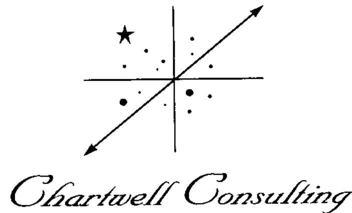

CHARTWELL REVIEW

January 2004 **FOURTH QUARTER 2003** Volume X, Issue No.4

Bubble II: The Sequel?

Twelve months ago, we wrote: *"Aversion to return uncertainty is higher than ever. Because of this, guaranteed returns are at 40-year lows and potential returns on risk capital haven't been better in years."*

From our lips to the market's ears, apparently. As Tables 1 & 2 confirm, the greater an asset classes' perceived riskiness, the higher its return in 2003. Thus, emerging markets equity, international and domestic small-cap stocks, and high yield bonds have led the way up, with all equity sectors participating. Government bonds did poorly in 2003.

The predominant theme of most year-end investment letters we've read has been – *what a difference a year makes.* When it comes to current portfolio valuations, we'd agree. But, investors' fears of January 2003 have simply evolved into today's investor uncertainty. The economy's grown for nine straight quarters, at an average rate of almost 4%, *but is this growth sustainable?* Quarterly corporate profits have increased for eight straight quarters, and will be up nearly 20% for 2003, *but can they continue to grow?* Consumer inflation was only 2% in 2003*, but overall producer prices rose 4%. How long will it be before the Fed starts raising interest rates, and won't that collapse stock prices?* A classic investors' wall of worry.

We think things are really pretty much the same as last January, when we also wrote – "*Regardless of how uncertain the investment future now seems, we've still got to work the problem. Doing so requires that we apply some perspective and forward focus in figuring our next moves.*"

Table 1. Index Benchmarks

Market Index	**Q4**		**Trailing Returns ***		
	2003	**1Yr**	**3Yr**	**5Yr**	**10Y**
S&P 500	12.2	28.7	(4.1)	(0.6)	11.7
U.S. Large-cap Stocks	11.7	26.7	(6.0)	(2.4)	10.9
U.S. Mid-cap Stocks	14.0	42.7	(6.1)	2.0	9.4
U.S. Small-cap Stocks	14.5	47.3	6.3	7.2	9.5
International Stocks	17.1	39.2	(2.7)	0.2	4.7
T-bills (3 month)	0.2	1.3	2.9	3.8	4.4
1-3 Year Treasuries	0.2	1.9	5.3	5.4	5.7
Aggregate Bonds	0.3	4.1	7.6	6.6	7.0
High Yield Bonds	6.4	30.6	10.7	5.4	7.3
Global Bonds, hedged	(0.1)	2.0	5.4	5.6	7.3
CPI, **annualized**	(0.5)	1.9	2.0	2.4	2.3

* Annualized trailing returns for periods ending 12/31/03.

Table 2. Average Mutual Fund Returns

Fund Category	**Q4**		**Trailing Returns ***		
	2003	**1Yr**	**3Yr**	**5Yr**	**10Yr**
U.S. Large-cap	11.7	28.1	(5.0)	0.0	9.5
U.S. Mid-cap	12.6	35.9	(1.6)	6.4	10.5
U.S. Small-cap	14.3	45.4	6.6	10.8	11.3
International Lg. Cap	15.8	35.8	(2.4)	2.4	5.4
International Sm. Cap	15.4	52.6	5.1	11.8	9.2
Emerg. Mkt. Equity	17.8	56.4	12.3	11.7	0.6
Balanced/Hybrid	7.3	18.8	1.1	3.2	8.1
General Bond	0.5	4.8	6.8	5.9	6.1
Government Bond	0.1	2.2	6.0	5.6	5.9
High Yield Bond	5.7	24.4	8.2	4.0	5.5

* Annualized trailing returns for periods ending 12/31/03.
Source of fund's data: Morningstar

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January marks Chartwell's 10th anniversary as an independent investment consultant. We've succeeded without any "pay to play" arrangements with the investment community. As you know, such conflicted arrangements are now undergoing an SEC investigation.

This "*Review*" also marks our 40th quarterly commentary on investment markets, each one of which has afforded us the opportunity to do a fair amount of research on where we are(were), how we got there, and where we might be headed. We've tried to share some of that long-term perspective in the following sections.

The Economy

Third quarter GDP growth was at a seasonally adjusted annualized rate of 8.2%, which pretty much shocked everybody. In the July "blue chip" survey of economists (perhaps an oxymoron), the highest guess for 3Q growth was 5.4%. Per Table 3, primary drivers were the sharp rise in personal consumption, very strong investment spending – for both business equipment/software and residential housing, and robust export growth (the latter for the first time since 2nd quarter 2002).

Table 3. Contributions to 3rd Quarter GDP

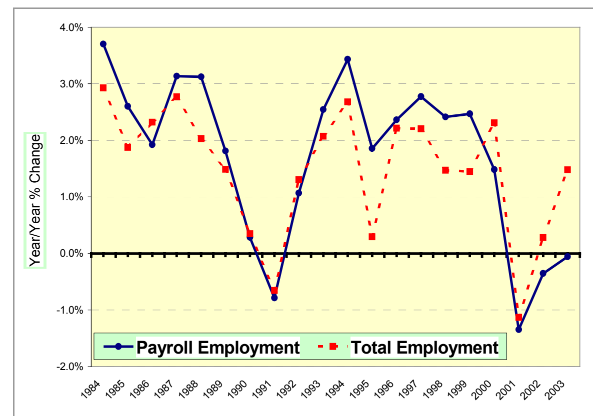
Factor	Contributed …	…By Rising
Personal Consumption	**4.89%**	**6.9%**
Fixed Investment	**2.30**	**15.8**
(- by Businesses	*1.25*	*12.8)*
(- by Consumers	*1.05*	*21.9)*
Chg. in Inventories	**-0.13**	**na**
Exports	**0.92**	**9.9**
Imports	**-0.12**	**0.8**
Government Spending	**0.34**	**1.8**
Real GDP	**8.2%**	**na**

The strong 3rd quarter result combined with a string of highly positive monthly data items to ratchet up expectations for the 4th quarter (and beyond). Current forecasts are for 5% growth, which would mean that GDP grew by 4.5% for the full year, compared to just 0.5% in 2001 and 2.2% in 2002. *This would equal the highest annual percent change since 1984 (tied with 1997 and 1999).*

Five basic economic issues concern investors –

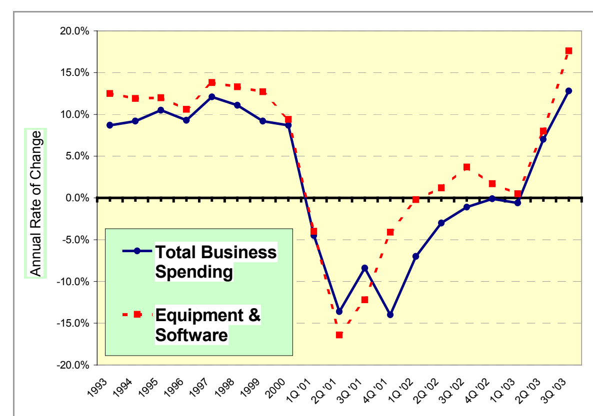
Consumer spending - During the past year, real consumer spending growth averaged 3.7%, but was topped by a 6.9% annualized rate during the 3rd quarter. This is an average result compared to the prior ten years. What bothers economists is the anemic growth in median real wages/salaries, which changed by only +0.1% in 2003. Consumer spending growth in 2003 was largely driven by income tax reductions and mortgage refinancings (which are not sustainable events), rather than growth in take-home pay.

Chart 1. Annual Employment Growth: 1984 - 2003



To explain the low real wage growth, economists point to modest **employment growth**. Chart 1 tracks long-term historical growth rates for employment. Payroll employment was flat from December '02 to December '03, and has *fallen* over the past three years. But, total employment (based on household data) grew by 1.5%, or 2 million persons, in 2003, with nearly 40% occurring in the 4th quarter. It has *risen* over the past 3 years.

Chart 2. Annual Change in Business Spending



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Business spending - Although a small component of GDP compared to consumer spending (even government spending is a much larger component), commentators keep an eye of this area for indications of business financial health and optimism. The last two quarters have seen a notable resumption of business spending growth, as Chart 2 reflects. Many expect business spending to continue growing at a double-digit pace throughout 2004.

Our trade account and fiscal deficits - Both deficits are growing quickly, and are each expected to approach $500 billion in 2004. After a major currency devaluation, our monthly trade deficit finally dipped in November, to $38 billion, down from the $40bn/month rate we've seen for most of the year. Yet, the trade deficit's most notable impact during the quarter was simply the continuing decline in the Dollar, which fell 7.9% versus the Euro and 4.2% versus the Yen. This precipitated a moderate acceleration in import and export prices, which rose at annual rates of 3.3% and 4.1%, respectively, during the quarter.

The inflation picture - The raw Consumer Price Index declined in the 4th quarter, and was flat after seasonal adjustments. For the full year, the CPI rose just 1.9%. Conversely, the producer price index for finished goods rose at a seasonally adjusted annual rate of 3.1% in the quarter, and 4.0% for the year. The all commodities component rose 18% in 2003, including a 12.3% gain in crude energy prices. The CPI rose less in 2003 than it did 2002, but few people are worried about *de*flation any longer.

The Bond Market

(As we go to print, the 10-year Treasury bond now yields 4.08%)

Risk-free interest rates rose 20 to 40 basis points during the 4th quarter, depending on maturity, leading to net investment losses for investors in government bonds and weak returns in other sectors (see Table 4). Handling interest rate exposure was a difficult proposition for bond managers throughout 2003. The benchmark 10-year Treasury started the year yielding 3.83%, but price declines saw its yield rise to 4.26% by year's end. In between, it hit 3.11% and 4.66%. This equates to price risk of 12.6%, which hardly seems compensated for by the meager 4.25% coupon.

Table 4. Fixed Income Sector Returns

Periods ended Dec. 31, 2003; indices are cap-weighted

Index (% of Aggregate)	**4Q03**	**1 Yr.**	**3 Yrs.**
Aggregate Bonds *(100%)*	**0.3**	**4.1**	**7.6**
US Gov't, all *(34%)*	(0.4)	2.4	7.0
- US Treas, long (7%)	*(1.2)*	*2.5*	*7.6*
Mortgages *(35%)*	0.9	3.1	6.7
Inv. Grade Credit *(27%)*	0.5	7.7	9.5
- "BBB" Bonds (11%)	*1.2*	*11.8*	*10.2*
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High Yield Bonds	5.9	28.2	9.5
- "B" Bonds	*5.9*	*29.5*	*10.4*
Global Bonds, Unhedged	5.2	14.9	10.8
Global Bonds, Hedged	(0.1)	2.0	5.4
Emerging Market Bonds	5.3	28.8	13.5

Bond investors again focused most aggressively on the corporate sector during the 4th quarter. Adjusted for maturity, credit spreads declined further in the quarter, as prices for these bonds stayed high. The overall Credit bond index now yields only 110 bps over the Treasury index, down from 140 bps in September and *250 bps* just fifteen months ago.

A record $27.9 billion of new money was added to high yield mutual funds last year, more than the prior four years combined, as improving credit quality trends extended investor interest. This demand caused high yield bonds to rally strongly in the 4th quarter and throughout the year, as investors sold low yield Treasuries. But, the overall high yield sector now enjoys a yield spread over comparable Treasuries of just 360 bps (down from 870 bps just one year ago).

As 2004 begins, we think the most intriguing fixed income sector is that of emerging market bonds. The sector has performed extraordinarily in recent periods, as Table 4 reflects. Such is usually not a favorable indicator for future returns, but EM debt retains two highly positive characteristics – comparatively high yields and improving credit quality. Emerging market bonds offered a yield spread over comparable Treasuries of just over 400 basis points at year-end, which compares favorably to domestic high yield bonds. Yet, investment grade countries now make up almost 50% of the EMBI index, up from less than 25% just five years ago.

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Domestic Equities

(As we go to print, the S&P 500 index stands at 1144)

Domestic equity sectors advanced sharply during the fourth quarter (see Table 5), with a decided rotation toward value in every market cap range. Compared to 3rd quarter results, "value and smaller" replaced "smaller and growthier".

Table 5. Equity Returns by Style/Market Cap

Periods ended Dec. 31, 2003; indices are cap-weighted

	4Q03	1 Year	3 Years
Growth			
Large Cap	10.0	26.6	(10.1)
Mid Cap	12.2	42.8	(6.1)
Small Cap	12.7	48.6	(2.0)
Value			
Large Cap	13.7	26.8	(1.8)
Mid Cap	15.2	38.1	8.5
Small Cap	16.4	46.1	13.8

In 2003, equity investors evidenced a notable risk preference, compared to their risk aversion of 2002. Volatile and speculative stocks outperformed more defensive "blue chip" names. Money managers have characterized the current bull market as a "junk stock" rally. In what seems to be a triumph of hope over reason, companies with no current earnings (P/E = "na"), no dividends, micro cap stocks, and companies with *projected* EPS growth rates of greater than 20%, performed well compared to the broad market.

Chart 3. Equity Investors Continue to "Buy Risk"

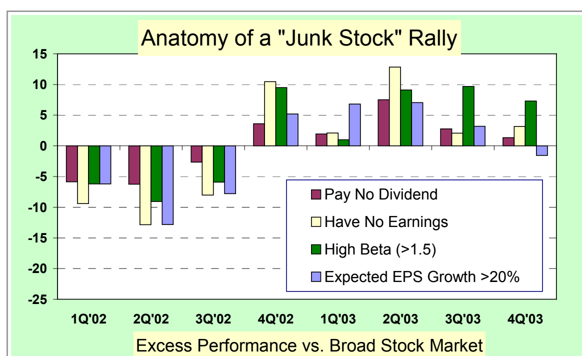

Chart 3 reflects our updated analysis of the junk stock rally through the 4th quarter. The preference for high volatility stocks has clearly not abated. The other junk factors appear to have slightly weakened their grip on investors during the fourth quarter, but not released it.

From an economic sector perspective (Table 6), large-cap stocks in areas highly sensitive to the business cycle (technology, capital goods, and raw materials) again led the quarter's advance. They were joined in the quarter by the energy and services sectors. In contrast, health care, utilities, and consumer non-durable stocks continued to underperform. Smaller cap companies (Non-S&P) have benefited across the board from intense buying pressure this year, with tech stocks most positively impacted (the non-S&P return figure for the multi-industry sector is a special case).

Table 6. U.S. Equities - Sector Performance

(Cap-weighted data; Vestek)	S&P 500		Non S&P
Sector (*% of S&P*)	4Q03	1-Yr.	1-Yr.
Financial Services (20%)	11.9	31.1	33.9
Technology (18%)	13.3	44.9	66.6
Health Care (13%)	8.3	15.0	62.3
Consumer Non-Durables (9%)	12.0	18.3	24.8
Retail (7%)	5.0	25.2	44.9
Utilities (6%)	10.9	14.8	43.9
Energy (6%)	15.3	25.9	28.4
Consumer Services (5%)	15.1	33.4	30.2
Multi-Industry (4%)	9.6	33.9	123.5
Business Equip. & Serv. (3%)	14.5	37.4	54.6
Capital Goods (3%)	23.8	46.2	46.6
Raw Materials (2%)	25.6	39.6	37.7
Transportation (2%)	13.6	19.9	44.6
Shelter (1%)	13.3	37.8	44.3
Consumer Durables (1%)	23.6	41.9	50.6
Universe	**12.2**	**28.7**	**44.4**

The domestic equity market has advanced in 9 of the past 10 months, on its way to a 30+% one year return. You have to go back to mid-1996 to find a stretch of such consistently excellent returns. Investors shouldn't be surprised or dismayed if there is a short-term break, even a significant one, in this upward advance. In August 1998, the S&P fell 14.5%, but advanced 28.6% that year.

International Equities Breakout

For a second consecutive year, international equities (as measured by the MSCI EAFE index) outperformed our domestic equity market (as measured by the S&P 500) in 2003. The margin of outperformance has been so large that until one looks at trailing *seven*-year cumulative returns, international equities are ahead of domestic.

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Currency revaluations have played a large role in recent results (Table 7), and the fourth quarter was certainly no exception. The US$ continued to weaken sharply against the Euro, the British pound sterling, other European currencies, the Yen and the Aussie Dollar.

Table 7. International Equity Markets

Cumulative % returns for the periods ended Dec. 31, 2003

	4Q03		One Year	
	Return In US$	Change in Exchange	Return In US$	Change in Exchange
EAFE *(100%)*	**17.1**	**7.1**	**39.2**	**15.2**
- EAFE Growth	15.7	-	32.5	-
- EAFE Value	18.5	-	46.0	-
Europe *(68%)*	20.4	7.9	39.1	15.7
Pacific *(31%)*	9.8	5.1	39.0	13.9
- Japan *(21%)*	8.4	4.2	36.2	10.7
MSCI EMF	**17.8**	**0.2**	**56.3**	**6.5**

Data Source: Capital Guardian

During the fourth quarter, European and emerging markets were the strong performers, while the Pacific region including Japan posted positive, but lagging returns. For the year, emerging markets were the clear winners, although EAFE's 39% return can hardly be considered shabby. Value stocks significantly outperformed growth stocks and (as in the US) small cap companies outperformed large cap companies.

The best performing economic sectors in the quarter were: Energy & materials (reflecting the world's rapidly rising commodities prices), financials and telecommunications (Table 8). For the year, these sectors plus technology and industrial firms topped the list.

A significant development during the quarter was the decision of European finance ministers allowing Germany and France to avoid financial penalties for breaking the fiscal deficit rules of the European Monetary Union's stability and growth pact. Perhaps more importantly, the recent earnings season was a strong one for European companies and higher revenue growth was evident. The German stock markets advanced 37% in local terms last year, with the Euro's revaluation adding 21% for U.S. investors.

Table 8. Int'l Equities - Sector Performance

MSCI Sector	4Q03	1-Year
Energy	20.8	27.0
Materials	22.8	49.3
Industrials	15.4	49.2
Consumer Discretionary	15.8	37.2
Consumer Staples	12.2	23.2
Health Care	15.7	28.5
Financials	19.4	48.1
Information Technology	10.3	48.9
Telecommunications	19.0	40.4
Utilities	16.8	31.8
MSCI EAFE	**17.1**	**39.2**

Data Source: Capital Guardian; Returns in US$

Structural improvements in the Japanese economy, strong Chinese demand, overall economic growth and rising commodity prices bolstered market performance in the Pacific region. Australian and New Zealand markets had the strongest returns in the region, owing much of their gains to currency translations (11% appreciation versus the US$ in the quarter, and over 25% for the year). Hong Kong and Singapore markets posted sluggish returns for the quarter, but both benefited from the resurgence of technology and property stocks in 2003.

Like the developed markets, emerging markets saw their greatest gains in materials, energy, industrials and consumer discretionary sectors. Latin America was the best performing emerging market region for the quarter and the year. Brazil, Colombia, Argentina, Chile and Peru all rose sharply, with Mexico lagging. Social reforms, positive economic news and rising commodity prices contributed to strong market performance in these countries. In Asia, Thailand, China and India all posted strong returns. Taiwan and South Korea were positive, but weaker contributors.

A popular misconception is that international returns have lagged the U.S. in local currency terms because foreign firms have weaker earnings, cashflows, or balance sheets. But as of year-end, the price/book ratio of U.S. firms was 3.15x, versus only 1.66x for Japanese, 1.99x for the EAFE index companies, and 2.13x for European firms. Price/cash earnings for the U.S. market was 13.6x; for Japan – 8.4x; Europe – 9.1x; and MSCI Emerging Markets – 9.1x. Dividend yields were: U.S. – 1.6%; Europe – 2.8%; Japan – 1.0%, and Emerging Markets – 2.3%.

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Perspectives

Many investors are concerned the domestic stock markets are "ahead of themselves", and will soon fall quite sharply. In one sense, that concern is good for the market. We've again updated our research on the domestic equity market's valuation relative to "risk-free" bonds. Modest, single-digit, appreciation from current levels seems a reasonable assumption for 2004. We think it will require improving investor sentiment *and* expected earnings growth, which is just how we see things unfolding.

Nevertheless, it would be unprecedented for the domestic equity markets to simply rise month after month without correction, even in the middle of a roaring bull market.

Check out the last column of Table 1. Over the past ten years, a simple style neutral 60/40 allocation between domestic equity and fixed income provided investors an annualized **real return** (i.e., after inflation) of over 7% (it would have been higher if you were style-biased toward value investing). *How* we got to that number over the past 10 years created many issues for investors, but only because short-term return volatility was so high.

The average annual rate of *real* GDP growth during the past 10 years has been 3.43%, which is almost exactly what it was during the prior ten years. Inflation averaged only 2.3% over the past ten years, but 3.7% during 1984-93. Most academics would tell you the lower inflation environment was less risky for investors. Yet, during 1984-93, a simple style neutral 60/40 allocation between domestic equity and fixed income would have provided an annualized **real return** of almost 10%, or 3% better than the last decade's. If long-term GDP growth and inflation rate shifts don't fully explain long-term real returns, how excited should institutional investors get about short-term economic data?

After 4 months, the NY Attorney General's investigation of bad mutual fund governance and management appears to be focusing on its true purpose – fees and costs charged to manage these investment portfolios (that's all a mutual fund is) are unjustifiably high compared to the fees and costs absorbed by separately managed institutional accounts of similar size. He's following the money, because the total economic harm done to investors as a result of all market timing trades will prove to be a pittance compared to this issue.

We believe the country's twin deficits are ultimately unsustainable at 2004 levels. The Dollar will be prone to continued decline until global behavior is affected enough to reduce the trade deficit, even if central bankers are willing to prop it up in the short term. Treasury bond prices will be prone to decline as well, as the Federal government sells more bonds into lesser demand. We think the *future strategic implications* for investors are –

- You need to dial down your ***real return*** expectations, or dial up your risk taking;
- Domestic Treasury Bond yields will be flat to rising, and when they rise is apt to be quite independent of domestic issues. Our general "long credit risk, short interest rate risk" fixed income recommendation remains;
- The Dollar's weakness will provide additional opportunities for global investors versus purely domestic ones. As a tactical matter, we continue to recommend investors keep above their international equity and debt allocation targets, and strategically establish or increase emerging market allocations;
- Both deficits are very stimulative to the economy in the short term, provided inflation doesn't ramp up too quickly. Corporate volumes and margins will continue to be favorably impacted, ultimately benefiting corporate earnings;
- However, due to valuation levels, we would be careful to keep overall equity allocation in line with strategic targets. In effect, the shelf life of our "overweight stocks" recommendation in July 2002 is finally approaching its expiry date.

See you next quarter!

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

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