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## *Financial Markets Commentary*

### *4<sup>th</sup> Quarter 2004*

January 21, 2005

#### Summary

The final quarter of 2004 was by far the best. There is usually a post-election rally, but this year the rally was greater than usual (perhaps because there was more than the usual uncertainty preceding it). In any event, stocks rose across the board, with smaller and more aggressive stocks gaining the most (over 12%). This is largely a function of interest rates being very low, which facilitates speculation. Investors tended to prefer technology, telecommunications, and real estate during the fourth quarter, opting to take some profits in energy (which was the leading industry through November). The only areas of weakness were pharmaceuticals (on several high profile drug withdrawals) and gold (which tends to do poorly when other assets do well).

International stocks were especially rewarding for U.S. investors, as currency gains from the falling dollar added to very nice appreciation in foreign markets. Demand from China lifted raw materials from energy to copper to cement to timber. Much of that comes from Asia, Canada, and South America. In truth, there really weren't any foreign markets that didn't perform well. Even Japan and Europe were up double digits.

As economic growth began to look more solid, the Federal Reserve was obliged to begin making credit a little less easy. The weak dollar and soaring energy prices sparked inflation concerns, which the Fed wanted to contain. As a result, interest rates rose 150 basis points from 0.75% to the current 2.25%. Rising interest rates typically punish long dated bonds the most. In this case, however, long-term bond yields did not rise because the bond market concluded that the Fed's actions were proactive and would prevent inflation from getting a foothold. As a result, short-term bonds returned only 1.6% in 2004 whereas long-term bonds gained 4.5%. Venturesome bond investors were able to earn over 9% in high yield corporate bonds and international bonds and close to 12% in emerging market debt.

#### Strategy

We didn't alter our strategy during the quarter. We expected something of a relief rally since it was highly unlikely this election would involve the courts again. (2000 was a rare event historically; even very close elections in 1960 and 1968 resulted in

clear winners). Though our performance was merely in line with the market over the strong fourth quarter, it outstripped the major averages handily on a twelve month and three year basis. We achieved this by under-weighting large company stocks relative to small caps, growth stocks relative to value stocks, and corporate and international bonds relative to U.S. government bonds.

## Outlook

We expect some profit taking early in the quarter as strategists re-allocate some of last years gains into areas that didn't do as well. With inflation under control and the economy humming along, the first half of 2005 could be very decent for investors. At some point, however, the Federal Reserves interest rate hikes will begin to slow down growth (there is usually a 6-12 month lag). We are somewhat concerned about the rapid rise in real estate; prices here easily exceed replacement value, and this industry tends to be susceptible to rising interest rates. On the other hand, we believe energy will continue to be a leading industry.

## Market Commentary – Beyond Here Be Dragons?

The average stock is as richly valued as it has been in a very long time, but I am not overly concerned. While there are very few bargains left, there are also very few areas where investors have gotten carried away. This environment differs greatly from that of 2000. Let me explain.

Value Line is the financial industry's most recognized stock rating service. They break the stock market down into 98 industry groups. Of those 98 industries, many carry higher valuations than at any time in at least the last two decades. Note that this is different than saying that the market as a whole is more overvalued. Five years ago, certain industries – telecommunications, semiconductors, software, Internet, for example – were extremely overvalued, whereas dozens of more “mundane” industries (home finance, energy, steel, apparel retailing, basic chemicals, trucking companies, etc.) were almost completely ignored. It was very easy to find bargains then; one just had to wait for the mindset of the market to change. Today, rather than a dozen industries being ridiculously overvalued and the other 85 or so on the bargain counter, we have 90% of industries 5-10% overvalued and the remainder only modestly inexpensive. This is the recipe for modest disappointment (say 6-7% annual returns instead of the normal 10%), not the disaster some experienced five years ago.

Our focus is not just on the next quarter or the next year or two. We also have to look out long term in order to determine if there are potential events that could lead to a prolonged period of below normal returns. Most of these are low to very low probability events, having to do with things like natural disasters and terrorist attacks. Today, however, we have to look at one other situation that while not an imminent concern is certainly serious enough to be a major potential threat to future returns. What I'm referring to is debt -- more specifically, our national debt. Right now our national debt stands near \$7.6 trillion. We are expected to

run a \$500 billion dollar deficit in 2005, but that figure conveniently omits the cost of the Iraq Conflict. By any historical measure, these are large numbers. On plus side, we are easily the most prosperous nation on earth, and we continually generate more than enough income to service our debt. Our creditors continue to finance us at very reasonable terms – after all, if we were such a bad risk, wouldn't they demand higher rates or simply refuse to lend to us anymore? These are good points, but do we really want to risk our economy on the kindness of strangers?

Medieval mapmakers' knowledge of the earth was limited to the areas that had already been explored. What was beyond those areas was a mystery, but given their belief in a flat earth, it couldn't be good. Often they would label the unexplored areas to the west "Beyond Here Be Dragons". This sums up our concern about piling up more and more debt. We just don't know how much debt we can support, and neither do we know at what point (if any) other nations would decide we are too risky a credit and force us to either change our policies or default.

Remember, of course, that we get paid to worry. I honestly don't know how concerned we should be over our existing national debt and growing trade deficit. We might find out that our capacity to take on debt is much greater than we thought and though this, our ability to stimulate world growth. Or, we might have to undergo wrenching restructurings and/or asset sales as we try to pay down debt to re-establish our credit rating (this is what many South American countries went through over the past 25 years). What is clear is that our debt has put us in uncharted territory. While this may be manageable for many years, we might remember that the symbol of China, the country with whom we are running the greatest trade deficit, is in fact the Dragon.

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