

## ***FINANCIAL MARKETS COMMENTARY***

***3rd Quarter 2003***

**October 17, 2003**

### **Summary**

The stock rally continued into the third quarter of 2003, though the correction during the last eight trading days cut the gains approximately in half. Hopeful signs that the economy was reviving was responsible for the second quarter gain, and to the extent that data released over the summer confirmed this, stock prices rose further. Industries (such as retailing) that depend on strong consumer spending benefited from refinancing and tax rebates, and industries that need strong business spending (technology) were helped by lower tax rates. On the other hand, those sectors of the market that tend to be more consistent and defensive (health care and utilities) were decided laggards. As the quarter drew to a close, investors got a case of “October jitters” and took some profits, especially in sectors that had run up strongly since April.

Smaller companies, especially those leveraged to the economic cycle, led the way last quarter (8.3%). Larger companies did significantly less well (2.4%). Areas of the market that did not get “beat up” between 2000 and 2002 understandably had much less ground to make up.

International markets were strong last quarter as well. Most nations are net exporters to the U.S., so the fact that our economy is strengthening is very good news to those who depend on selling to us. An additional benefit was the continuing decline in the dollar, which makes international investing especially rewarding to the dollar-based investor. Both Japan and China rose more than 20%.

A recovering economy tends to put upward pressure on bond yields, as demand for credit increases. As a result, government bonds posted small declines last quarter. Corporate bonds, which have less interest rate sensitivity and more exposure to improving corporate balance sheets, were able to record modest gains. International and emerging market bonds rose 2-4%.

### **Strategy**

Recognizing that the rally was led by riskier companies (in fact, by companies that actually had negative earnings, according to the Wall Street Journal), we were largely inclined to stand pat last quarter. We are not convinced that we are at the beginning of a multi-year economic upturn (which would justify

valuing stocks on the basis of expected future robust increases in profits). In our view, this is a credit-driven cyclical upturn in an economy that is still digesting the massive technological changes that have occurred over the last several years. The 20%+ gain in stock prices since April has taken the average stock from slightly undervalued to modestly overvalued. Bonds are not attractive given the near-certainty of rising interest rates in the intermediate term, so we trimmed positions during the quarter.

### Performance

Our Balanced Model Portfolio gained 2.44% last quarter. This compares with the 2.55% return for the Balanced Benchmark. We continue to be more conservative than the benchmark. Our Aggressive Model Portfolio gained another 4.67% during the quarter, versus the Aggressive Benchmark's 5.62%. Relative to the gain of the average stock fund (4.41%) we did well. Even in an aggressive portfolio, we didn't want to put more than 15% in speculative stock funds.

### Outlook

The outlook has not changed much from last quarter. Stock prices are higher than warranted by current economic fundamentals, but interest rates are low, borrowing is easy, and the economy seems to be recovering. Furthermore, seasonal trends are positive and the election cycle often sees strength in the quarter before an election year (esp. 1995 and 1999). Therefore, the market is not particularly vulnerable and might well move higher in the short term. We look for larger, more financially strong companies to play catch-up in months to come. It will be important to watch bonds and the dollar for signs of weakness, but right now we are reasonable optimistic.

### Commentary – The Campfire

We believe the stock market is likely to rise over the next couple of quarters, and yet we are still positioning portfolios somewhat more conservative than the benchmark. How can these two statements be consistent? Let us use an example: if you have an ample supply of dry wood, of a type that is dense and has natural oils that burn slowly, all you have to do is light the logs and stand back. Besides occasionally adding a log or adjusting the pile to improve ventilation, there's not much you need to do. However, if the wood is wet or of poor quality, you need to tend it continually, and even with a lot of kindling and lighter fluid it will still yield more smoke and less heat than the former.

Think of stock market cycles the same way. Financially strong companies are the "good wood" that is the foundation of a long burning bull market. Dry conditions are cheap stock prices and low borrowing costs. Kindling is tax cuts, regulatory changes, interest rate cuts or other stimulative measures that may have a short term cost but are worthwhile if they ignite activity that ultimately pays for itself in terms of greater revenue down the road. The long bull market

of 1982-2000 burned so long because it started with great skepticism toward all stocks such that even very good companies were not expensive. Inflation declined from 14% to 2%, allowing interest rates to fall and providing the atmosphere where companies could comfortably borrow to buy equipment or even other companies. The Federal Reserve could simply follow inflation down. Only three times (1987, 1990-91, 1998) did the Fed have to get involved to keep the fire going.

If you fast-forward to today, however, you will see that the pre-conditions for a long up-cycle are not there. The “wood” isn’t as good today -- the average blue chip company carries much more debt than it did in 1982. Back then, debt was so expensive that companies limited borrowing, even for really promising initiatives. When borrowing costs fell, these long-awaited projects or mergers were completed. Now, borrowing costs have been driven down such that the promising initiatives have been funded, as have the good ones, the mediocre ones, and a few of the downright stupid ones. The conditions are nowhere near as dry today - interest rates are low, but stock prices are high relative to corporate earnings and cash flow (in fact more than twice as expensive as they were in 1982.). The Fed has been pouring on the “lighter fluid” (13 interest rate cuts) on the “kindling” of subsidies and tax incentives, trying to ignite the kind of economic activity that just naturally occurs when conditions are more favorable. The crumpled paper burns, the wood smolders, but it cannot generate the true heat of a secular bull market.

To go back to the question asked at the top of this section, we aren’t getting more aggressive now because today’s prices will probably be re-visited on the down side. It is not our philosophy to jump in and out of the stock market like timers. Getting more aggressive now would force us to have to time our future selling just right (since we would want to sell higher and before the many others who would presumably also want to be sellers at a high price). We try to position ourselves to be on the right side of major trends, and we do not regard the current rally to be a major trend worth making a significant re-positioning for. We hope the rally lasts a long time. For the reasons outlined above, we believe it won’t.

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