



7705 TANGLEWOOD COURT ■ EDINA, MN 55439 ■ 952.926-3000 ■ www.capstratcorp.com ■ e-mail: capstrat@mn.rr.com

## ***FINANCIAL MARKETS COMMENTARY*** ***2<sup>nd</sup> Quarter 2004***

**July 20, 2004**

### **Summary**

In the second quarter of 2004 the upward force of economic recovery ran into the downward force of rising inflationary pressures. For the most part, the stock market fought this battle to a draw. Bonds, on the other hand, had a very poor quarter. Most bonds don't benefit from an improving economy, but almost all bonds are hurt by inflation. Since bonds lost more money than stocks gained, they were the primary driver of performance during the quarter for the great majority of investors.

The economy bottomed early in 2002 (statistically), but bond yields continued to decline through June 2003. While strategists (ourselves included) have predicted that interest rates would rise and spell trouble for bond investors for well over a year, it hadn't come to pass. That is, until April. Job growth had been weak for three years when on April 2nd the Labor Department reported a 300,000+ gain for March (this was followed up by a similarly strong report the next month). This report confirmed the belief that the economic recovery was solid. Leveraged positions designed to capitalize on the difference in yields between the 1% short-term rates and 4% to 5% 10 & 30 year bond yields were rapidly unwound, which meant selling of bonds. From April 2<sup>nd</sup> to May 17<sup>th</sup> bond yields rose so sharply that they swamped the stock market. Eventually as interest rates stabilized at higher levels and stock investors began to focus on earnings again, and earnings look good! Stocks have staged a decent rally over the last six weeks of the quarter and finished with a gain of about 1% on average. Bonds have recovered only a small portion of what they lost earlier, losing 2.4% on average.

International funds also declined during the quarter. China has been the world's biggest driver of economic growth over the past year, as they have been building and rebuilding their infrastructure. This requires a lot of raw materials, such as steel, cement, oil, copper, aluminum, etc. The main beneficiaries have been their Pacific Rim neighbors. While much attention gets paid to the fact that America runs a large trade deficit with China, the Chinese run a large trade deficit with just about everybody else. Last quarter there were a number of reports that suggested that China's rapid growth was putting a lot of stress on its fledgling financial system, and that the authorities

were going to have to slow the economy. This led to a sell-off in those countries that are more dependent on selling to China. Asian and emerging markets fell almost 10% during the quarter. The effect was a lot smaller on Europe, which does not export much to China. Like the S&P 500, EAFE climbed to a quarterly gain of more than 1%.

## Strategy

We did not make any changes to our client's portfolios last quarter. In our Balanced Model we prepared for rising interest rates last quarter by adding a commodity-linked fund, by trimming the weighting in longer term bond funds and adding the very defensive FPA New Income fund (which rose 0.8%). In our more aggressive models, bonds are not a significant component, so no changes were necessary. In light of the lack of a significant trend in equity markets, and the overall tendency of investors to buy on weakness and sell on strength, there is really not much to adjust here.

## Performance

Our Balanced Model Portfolio declined 0.72% last quarter. This compares with the -0.13% return for the Balanced Benchmark. Our Aggressive Model Portfolio lost 0.12% during the quarter, versus the Aggressive Benchmark's 1.15% gain. Coming out of the mid-quarter decline investors had a preference for transportation stocks on the belief that they would benefit from a falling oil prices. This was not a move we believed in (we still don't) and therefore we did not participate. The rest of the difference was having a little bit more in financial services and real estate and a little bit less in technology and health care than the benchmarks. We are comfortable with the way our model portfolios are currently structured. We continue to focus on outperforming the benchmarks on a long-term basis over multi-year periods, as we have been able to do, rather than trying to outperform on a quarterly basis.

## Outlook

The interest rate cycle has finally made its shift to the upside. Historically, this is not a great time to be invested. The mitigating factor is that once the stock market perceives that the Fed is done raising rates, it *usually* rallies sharply. If you wait until it actually eases, much of the move in the stock market may have already occurred. We are in the place now where most of the interest rate increase is still ahead of us, but the market has largely discounted this fact, so the impact may already be largely behind us. With the relatively weak economic reports in recent days (including a job gain of only 112,000 in June), pressure on interest rates has receded. Perhaps the only thing holding us back from a decent summer rally is uncertainty over the election. As you know, there is nothing the market hates more than

uncertainty, which is why a disproportionate share of the stock market's gains in election years historically has occurred after Election Day.

### Commentary – Investing in a Trendless Market

We all know that the way to do well in the stock market is to buy low and sell high. In practice, it is difficult to identify what might be looked at as “low” ten years hence. The best we can normally do is to identify trends that we believe will persist long enough to reward purchases we make today (even if those securities don't appear all that low right now). In bull market with well-defined trends, you don't have to worry as much about current prices. Technology was a great sector to invest in during the 1990s even though prices were almost never cheap. On the other hand, buying things that were clearly low (steel, metals & mining, machinery) were not rewarding at all because those stocks *stayed* low. If investors believe prices and earnings are going to rise steadily in a sector, they will correctly conclude that today's high valuations will eventually appear quite modest. Unfortunately, we are not always in a bull market.

During periods such as the one we are in right now, there are no well-defined trends. Investors are wary of making aggressive assumptions about the growth in any sector. They are more willing to buy industries that are absolutely low. The logic for this is simple – if you buy low and the sector stays low, you make no money. If you buy a high priced sector assuming rapid growth will continue and it doesn't, then you are going to lose a lot of money. In the 1990s, investor pain came mostly from missing opportunities. This decade, pain has come from losing money. Investors usually adopt strategies to minimize the pain they expect as much as possible. Our preference is (still) to find industries that we believe will appear to have been cheap when we look back on it five or ten years from now. In this more defensive environment, however, we have to invest more of our portfolios in areas that we are confident will not turn out to have been *expensive* in hindsight. In other words, we may under-perform some rallies, but we will avoid much of the suffering in down periods.

The only areas of the market we believe that we can buy low right now relative to where they will be five or ten years from now are in the energy and hard assets sectors. These areas were under-invested for most of the last twenty years due to a surplus of supply over demand. Now we are seeing a great deal of demand (again, this is where China comes in), and existing production facilities are not sufficient. We would be inclined to balance this with greater than normal weightings in consumer non-durables, which if not exciting are at least steady. Industries such as financial services, technology, and health care, which thrived during the 1990s, still tend to be priced somewhat aggressively. Unfortunately, when sectors do well for an extended

period of time, they tend to get crowded by new entrants, which depress profitability for everyone. Even when the cycle has peaked, it still takes a while for less profitable firms to be bought out or liquidated. Remember - it is always better to invest in a great company in a mediocre industry than a mediocre company in a great industry (the former will gain market share, the latter will lose it). A great company in a great industry is often not as good of an investment, because the “great-greats” are usually priced very richly.

## **Capital Strategies Financial Corporation**

**Mark A. Carlton, CFA**

**Eric C. Graber  
President**