

Q3 2003 Market Review

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The Dow Jones Industrial Average rallied to a 15-month high and the Nasdaq crested above 1,900 in late September. Had it not been for a market selloff in the last days of the quarter, September would have been the sixth straight positive month for the major indexes. Anyone remember the bear market? Meanwhile, Richard Grasso resigned as the embattled chairman of the world's most prestigious exchange after public outcry over his \$140 million compensation and the SEC launched a probe into illegal trading within the mutual fund industry. While the scandal is still unfolding, it remains unclear whether the affair will become the fund industry's version of the Enron debacle. With such strong momentum for stock funds, however, it seems investors are focused more on money making than lawbreaking.

Investors poured an estimated \$38 billion into U.S. stock funds in July, August and September, continuing an upward trend not seen since the first quarter of 2002. The Dow is up 12% for the year but whether stocks continue their run-up or fade in the final quarter will depend heavily on whether the earnings due to be announced in the next few weeks live up to analysts' high expectations. Investors have bid stocks up in hopes that companies will begin delivering strong earnings gains, both in the quarter that is just ending and in the next few quarters. Now, those investors are worrying about whether companies will live up to expectations.

Most earnings indications are upbeat. Ordinarily at this time in the quarter, companies are lining up to deliver their "confessions" -- warnings about earnings that aren't going to reach analyst expectations. But so far, fewer companies than normal are doing that. Meanwhile, Wall Street analysts have been doing something downright unusual: Raising earnings estimates for companies. During the bear market, most equity research analysts couldn't cut profit targets fast enough.

Despite this good news, the economy still isn't as strong as during a normal recovery. Earnings have moved up from the sub-basement to the basement but aren't nearly normal yet. The rebound is still being led mainly by consumer spending and government stimulus but consumers could throw in the towel if the job market doesn't get out of its rut soon and while the tax relief has kicked in, the effects of monetary stimulus haven't fully materialized.

What's troubling to market pros is that top-line growth doesn't seem to be the reason for the expected increase in third-quarter earnings, meaning gains will largely be attributed to the same corporate belt-tightening of the last few quarters; a trend that has resulted in greater productivity, but not necessarily

greater sales. It's going to be crucial that companies show some improvement on the top line.

Further counteracting market appreciation is the 'soft dollar' monetary policy coming out of Washington. While a lower dollar should enable U.S. manufacturers to compete better both at home and abroad -- a key goal of the Bush administration -- investors are worried that the lower dollar's benefits would be more than offset by rising interest rates as foreigners buy fewer Treasury bonds. Fears spread that foreign investors, who are estimated to hold more than one-third of U.S. Treasury bonds, could pull back from Treasuries and from U.S. stocks if they fear further declines in the dollar's value. (A weaker dollar dilutes the value of dollar-denominated income.) This has added a strong boost to international bonds meanwhile as the monies are reallocated to bonds issued by industrial countries outside the U.S.

It's a safe bet bond rates are headed higher at some point. Given signs of an economic recovery, businesses will find it expedient to raise long-term cash in order to finance the purchase of the plant and equipment that they usually need when sales pick up. This time around, you can add to the demand for long-term funds the needs of the federal government. Instead of shrinking as it usually does when a recovery sets in, Washington's current budget deficit of \$336 million is just below the record set in early 1992, when rates on 10-year Treasuries were 3.25 percentage points higher than they are at the moment. Then there's inflation. For all the moaning about the lack of pricing power, the fact remains that by some measures, the rate of inflation has picked up in recent months. While consumer prices remain tame, as long as the economy continues to grow, these pipeline pressures are bound to show up.

Hard assets like gold and real estate have shown further confluence of market direction. With higher rates, real estate and home property values, which normally decrease in an inflationary environment, have increased. Meanwhile, gold prices hit a seven-year high two weeks ago. It's almost getting painful to watch investors try to make up their minds about the near future. Deflation is coming! Buy bonds. No, inflation is coming! Load up on gold. The economy is roaring back! Buy the Nasdaq. But there's a debt bubble. Sell the dollar! In the movie version (working title: *The Three Faces of the U.S. Economy*), the role of financial markets will be played by Joanne Woodward.

The lesson to be learned is that the investor should be prepared for any and all of the scenarios above. If anything, the see-saw performance of the equity and fixed income markets has given even more credence to the merits of Centurion Counsel's asset allocation philosophy. We preach that the well-diversified investor should own stocks, domestic & international bonds, real estate and natural resources in all market conditions. Our efforts to ensure proper

diversification amongst our accounts allows us to maintain a buy-low, sell-high discipline that has helped our investors gain from the tumultuous markets of the past three years and positions them well in the market uncertainty we face today. The equity run-up of the past two quarters has projected a rebound from corporate America as we enter year-end guidance. While the market anxiously awaits whether companies will deliver on their earning expectations; Centurion investors can rest easier knowing we are well positioned to deliver on theirs.