personal taxes. Real spending then declined slightly in April, despite rising disposable income, as consumers engaged in further balance sheet repairs. This shifted around in May, as disposable income was flat, but real spending rose 0.4%. While income and spending are affected by many things, real wage growth is certainly crucial. On this score the data is not good for 2004, with June's 0.8% decline in real average weekly earnings representing the 5th consecutive monthly drop.

Employment growth – This stat seems to have become the litmus test of the economy's real-time status, with considerable market-moving power. April's report of the very strong March '04 employment picture really shook bond markets as the quarter began (bond prices had actually begun moving down in mid-March, in anticipation). Job growth during the 2nd quarter was robust, and barely missed the widely quoted "250,000 new jobs per month for the rest of the year" estimates, with 730,000 more people employed during the quarter based on household survey data. Since June 2003, the government estimates 1.36 million more persons have been employed, causing the unemployment rate to drop from 6.3% to 5.6%. Nevertheless, the July 2nd report that payroll jobs increased by only 112,000 in June had the effect of convincing many economists (and, more importantly, investors) that growth projections for 2004-5 are too optimistic.

Business spending – Nonresidential fixed investment accounts for just over 10% of GDP, but is nevertheless focused on closely by investors. It decreased for nine consecutive quarters through March 2003, and has rebounded smartly since. However, the Q1 2004 growth rate of only 5.3% represented quite a moderation from last year's blowout third quarter (+12.8%). This, combined with a decline in June's reported industrial production figures (-0.3%, after strong growth in April and May) and a modest drop in estimated capacity utilization, has convinced some that business spending will not be quite the engine of growth expected just a few months ago, even though current production and capacity utilization rates are both increased from one year ago.

International transactions – The broadest measure of our international transactions, the current account deficit, gets reported with a lag. Thus, we learned in mid-June that our 1st quarter deficit from trading in goods and services was $145 billion, up from $127 billion the prior quarter, and another all-time record. By far the largest element of this stat is goods imports, which rose 5.6% in the quarter. Goods exports rose only 4.3%, and the overall "goods gap" grew to $151 billion. In counterbalance, net financial inflows – net acquisitions by foreign residents in the U.S. less acquisitions by U.S. residents abroad – were $158 billion. However, this represented a $10bn decline from the prior quarter, as U.S. purchases of foreign assets increased by more.

The inflation picture – The first quarter's reports of rising inflation (+5.1% annualized rate) were followed in the second quarter by continued reports of higher inflation. Overall consumer prices ("CPI") rose at an annualized rate of 4.8% for the 3 months ended June.

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During the past 12 months, consumer prices are up 3.3%, the highest 12-month rate of change since June 2001. For all of 2003, the rise was just 1.9%.

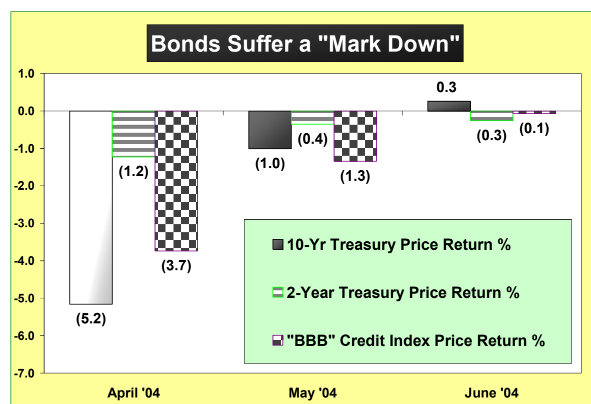
Despite the headlines, sharply higher energy prices (+18% over the past year) make up only part of the story. Food prices have risen at a 3.2% annual rate in 2004 (+4.9% annualized in the 2nd quarter), and medical care costs are rising at the rate of 4.8% (+3.8% annualized in the 2nd quarter). Housing costs, ironically, are reported to have risen only 2.7% in the past year (+4.1% annualized in the 2nd quarter), because of the arcane way this category is calculated.

The "other" inflation rate is the *producer* price index (PPI), which basically measures the rising costs of inputs for enterprises that make stuff. The PPI for finished goods declined in June, but it rose at a 5.0% annualized rate during the quarter, compared with only a 3% annual rate for the last half of 2003. The PPI for finished goods is up 4% in total over past 12 months, while the PPI for intermediate goods has risen 6.9% (+6.2% if you take out energy costs).

The Bond Market Turns More Volatile

The domestic bond market continued on its roller coaster ride during the second quarter (and into the third), with a number of sharp changes in general market yields as investors and traders reacted (overreacted?) to the shifting economic viewpoint. We began the second quarter with long-term Treasury rates in the middle of a sharp run-up (and prices a sharp decline). From mid-March, when the 10-year Treasury hit a 2004 trough yield of 3.68%, prices fell rather dramatically through April to a 4.5% month-end yield.

Chart 1. Bond Prices Declined in the Quarter



As the prior graph reflects, the same pattern continued in more moderate fashion through May and into mid-June, when the 10-year Treasury yield hit a two year high of 4.87%. Then, like unringing a bell, bond prices began a rally that has taken the long-term yield back down to its present level of 4.43% as we go to print.

For the calendar second quarter, the result was a decline in bond prices that completely outstripped the low coupon income earned, with the longest average maturity securities in each category suffering the highest losses. Among the primary bond sectors tracked in Table 4, mortgage-backed securities performed considerably better than others, because investors began to assume refinancing activity would be markedly curtailed. "Low risk" long-term Treasuries lost the most value, because they have the most exposure to interest rate shifts. "High risk" junk bonds performed quite acceptably in the quarter, because their much better coupon yields help cushion them from price declines caused by market yield curve shifts.

Table 4. Fixed Income Sector Returns

Periods ended June 30, 2004; indices are cap-weighted

Index (% of Aggregate)	**2Q04**	**1 Yr.**	**3 Yrs.**
Aggregate Bonds *(100%)*	**(2.4)**	**0.3**	**6.4**
US Gov't, all *(35%)*	(3.0)	(1.4)	6.1
- US Treas, long (6%)	*(5.2)*	*(4.0)*	*7.7*
Mortgages *(35%)*	(1.1)	2.2	5.6
Inv. Grade Credit *(26%)*	(3.4)	0.1	7.5
- "BBB" Bonds (11%)	*(3.6)*	*1.2*	*8.1*
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High Yield Bonds, all	(1.2)	9.7	9.7
- "B" Bonds	*(0.7)*	*9.8*	*9.5*
Global Bonds, Unhedged	(3.3)	5.7	11.9
Global Bonds, Hedged	(1.5)	(0.5)	4.5
Emerging Market Bonds	(5.9)	4.8	10.4

U.S. Equities – Forward to the Rear?

(As we go to print, the S&P 500 index stands at 1096)

The broad S&P 500 index of companies ended the first quarter with a value of 1126, and the second quarter with a value of 1141. In between, it varied remarkably little from this range. April was the "difficult" month because of rising bond yields and rising inflation fears, but it brought just a 1.6% decline. Equity prices recovered in both May and June, but just enough to produce the same 1.7% return as the first quarter.

A few years ago, major stock market indices seemed to often rise or fall 1-2% each day, let alone for an entire month. This year, some of highest equity markets volatility has come since the second quarter ended, with

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the S&P index down 4.8% and the Russell 2000 off 8.8% during the first three weeks of July.

Per Table 5, the quarter's modest monthly volatility ultimately resulted in very modest forward momentum for any market sector. The "market cap/style differential" was a low 2.1% for the three months (large-cap growth vs. small-cap growth). The "cap effect" narrowly favored *large*, but "style" (favoring *growth* in larger stocks, and *value* in smaller) also had an impact. The past year's market environment has clearly favored a smaller-cap and value bias, as have the last 3 years.

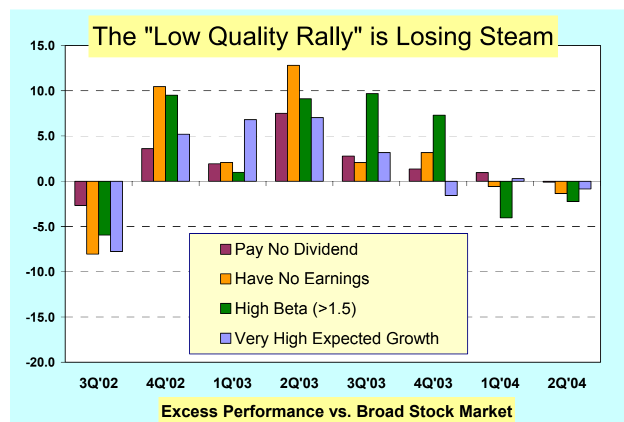
Table 5. Equity Returns by Style/Market Cap

Periods ended June 30, 2004; indices are cap-weighted

	2Q04	1 Year	3 Years
Growth			
Large Cap	2.2	15.6	(4.7)
Mid Cap	1.1	27.3	0.2
Small Cap	0.1	31.5	(0.2)
Value			
Large Cap	0.5	17.1	0.1
Mid Cap	1.7	30.8	9.8
Small Cap	0.8	35.2	12.2

We've recently been tracking the performance of stocks with certain unambiguously risky characteristics, like no current earnings, a history of extreme share price volatility, and a current expectation of very high growth (realized high growth is great, of course, but projecting it is risky). Chart 2 explores this theme through the second quarter. It appears these risky themes may be playing themselves out as drivers of excess return.

Chart 2. Equity Investors Rotate to "Fundamentals"



Per Table 6, the quarter's unambiguous stock winners were to be found in the energy and industrials (cap goods, transportation, defense) areas, where every industry group was a winner. Among the "big three" sectors (financials, health care, and technology) the weakness in financial services stocks stands out. The financial sector in each market cap bucket (Large cap, mid-cap, and small-cap) declined during the second quarter, as robust employment gains escalated concerns that inflation and short term interest rates would shortly begin an inexorable upward climb. With short maturity borrowed funds the most important "raw material" for financial companies, any sustained rise in its price is seen as hurting margins. Only life and health insurers avoided the carnage, which makes sense.

Table 6. U.S. Equities – Selected Sector Performance

(Cap-weighted data; Vestek- 6,900 stocks)	**S&P 500**		**Non S&P**	
Sector *(% of S&P)*	**2Q04**	**1-Yr**	**2Q04**	**1-Yr**
Financial Srvcs *(20%)*	(2.4)	19.3	(2.3)	26.8
Technology *(17%)*	2.9	25.8	(5.2)	25.8
Health Care *(13%)*	2.7	5.4	3.1	38.7
Cons. Non-Durables *(9%)*	2.6	21.1	3.5	31.3
Retail *(7%)*	(4.6)	11.9	(0.7)	32.9
Utilities *(6%)*	(1.0)	9.3	1.3	23.6
Energy *(6%)*	7.5	31.8	9.4	38.4
Cons. Services *(5%)*	(1.4)	8.0	(1.3)	7.7
Bus. Equip&Srvcs *(4%)*	11.2	32.6	2.1	31.3
Capital Goods *(3%)*	8.3	47.9	5.0	42.9
Raw Materials *(2%)*	2.0	31.4	3.0	45.7
Transportation *(2%)*	9.0	17.9	11.6	34.4
Shelter *(1%)*	(0.2)	31.2	(5.4)	30.0
Consumer Durables (*1%*)	8.1	41.7	3.5	45.1
Universe	***1.7***	***19.1***	***(0.1)***	***29.2***

The quarter's low intraperiod volatility and lack of consistent price momentum would normally favor active managers, while the negative market cap effect (large cap did better than small-cap) favors the index instead of active managers. This suggests managers were substantially reliant on their sector/industry allocation and individual security selection decisions in order to make a difference during the quarter.

International Investing Slows Its Pace

In Dollar terms, international equities relinquished their front-running position over domestic large cap equities in the 2nd quarter. Generally speaking, this was due to the Dollar's 2.1% rise versus the basket of EAFE currencies. The Fed's announcement of a return to a more neutral monetary policy created demand for the US$ (i.e., helped strengthen it), despite increased

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widening of the US trade deficit and current account deficit. The US$ appreciation hid the fact that many foreign markets generated stronger returns in *local currency* terms. Most European markets gained between 1.8% and 8.5% in local terms, but major Pacific Rim markets (in particular, Japan, Hong Kong, Taiwan, and Korea) were weaker in local terms (see Table 7).

Table 7. International Equity Markets

Cumulative % returns for the periods ended June 30, 2004

	2Q '04		One Year
	Return In US$	Change in Currency	Return In US$
EAFE *(100%)*	**0.4%**	**(2.1)%**	**32.9%**
- EAFE Growth	(1.3)	-	26.8
- EAFE Value	2.1	-	39.0
Europe *(69%)*	2.4	(0.9)	29.4
Pacific ex-Japan *(7%)*	(4.0)	(5.0)	41.5
Japan *(24%)*	(3.8)	(4.7)	46.4
MSCI EMF	**(9.6)**	**(1.5)**	**33.6**

Data source: Capital Guardian

Concerns over higher oil prices (peaking at over $42/barrel), prospects of higher US interest rates, fears of a significant "engineered" slowdown in China, and continued tension in the Middle East, were the reasons most attributed to the sluggish quarter for international equities. Stock exchanges in emerging markets were the most effected, and the relevant index declined 10%.

During the quarter, international growth stocks once again fell short of value stocks, creating a 4.2% differential on a year to date basis (2.7% for EAFE Growth and 7.0% for EAFE Value). Small cap stocks also continued to outperform their larger counterparts, and the valuation gap between small and large cap stocks has expanded to multi-year highs (with small-caps now relatively expensive). This valuation gap, coupled with a higher interest rate, slower growth environment may set the stage for larger, higher quality stocks with less interest rate sensitivity to perform well.

Economic growth remains lackluster across many European countries (with the exception of the UK). Expected GDP growth in Continental Europe is 1.6% for 2004, hindered by weak prospects in Germany and Italy. Nevertheless, improvement in domestic consumption and business confidence without accelerating inflation ***is*** evident, and its gradual nature takes pressure off the ECB to raise interest rates.

With market interest rates already higher than in the US, performance in the non-U.S. bond markets is expected to be quite strong relative to the domestic one.

Japan has been experiencing a strong economic recovery, with GDP growing at a 6.1% annualized rate in the first quarter. Japan's growth is being driven by increased demand for exports from the US and China, a decline in their domestic savings rate and an acceleration in business spending. Business confidence reached its highest level since the burst of the asset bubble in 1991. But, this good news did not prevent second quarter returns for Japan and the Pacific Rim from being negative for the quarter, due to investors' fears of the impact a slowdown in China's economy will have on the region.

The Russian market, which occupies a high "share of mind" among emerging markets investors (even though its companies account for only 5% of the index), posted the weakest 2nd quarter result, falling 20% on political developments related to Yukos, the country's largest oil company. Finland was the developed markets' weak sister, declining 19.5%.

From a sector perspective, developed market energy firms, consumer staples (especially European household products firms), health care (especially European healthcare equipment, *not drug*, companies), and utilities were the leaders. Information technology (especially tech hardware and equipment makers in Europe and emerging markets) and telecommunications services firms were the quarter's laggards. So far this year, utilities and energy stocks are strong across the globe, but so are consumer companies in Europe and Japan (*especially* retailers).

Table 8. Int'l Equities - Sector Performance

MSCI Sector	**2Q04**	**YTD 2004**
Energy	7.2	7.5
Materials	0.0	0.7
Industrials	(0.9)	7.3
Consumer	2.4	9.2
Consumer Staples	3.6	9.0
Health Care	3.0	2.7
Financials	(1.2)	3.1
Information	(7.4)	4.2
Telecommunications	(2.9)	(2.9)
Utilities	2.9	10.2
MSCI EAFE	**0.4**	**4.9**

Data Source: Capital Guardian; Returns in US$

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Back Page Perspectives

The Government reports its first estimate of 2nd quarter GDP growth on July 30th. The official "street estimate" is 4.3%, but this was revised up from 3.7% back in January. Most economists and strategists have quietly taken their January forecast off the table, and replaced it with 3.5% to 3.9%.

China's explosive growth may *slow*, but it will not *stop.* Japan and other Pacific Rim countries will continue to be big beneficiaries of China's growth. Further, some moderation in China's commodities demand, especially for metals and industrial feedstocks, will reduce global inflation pressures, including those evident in the U.S.

Cumulative returns on investment in the global capital markets since July 2002 have favored non-U.S. versus domestic, and stocks versus bonds, as follows-

Asset Class	**Cumulative Return %**
U.S. Investment Grade Bonds	6%
Global Investment Grade Bonds	15%
Emerging Markets Stocks	71%
U.S. Small Cap Stocks	67%
EAFE Market Stocks	56%
U.S. Large Cap Stocks	44%
U.S. High Yield Bonds	43%

These are heady returns, except for the U.S. investment grade bonds. With the bitter memory of what happened during the two prior years, it's tempting to explain 2004's weak equity market by observing that price improvement simply has proceeded too far, too fast.

But, closer analysis suggests it is not that simple. Two years ago, S&P 500 index investors were paying $820 for $41.61 of trailing, or $52.00 of projected, operating earnings (which represented an overly optimistic forecast, as the actual number turned out to be $48.95). This worked out to a P/E of either *19.7x or 15.8x*, depending on your willingness to discount the uncertain future. The 10-year bond's yield was 4.51%. The S&P was cheaper than bonds by the biggest margin in 15 years, and we urged each of our clients to overweight equities. (It worked out okay – see above)

Today, you'll pay $1,096 for the S&P 500 index, and capture $61.47 of trailing or $68.60 of projected corporate earnings. This works out to a P/E of *17.7x or 15.8x*, depending on your willingness to discount the uncertain future. The 10-year bond's current yield is 4.44%. Thus, on the same basis as two years ago, the stock market's current valuation appears to present one of ***the*** buying opportunities of the past 17 years.

Assuming an excessively cheap stock market doesn't occur all that often, what else might be going on here? Perhaps investors believe interest rates are going to rise sharply from current levels, despite recent signals that economic growth is moderating. This might cause stocks to get even cheaper (but if so, why hold bonds?). Another scenario which makes sense of current circumstances is that corporate earnings are soon going to decline, instead of rising as projected.

These two scenarios each suggest the onset of the "S-word". Stagflation. An environment of rising consumer and producer prices, without the attendant increase (perhaps even a decrease!) in consumption. Supply constraints without the demand, causing the sales volumes of both service and manufacturing firms to flatten, margins to ultimately erode, and profits to fall. The overly leveraged consumer won't be able to increase spending as interest rates rise and wage levels don't. Our trading partners will keep the Dollar at its relatively high valuation despite massive trade and fiscal deficits, in order to keep their factories running to supply us with artificially cheap goods, effectively hollowing out our industrial base. Stock prices don't rise, because corporate profits don't rise, and bond prices fall because interest rates go up to account for the rise in inflation. Only cash will be king. Etc., etc., etc.

Few acknowledge a serious bout with stagflation is on the horizon (and we're **not** one of them). But, it's about the only explanation for the recent relationship between stocks and bonds.

That said, and despite the above table, there are some seeds of validity in the stagflation concerns. That's why we pulled our July '02 "overweight equities" recommendation in January of this year, in favor of a more neutral posture. But, we continue to recommend investors keep above their international equity and international debt allocation targets, and consider strategically establishing or increasing emerging market allocations. Overseas markets are still attractively valued relative to the U.S., and they offer the additional benefit of currency diversification. Our massive current account and fiscal deficits almost ensure the Dollar's devaluation, especially in a stagflation environment.

Finally, if inflation and interest rates are really shifting into a higher gear, shouldn't your strategic asset allocation targets explicitly take this into account?

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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