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2004 First Quarter Market Review **4/15/04**

The first quarter of 2004 proved to be mixed for the markets. Overcoming worries about terrorism, weak job growth and high gas prices, the Standard & Poor's 500 index rose 1.3% to 1126 in the first quarter, its fourth-consecutive quarter of positive returns. However, the Dow Jones industrial average declined 0.9% to 10,358, its first quarterly loss in a year. The Nasdaq composite, the technology-dominated index that soared 50% in 2003, fell 0.5% to 1994 in the quarter, ending a five-quarter streak of positive returns.

As we suspected, stocks were volatile over the first three months of the year. Prices rose sharply in the first six weeks as positive momentum carrying over from 2003, coupled with strong cash flows into stocks, put investors in a buying mood. Stock funds attracted roughly $50 billion in new cash in January and February, the strongest two-month demand since the first quarter of 2002 according to the Investment Company Institute, a fund-industry trade group. It was as if people threw caution to the wind at the beginning of the year, convinced that stocks had no way to go but up after last year's enthusiastic results. Beginning in mid-February, however, the broad market suffered a slide that resulted in its first 5%-plus price drop in a year amid concerns over unemployment, the terror bombing in Madrid and the belief that stocks had gotten too pricey. Inflows dropped sharply in March to an estimated $1.1 billion as the initial euphoria waned. But a rally in the final days of March, sparked by strong labor data and the belief first-quarter earnings would come in strong starting next week, put the market back in the black for the quarter.

In a way, the inspiring jobs report demonstrated just how fickle the financial markets can be. The stock market favored last week's job numbers, but the bond market didn't greet the news with the same enthusiasm as bond yields took their largest leap since last July. More jobs lead to inflation, which triggers higher interest rates. The last time the job's report came out, the figure was very weak, way off expectations, yet we still saw a rally in the market. Only that time investors chose to interpret poor job growth as a reinforcement of the Fed's hands-off approach with interest rates. That just illustrates how quirky and unpredictable the market remains.

Stocks seem to have hit headwinds and it seems difficult to expect anything nearly as robust as what the markets returned last year. The Dow industrials and the S&P 500, many believe, would be lucky to finish with percentage gains that are half as big as those of last year, while the Nasdaq performance could be a fraction of last year's. That means that we can expect even more advances and pullbacks along the way.

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Why the more muted outlook for the rest of this year? Two reasons. First, the political worries today are more treacherous than a year ago. Last year, people hoped for a quick resolution to the long-awaited war, and they got it, at least in terms of the actual fighting. Now, the focus is the much murkier problem of terrorism, and the concern is that the issue could hang over stocks for some time, with no clear sign of resolution.

The second problem is that the outlook for corporate earnings simply isn't as robust as a year ago. Then, earnings were getting ready to surge on the back of an economy that finally was recovering from recession. Now, the economic recovery is more mature and earnings pops are likely to become more modest. As the rally progresses, expectations rise. As time goes by, companies begin first to match expectations rather than exceed them. Finally, as expectations get ahead of reality, companies start falling short of rising expectations, and the rally can begin to fade. Right now, expectations are only just beginning to catch up with reality, which means companies can continue to offer positive surprises for a little longer. Later this year, a growing number of disappointments could begin to crop up.

Many investors fear that stock indexes actually could hit their highs in the summer or autumn and then decline as the November election approaches. One worry is the risk that super low interest rates could begin to rise as the year wears on. Another is the election itself, which is turning into a source of uncertainty that is beginning to hang over the stock market. Whatever the election result, it seems evident we are no longer in that get-rich-quick kind of situation.

One big question is how best to invest in this kind of environment. If economic growth and corporate investment prove moderate, it could lead to disappointments in the performance of some of the high-flying technology stocks that led the market last year. As long as the Fed keeps rates low (and we expect they will do that until early next year), the market will hold up pretty well. After the recent pullback, it seems like the market is taking a breather rather than running out of breath and if stocks climb a wall of worry, the March downturn piled the bricks. The big question is how robust the earnings gains will be. We would temper investors to brace for a year in which earnings increases will stop dazzling the financial markets. As a wise man once said, 'uncertainty is the only part of investing of which you can be sure.'