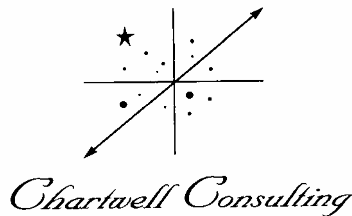

CHARTWELL REVIEW

January 2005 **FOURTH QUARTER 2004** *Volume XI, Issue No.4*

Wave of Despair

A check of this report's masthead, and some quick math, reveals we've had the privilege on 44 occasions to write this quarterly commentary about investment market developments affecting our clients. In three of those cases we've felt the quarter's real news wasn't about finance, economics, or investing at all. In the first two, October '01 and April '03, it was about man's inhumanity to man. This time it's all about December 26th, when in the space of a few hours we were reminded that nature's inhumanity to man can be so much more powerful. Our prayers go out to the millions of people whose lives were either ended or irretrievably changed by the tsunami. The situation is really very hard for someone sitting 8,000 miles away to even grasp. There isn't any level of response which is "appropriate". We simply need to do all that we can (sermon ends).

As the tables at right reflect, the fourth quarter "made the year" for most equity strategies, and the year seems to have made the past three years. The latter isn't precisely correct, because 2003 more than cancelled out 2002's market capitulation, except in the domestic large-cap sector. Weak 3-year and 5-year trailing returns are really a function of ~150 of the world's largest cap growth stocks (from an investable universe numbering in the thousands). As we now know, they were over-loved, over-owned, and overvalued. But, five years ago few of us admitted to such a thing, and even three years ago we clung to them and kept them the largest part of our investment portfolios. There are some fundamental investment lessons in all that, but they are really hard to learn (and to teach).

Table 1. Index Benchmarks

Market Index	Q4 2004	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	9.2	10.9	3.6	(2.3)	12.1
U.S. Large-cap Stocks	8.4	8.3	1.7	(4.6)	11.6
U.S. Mid-cap Stocks	13.7	20.2	12.2	7.6	14.5
U.S. Small-cap Stocks	14.1	18.3	11.5	6.6	11.5
International Stocks	15.2	20.8	12.7	(0.5)	6.2
T-bills (3 month)	0.4	1.2	1.3	2.8	4.0
1-3 Year Treasuries	0.0	0.9	2.8	4.9	5.7
Aggregate Bonds	1.0	4.3	6.2	7.7	7.7
High Yield Bonds	4.7	10.1	12.3	7.1	8.4
Global Bonds, ½ hedged	5.1	7.7	9.9	8.4	8.3
CPI, **annualized**	3.0	3.3	2.6	2.5	2.4

* Annualized trailing returns for periods ending 12/310/04.

Table 2. Average Fund Returns

Fund Category	Q4 2004	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	9.6	10.4	3.2	(1.4)	10.9
U.S. Mid-cap	12.4	15.8	7.8	3.7	12.7
U.S. Small-cap	13.4	16.7	10.6	8.4	13.2
International Lg. Cap	14.4	18.8	11.6	(0.3)	7.5
International Sm. Cap	15.6	26.1	22.1	5.4	11.0
Emerg. Mkt. Equity	16.2	23.6	21.7	5.4	4.7
Balanced/Hybrid	6.3	8.2	5.2	3.0	9.3
General Bond	1.1	4.2	6.0	7.2	7.3
Government Bond	0.8	3.4	5.0	6.5	6.7
High Yield Bond	4.4	10.0	10.8	5.4	6.9
Hedge Funds Universe	*5.5*	*8.3*	*8.6*	*7.7*	*11.6*

* Annualized trailing returns for periods ending 12/31/04.
Source of fund's data: Morningstar; Hennessee

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Knowns, Unknowns (known) and Surprises

The quarter's, and perhaps the year's, biggest surprise for investors was the continued decline in longer-term U.S. bond yields, even as the Fed kept to its pre-announced measured pace of increasing short-term interest rates. This almost unprecedented process has played out over the past six months. A consensus among bond managers has developed around the idea that the yield curve will not flatten much more, with rising short rates in 2005 leading to rising long rates.

U.S. stocks staged a strong post-election "Santa Claus" rally during November and December. Its magnitude surprised many investors, who had previously "discounted" strong corporate earnings.

Market data failed to show signs of accelerating prices during the quarter, despite the depreciating Dollar, continuing record current account deficits, and a burgeoning federal budget deficit. All three are "supposed" to be pro-inflation, but other factors – especially the lack of global aggregate demand, have constrained prices.

Developments in the Economy

Late in the 4th quarter, the government issued its final report on real GDP growth for the *3rd* quarter. Investors learned our domestic economy grew at an annual rate of 4.0%, quite a bit above the 3.3% growth rate for the second quarter. The news wasn't all good. In nominal terms (before inflation was factored out), growth was a relatively low 5.5%.

Consumer spending – The biggest contributor to the 3rd quarter's economic activity was an unexpected pop in personal consumption spending. This was concentrated in durable goods – especially motor vehicles. But, disposable personal income rose much less in the quarter than did personal spending. In effect, consumers reduced their already low savings rate to its lowest level ever, at less than 0.5%, in order to increase expenditures. That trend was again highly evident in October, but less so in November.

With consumers down to spending nearly all they make, disposable income growth and incremental borrowing capacity are the critical factors determining future spending growth. The former rose just 2.4% in real terms in 2003, and is up 2.4% annualized so far this year. (Not so good)

Table 3. Contributors to Third Quarter GDP

Factor	Contributed …	…By Rising
Personal Consumption	**3.57%**	**5.1%**
Fixed Investment	**1.37**	**8.8**
(- by Businesses	*1.27*	*13.0)*
(- by Consumers	*0.09*	*1.6)*
Chg. in Inventories	**(0.97)**	**na**
Exports	**0.59**	**6.0**
Imports	**(0.69)**	**4.6**
Government Spending	**0.13**	**0.7**
Real GDP Growth	**4.0%**	

This has shifted focus squarely onto the issue of whether consumers are in a position to continue borrowing, or must cut back. To help answer this, the Federal Reserve tracks the "financial obligation ratio", or FOR, adding up rent, mortgage, consumer debt, auto lease, home insurance and property tax payments compared to current disposable income. As we entered the 4th quarter, the combined FOR was estimated to be 18.3%. It peaked at 18.9% at the end of 2002, and was 18.0% five years ago. (Not so bad)

Business Spending – nonresidential fixed investment (business spending on property, plant and equipment) again rose at a double-digit annualized rate in the 3rd quarter, for the fifth quarter in the past six. Despite this fairly aggressive spend path, overall industrial capacity grew at only a 1.3% pace in 2004. Except perhaps in pure service sectors, spending has been focused almost exclusively on productivity (read: margin) enhancements. While industrial production grew at a relatively leisurely 4% annualized rate for the fourth quarter (and full year), overall capacity utilization has bumped up to 79% (still low by historical standards).

Employment Levels – Continue to reflect moderate, but consistent, increases. Based on household survey data, 330,000 more people were employed at the end of December than September, although the final month saw a decline. For the full year, employment rolls increased 1.75 million persons. Because the labor force continues to grow, ***un***employment levels declined only 350,000 last year. Based on payroll data, 600,000 more people were employed during the 4th quarter, and 2004's employment growth was 1.4 million persons.

International trade – The government reports the third quarter's GDP growth rate was only modestly reduced by our international trade position, but at $155bn, the quarter's deficit was the highest ever (until the 4th quarter's data is out, which will be over $10bn higher).

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Based on the latest monthly data for November, our exports have increased only 6%, or $5.4bn, during the last twelve month's, while imports are up 20% or $25bn. Of the year's rise in imports, $14 billion reflected increases in the value of imported *industrial supplies and materials*, a category including petroleum and other hard commodities.

The Inflation Picture – General price inflation was a mixed picture in the fourth quarter, after slowing down in the third quarter. Overall consumer prices (including energy) increased at an annual rate of 3.0% during the three months through December, after increasing a modest 0.6% during the third quarter. Driving this was the complex of energy prices, which rose at a 10% annualized rate, and were up 17% for the year. Thus, the rise in "all item" CPI for 2004 was 3.3%, versus just 1.9% in 2003. Taking out food and energy, consumer prices advanced at a 2.0% rate in the quarter, and rose just 2.2% for the full year (2003 = +1.1%).

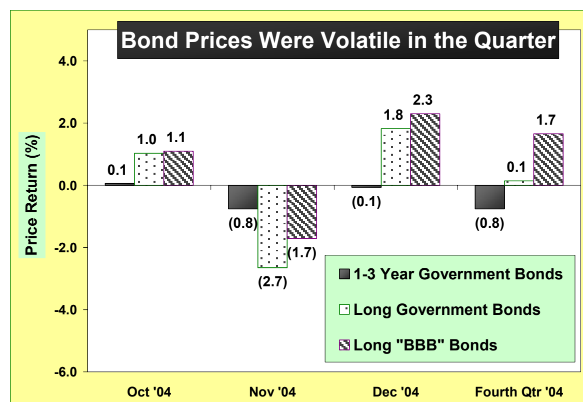
Prices for all imports were nearly flat in the 4th quarter, after increasing at a 10% annualized rate during the second. But, non-petroleum import prices rose at a 5.3% rate in the quarter. Reflecting the U.S. Dollar's weakness, import prices rose almost 7% last year (versus 2.4% in 2003).

Monetary Policy - The target Fed Funds rate was twice raised by 25bps during the quarter, to 2.25%. In various reports and speeches by its governors during the 4th quarter, the Fed expressed concerns over "risks to an otherwise positive economic outlook", including rapid growth in U.S. government debt and "unprecedented" external imbalances, including the large U.S. trade deficit. They've indicated a need to raise short term interest rates "at a pace sufficient to keep inflation expectations at a low level". This has been interpreted as raising target Fed Funds by 25bps at more than half of its eight regular monthly meetings in 2005, the results of which would see the year-end Fed Funds rate between 3.5 % and 4.25%. The higher figure is seen as unlikely unless economic growth is unexpectedly robust during the next six months.

The Bond Market Continued to Surprise

Bond market volatility again surprised fixed income investors during the fourth quarter. Prices for short-term bonds weakened, especially during a very difficult November, in reflection of many expected Fed Funds increases to come. In view of the surprisingly strong gains by long-term bonds during the third quarter, most thought these prices would need to moderate/fall in the fourth, as the entire yield curve shifted upward. Instead, long-duration portfolios were again favored at the quarter's onset, as long-bond prices rallied in October. The final 2nd quarter GDP figure was reported weaker than expected, and the Fed's measured pace was seen as ultimately slowing down the economy even further.

Chart 1. Bond Price Volatility in the 4th Quarter



This became something of a set-up when a very high number for October CPI helped push down bond prices in November. But, long-term bonds again rallied in December, as the economic slowdown thesis re-asserted itself. Credit spreads tightened as risk-seeking investors began to stretch for yield. When the dust had settled, U.S. investment grade bond returns were weak for the quarter, while high yield and foreign bonds performed very well. The 80bps difference between 3 month and 2-year Treasury rates changed little in throughout the year. However, the yield spread between the 2-year and 30-year rates dropped 50bps in the fourth quarter, to 1.75%. One year ago, the spread was 3.25%.

Table 4. Fixed Income Sector Returns

Periods ended December 31, 2004; indices are cap-weighted

Index (% of Aggregate)	4Q '04	1 Yr.	2 Yrs.
Aggregate Bonds *(100%)*	**1.0**	**4.3**	**4.2**
US Gov't, all *(36%)*	0.5	3.5	2.9
- US Treas, long (6%)	*1.4*	*7.7*	*5.1*
Mortgages *(35%)*	1.3	4.7	3.9
Inv. Grade Credit *(25%)*	1.3	5.3	6.5
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High Yield Bonds, all	4.7	10.1	19.9
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Global Bonds, Unhedged	8.5	10.4	12.6
Global Bonds, Hedged	1.8	4.9	3.4
Emerging Market Bonds	5.1	11.8	20.0

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U.S. Equities Stage a Santa Claus Rally

(as we go to print, the S&P stands at 1167)

Rounded to a whole number, the broad S&P 500 index ended 2004 with a value of 1212. One year ago, the index ended 2003 at 1111. Our prediction for December 2005 is 1313. Conspiracy theorists, start your engines!

In October, U.S. market sectors advanced 1 to 3%, depending on cap size and style. Foreign market sectors were up about 3.5%. There was positive momentum, but not much. In November, U.S. equity sectors rose 3-9%, and foreign indices advanced 7%, despite rising interest rates. December saw domestic and foreign equity markets tack on another 3-5% of gains. Events in early November seemed to energize investors.

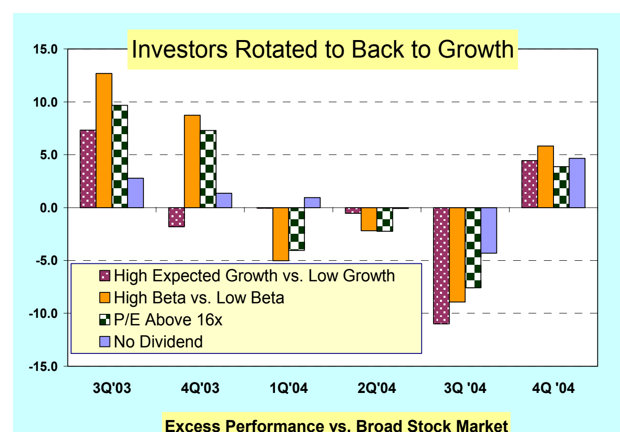
Table 5. U.S. Equity Returns by Style/Market Cap

Periods ended 12/31/04; indices are cap-weighted

	4Q 2004	FY 2004	2 Years	3 Years
Growth				
Largest Cap	7.7	3.7	14.6	(1.8)
Mid Cap	14.0	15.5	28.4	6.2
Small Cap	15.1	14.3	30.3	5.8
Value				
Largest Cap	9.0	13.3	19.9	5.6
Mid Cap	13.4	23.6	30.7	15.5
Small Cap	13.2	22.3	33.6	16.5

Cap size and investment style both played an important role in the quarter, but less so than at other points during this two-year bull market. The rising tide again favored small/mid cap stocks. For the first time in many quarters, growth indices outperformed value across the board. Stocks high in "growth fundamentals" enjoyed a clear rotation back into favor (see Chart 2).

Chart 2. Growth Factors Outperformed in the Quarter



Per Table 6, the energy sector scored a dubious "first to worst" move from the 3rd quarter to the 4th. Investors saw the drop in crude oil prices as a rationale to realize some capital gains after the group's big run-up in 2004. The quarter's other major lagging sectors were health care and financial services. In relative terms, 2004 proved to be the worst year on record for large cap drug stocks (declined 11.6%), and the fourth quarter was no exception (declined 0.2%). The non-drug portion of the sector did fine. The very large (20% of the overall market; #1) financials sector was modestly weak in the quarter because of property & casualty insurance stocks. That industry was a weak one throughout 2004, as it faces some major payouts due to natural disasters.

Technology has dropped to the second biggest economic sector (15%; peak was 29%). The quarter saw tech stocks participate aggressively in the rally, but 2004 was a losing year for tech if you didn't own Dell and Apple.

The quarter's winning industries were too numerous to mention. Of the 70 industry groups we look at, **31** had a quarterly return above 14%. Top performing *major* industry groups were REITS, software firms, computer systems, electronic components (rebounding from a terrible first nine months), and media (rebounding from a terrible first nine months).

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

(Vestek; cap-weighted data)	S&P 500		Small/Mid Cap	
Sector	**4Q '04**	**2004**	**4Q '04**	**2004**
Capital Goods	14.5%	23.2%	14.8%	24.5%
Consumer Services	14.2	3.6	16.9	14.0
Business Equip. & Serv.	13.0	21.2	14.5	12.5
Technology	12.9	2.5	16.8	(3.2)
Consumer Non-Durables	10.5	11.4	14.4	20.9
Utilities	10.3	22.2	10.8	18.3
S&P 500 index	**9.2**	**10.9**		
Russell 2500			**14.2**	**18.3**
Retail	8.3	12.1	17.0	23.8
Multi-Industry	8.3	17.0	21.6	34.1
Financial Services	7.7	10.5	9.7	17.3
Health Care	5.0	1.5	10.4	15.1
Energy	4.3	31.2	7.9	42.0

The U.S. equity markets started 2005 in weak fashion. The S&P 500 index declined 3.7% over the first fifteen trading days. When this happens, we check to see if earnings estimates for the quarter just ended and the next four have shifted. From mid-December to mid-January, analysts took their estimates of 4th quarter earnings **up**, by 1.5%. They took their estimates of 2005 earnings **down**, by 1%, to +9.5% year/year growth. (Not so bad)

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International Stocks Finish at the Top in 2004

For 2004, the MSCI EAFE index posted a superior 20.7% return, but the road to achieving this result was hardly a steady upward trend. Hopes for a global economic recovery got the year started off well and international markets were up +4.4% in the first quarter. As concerns about the sustainability of that recovery and geopolitical uncertainties grew, the markets stalled and posted a flat second quarter return (+0.4%). Rising interest rates, slowing economic growth in China and spiking oil prices had a negative impact on markets in the third quarter (-0.2%). In the fourth quarter, interest rates reversed themselves, oil prices moderated, and earnings were on a positive trend. This combination sparked a strong rally across all regions and an impressive 15.4% return.

Table 7. International Equity Markets

Periods ended 12/31/04; indices are cap-weighted

	4Q 2004 % Return In US$	Year 2004 Change in Currency	Year 2004 % Return In US$	2 Years % Return In US$
MSCI EAFE	**15.4**	**6.7**	**20.7**	**29.6**
- EAFE Growth	15.2	-	16.5	24.2
- EAFE Value	15.5	-	24.9	35.0
Europe	16.0	7.7	21.4	30.0
Pacific	14.0	4.3	19.3	28.8
Japan	13.1	4.6	16.0	25.7
Emerging Mkts	**17.3**	**8.2**	**26.0**	**40.3**

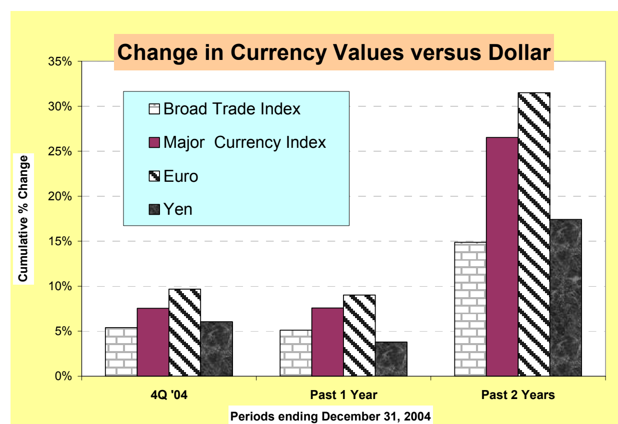
Source: Capital Guardian

During the fourth quarter, international equity performance was once again led by emerging markets, which advanced 17.3%. Latin America was the strongest region, led by Brazil and Mexico, each up 21%. Russia was the weak link in emerging markets, falling sharply on fears that the Russian government's commitment to free enterprise and shareholder rights is waning in light of the YUKOS takeover.

The European and Pacific market regions were each up over 14%. In the face of both a rising Euro and valuations, European markets were still able to advance on the back of upgraded earnings expectations. Slowly but surely, European companies have improved their balance sheets, cut costs and are establishing a solid base for future growth. Japan underperformed slightly in relative terms, as slow economic growth and a strengthening Yen are concerns for both domestic and export sectors.

On the positive side, unemployment in Japan has declined and industrial production has increased, boding well for a sustainable economic recovery.

Chart 3. The Dollar Fell Sharply in the 4th Quarter



All major sectors posted positive results during the quarter. Telecommunication services, financials, utilities and consumer staples were each up over 15%. Energy and health care were the weakest performing sectors, each up "only" 8%. From a style standpoint, international value very narrowly continued to outperform international growth, and small cap stocks outperformed large caps. What does this amount to for 2005? On average, international large cap stocks look less expensive relative to small cap stocks, and growth stocks appear to be better values that value stocks. Valuations in nearly all global markets are still lower than those in the US, supporting the case for continued international investment opportunities.

Table 8. Int'l Equities - Sector Performance

MSCI Sector	Developed Markets 4th Qtr 2004	Developed Markets Year 2004	Emerging Markets 4th Qtr 2004	Emerging Markets Year 2004
Telecom Services	21.0%	19.1%	23.4%	34.5%
Financial Services	19.7	24.1	26.4	39.4
Utilities	17.1	34.4	13.6	21.5
Consumer Staples	16.8	18.4	16.8	28.1
Industrials	14.6	22.5	20.2	33.2
Materials	14.3	21.4	11.0	21.6
Consumer Disc.	13.3	18.3	21.1	28.2
Information Tech	13.1	6.9	14.1	9.9
Energy	8.7	24.8	8.4	25.3
Health Care	8.3	14.6	15.9	7.7

Data Source: Capital Guardian; Returns in US$

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Back Page Perspectives

Twenty-four 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".*

	2 Year Return (%, per annum)
T-bills	1.2%
U.S. Investment Grade bonds	4.2
World Government Bonds, unhedged	12.6
Broad Hedge Fund universe	14.5
High Yield Bonds	19.9
S&P 500	19.5
World Equity, ex-U.S.	29.6
U.S. Small Cap	32.0
Emerging Market Equity	40.3

It's been a **very** good two years for risk-takers, no matter what risk you seemed to emphasize. Investors have naturally become optimistic, despite the obvious geopolitical and global economic challenges around us. But, evidence suggests we've moved into the mature phase of this economic upturn, and potential returns on fresh risk capital are inherently lower. Individual investment markets may still have alot of fundamental potential, but today you're paying much higher prices to get in. It's not the best time to *over*emphasize offense.

We suggest investors adopt the following approach – *Conservative allocation & Aggressive diversification.*

Return potentials relative to risk potentials have come down for equity and similar asset classes. Cumulative equity allocations **moderately below** your Plan's specific midpoint target should be entertained. This is the conservative allocation part.

By aggressive diversification, we mean staking out many different exposures to return opportunities within each asset class. For example, a simple equity investment program with a big slug of S&P 500 large cap exposure needs to aggressively spread out across domestic and international size/style/region sectors, including emerging markets. If they are able, Plans should be taking a longer look at replacing some of their traditional long-only liquid market allocations with private equity or long/short exposure.

On the fixed income side, we think viable and potentially attractive diversified return sources include high yield bonds (with some caution – credit spreads have gotten quite narrow), foreign bonds (developed and emerging markets, with currency exposure), real estate, and other real return plays. In the domestic fixed income arena, cash and short duration bonds may not be king, but they are likely to be the prince in 2005.

The private consensus among economists is for fourth quarter GDP growth to be only 3.8% annualized, with all of 2005 expected to see 3.6% real growth. We narrowly like "the over" in these forecasts, seeing actual growth as more robust than expected. The difference maker will be energy prices. *Sustained* increases from $50/barrel will bite hard on growth.

Absent substantial increases in non-energy prices, one wonders how long the Federal Reserve will keep raising Fed Funds rates. Higher short-term borrowing costs are hardly a solution for the rising cost of imported crude oil. The Fed has said it wants to create "room" for it to prudently *cut* interest rates if needed. To do this, they will need to use the economy's moderate strength to pump out as many well-telegraphed 25bps increases as possible. But, it would also be natural for Greenspan to be concerned about protecting his legacy, massive fiscal and trade deficits notwithstanding. Once Fed Funds pass 3.0%, we expect further increases to be grudging.

Don't underestimate the negative implications a much flatter yield curve has for bank trading portfolios and other leveraged accounts (read: many hedge funds). The 1.50% flattening in 2004 makes the marginal decision to borrow short and invest long a difficult one. What saved such "investors" in 2004 was the twist, as long-term rates declined enough to provide some price gains. However, at some stage rising FF rates will reduce appetites for maintaining some of the leveraged positions currently in vogue. In turn, this will increase the marginal selling pressure on the underlying long-dated bonds.

As the debate over re-organizing Social Security lengthens, it will be increasingly clear that our country's current fiscal *operating* deficit is not $400 billion, but $550 billion. That's because the lower figure includes $150bn of net Social Security surplus receipts, which isn't really "lockboxed" for future generations (but should be). This, plus our ongoing trade deficits, represents a combined $100 billion/month financing gap. Pretty scary stuff long-term, but its only explicit impact so far has been the U.S. Dollar's weakness (Chart 3).

See you next quarter!

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

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