

# MONTGOMERY BROTHERS WEALTH MANAGEMENT

## Second Half 2004 Investment Outlook July 4, 2004

**“When you get to a fork in the road... take it.”**

**—Yogi Berra**

In “The Road Not Taken,” poet Robert Frost concludes that, when faced with a choice between two roads, he “took the one less traveled by, / And that has made all the difference.” Earlier in the poem, however, Frost notes that “the two passing there / Had worn them really about the same.” And so, it seems to us, is the current presidential campaign. While on the surface it seems that there are huge differences between George Bush and John Kerry, upon closer examination their campaign promises are “really about the same.”

It probably would be preferable if we faced a larger choice in this election: Left vs. Right; Big Government vs. Small Government; Tax & Spend vs. Shrink the size of government; boxers vs. briefs, or at least a debate of such issues. Sure, the candidates talk up a big game to appeal to their core constituencies among conservative Republicans and liberal Democrats, but the battle is likely to be won by capturing a small majority of the more moderate middle. Once again, a small slice of independent, middle-of-the-roaders are likely to decide an election. And, once elected, the president will have to “rule” within a framework of a narrowly divided but fiercely partisan Congress. So, the chances of a big change in the political outlook are limited.

At this point, the presidential election is too close to call. One would think that for an incumbent president, unopposed within his own party and blessed with a rapidly expanding economy, reelection would be a walk in the woods. But George Bush is a divisive president who is disliked by many, even within his core constituency. Doubts about the economy and the war in Iraq and, to a lesser extent, on terrorism have racked his term in office. Unfortunately for the Democrats, John Kerry has been unable to capitalize on these issues as most might expect.

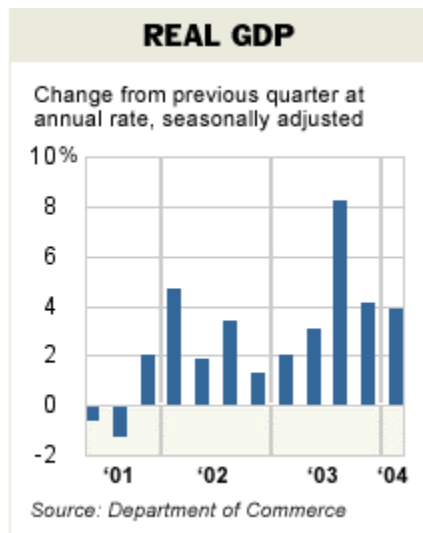
Current polls show the presidential race to be a dead heat. The most recent *Wall Street Journal*/ NBC News poll shows Bush with 45% of the popular vote, Kerry with 44%, and Ralph Nader with 4%. As happened in 1992 and again in 2000, a third party candidate might draw enough votes to effect the election. We’ll see! Ed Gillespie, who currently runs the

Republican party, believes that the election will hinge on an unforecastable event happening shortly before the election and the unpredictable reaction of voters to that event.

The elections are still four months away, and the campaign is likely to be long on name-calling and negatives and short on substance. There will be different impacts on the economy and financial markets based on the outcome of November 2<sup>nd</sup>, but they are more likely to be a matter of degrees than truly decisive. Sorta like Frost's (slightly) less traveled road.

## Economic Outlook

As is usually the case, many believe that the economy is at a crossroads. Over the past 12



months (through March 2004), the economy grew by 3.9% which was one of the fastest annual rates of expansion in two decades. During the first half of this year, more than 1 million payroll jobs have been created, and unemployment has declined, but only from 5.7% to 5.6%. While consumer confidence is at a two-year high, many Americans fear for their jobs, are concerned about the economic outlook, and are fearful of higher inflation and interest rates. These concerns are not, however, reflected in their actions. With new jobs being created for a few, but incomes growing for all, consumers continue to spend at a frantic pace. Faced with rising prices, consumers are doing what they normally do under such circumstances: buying now in anticipation of higher prices later. It is the same with interest rates. When the

price of money increases people borrow today in anticipation of even higher prices (interest rates) tomorrow. Nowhere is this more evident than in the housing market where rising mortgage rates and home prices have resulted in continuing strong sales in spite of endless forecasts of a real estate bubble about to burst. Sooner or later this will change. We're guessing it will be later.

Business spending is also strong. Inventories are being rebuilt, albeit slowly; orders are increasing; backlogs are growing; and hiring is expanding. Rising interest rates and the expiration, at year's end, of capital spending tax incentives are likely to keep business spending strong. Government spending remains high, but will have less stimulative effects moving forward. Even the trade deficit, which continues to grow, is more indicative of economic strength than weakness.

But now, suddenly, after 10 quarters of expansion, after most interest rates have risen, after a huge stock market rally, and after a major rebound in federal, state, and local taxes, economists and the press are concerned that maybe, just maybe, growth is peaking. Well... no duh! Hugely stimulative monetary and fiscal policies are diminishing and the economy will have to run on less high octane fuel.

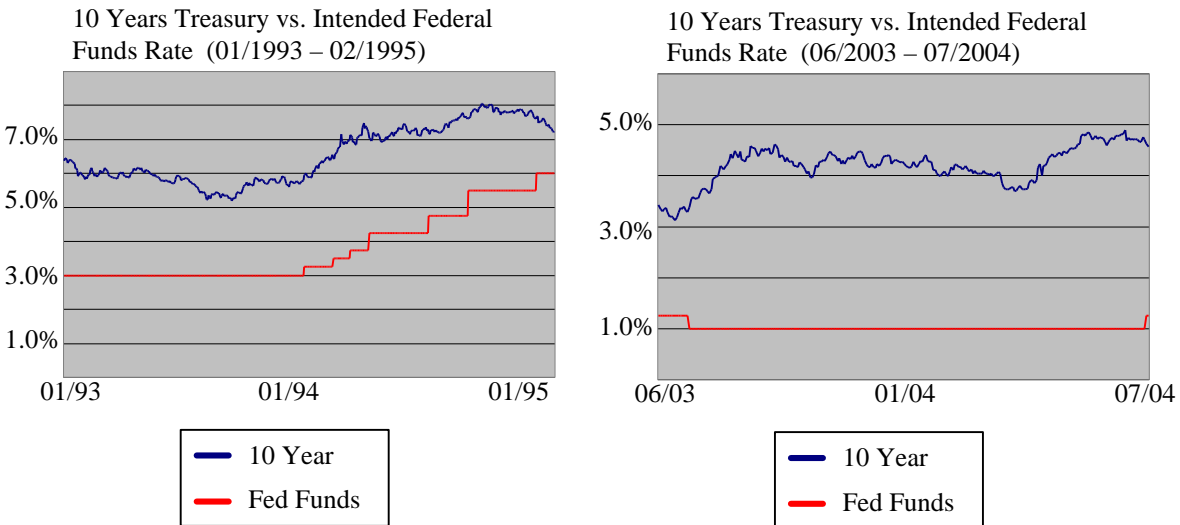
The most recent *Wall Street Journal* data shows an average 4.2% GDP growth prediction for the second half of 2004 and 3.7% for next year. Montgomery Brothers continues to forecast that economic growth will be above consensus forecasts for the short term but slow more sharply next year.

Prior to the Reagan Revolution, the economy was prone to shorter and more pronounced cycles of expansion and contraction. During the past twenty-plus years, the United States has experienced only two relatively brief and relatively mild recessions. Most of the time the economy has been methodically expanding. We prefer the more recent middle-of-the-road economic expansions to the boom/bust cycles of the past, although we fear a return of the latter.

## Interest Rate Outlook

On June 30<sup>th</sup>, after the longest drum-roll in monetary policy history, the Federal Reserve raised the target for the federal funds rate by 25 basis point (one quarter of 1%) to 1.25% and the Discount Rate, by 25 basis points, to 2.25%. The financial markets reacted as the Fed hoped—with a big yawn. This was the first increase in rates by the Fed in more than four years but left the only interest rates which the Federal Reserve actually sets at still expansionary levels and well below the trailing 12-month rate of inflation.

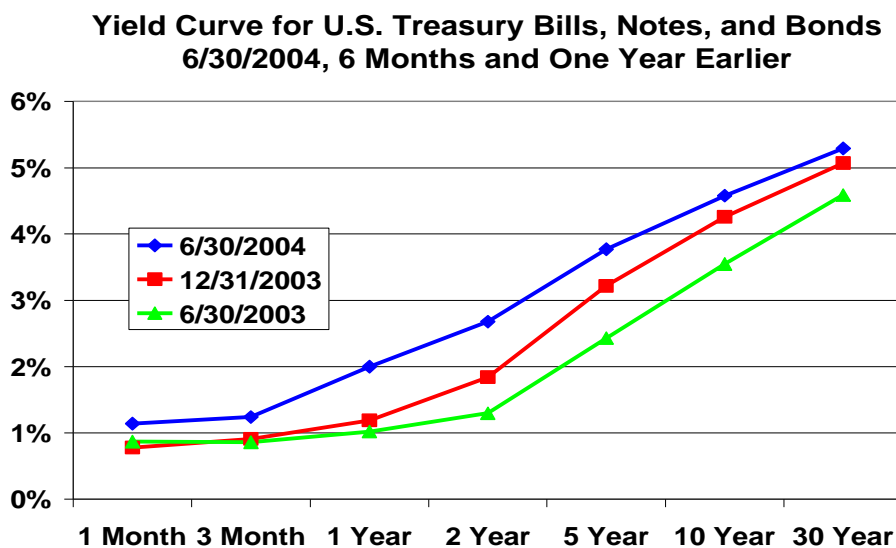
The debate continues to rage over which path the Fed will choose. Down its preferred path, the Fed plans future rate increases to be *moderate and measured*. Down the alternative path which all too many fear, would be a series of rapid increases similar to the Fed’s actions in 1994. Shown below are two charts.



The first shows the year before and the year after the Fed initially raised the target for the federal funds rate in February of 1994. It compares the Federal Funds rate and the 10-year US Treasury yield. The second chart shows the year before the Fed’s most recent rate hike and shows the same data.

As you can see, during the year prior to the February 1994 Fed rate hike, the yield on the 10-year US Treasury had increased only slightly, but after the Fed started to increase the target for the federal funds rate the yield on the 10-year initially rose while the yield curve flattened. In the second chart, you can see that the market determined yield on the 10-year US Treasury has already risen quite sharply, leading many to believe that the Fed is “behind the curve.”

Montgomery Brothers believes the Fed will choose whatever path the bond market determines but our (educated) guess is that the past will be prologue and increases in the federal funds rate will lead to a flattening of the yield curve without a big increase in longer term yields. As you can see from the chart below, the yield curve remains quite steep even compared to its slope six and twelve months ago.



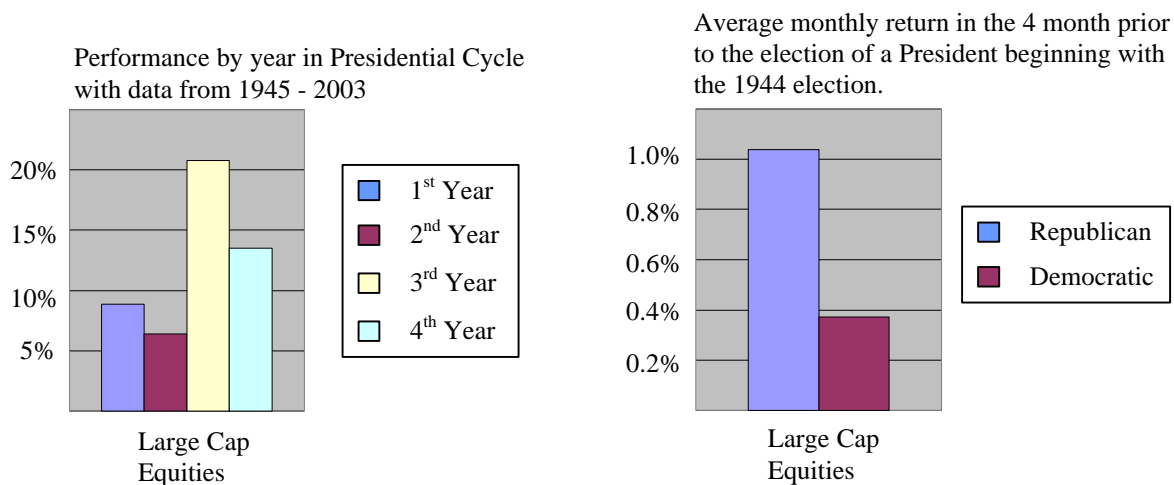
We do not believe that interest rates on longer maturities (10–30 years) bonds are likely to increase much even though we expect shorter maturity yields (0–5 years) to increase fairly sharply. We say this for two reasons. First, two years ago when “inflation was dead” and everyone wanted to buy bonds, the price of gold was bottoming and the value of the dollar was peaking. In our opinion, these early warning indicators were flashing yellow on the longer term outlook for inflation and interest rates. But now, with most wringing their hands over the possibility of higher inflation and rising interest rates, it appears to us that the price of gold is topping and the value of the dollar is bottoming. This leads us to believe that inflation will be less worrisome and that interest rates are unlikely to rise as much as most believe. Secondly, the most recent *Wall Street Journal* survey of interest rate forecasts shows that 14 of 15 forecasters predicted that the yield on the 10-year US Treasury would be higher in six and twelve months ahead. That’s a consensus which makes every self-respecting contrarian stand up and notice.

Monetary and fiscal policy continues to favor borrowers over lenders. But the millions of savers with billions of dollars in money market type investments will be pleased with higher short-term rates even as borrowers with variable rate debt feel the pain of higher financing charges. Is that a diverging path or is that the proverbial double-edged sword?

## Stock Market Outlook

The Bears tell us that the stock market is on “the highway to hell.” The Bulls tell us that the stock market is on “the road to recovery.” Montgomery Brothers believes the market is going nowhere fast. The price of stocks is a complex interaction of many factors, but none more important than earnings and interest rates. Corporate profits are likely to continue to grow but at a slower pace. The big increase in corporate profits seen during the earlier stages of this economic recovery are behind us. The share of the incremental sales dollar going to the “bottom line” now has competition from higher costs for labor, from higher borrowing costs and from higher commodity input prices, most notably energy. How much prices can be raised to cover these higher costs is problematic but probably prices can not be raised enough to keep profits growing at anywhere near the rate of the recent past. Nevertheless, corporate profit growth will continue to be decent. Unfortunately, price/earnings multiples are unlikely to rise given our flat to slightly increasing interest rate outlook.

Usually election years are good for the stock market. Shown below are two charts from a recent speech.



The first shows the four-year presidential cycle for stocks for the 1945–2003 period (from November of an election year to four years hence). The second shows the four months preceding the November presidential elections (i.e., July, August, September, and October) and shows what, on average, has transpired before Republican and Democratic victories.

Even though the data show that the stock market has, historically, performed better under Democratic presidents, most stock market investors prefer Republicans to Democrats. Regardless of the outcome of the election, we’re unimpressed with the near term outlook. A recent Barron’s poll showed that 80% of professional investors polled believed that Bush would win reelection. That’s a lot of room for disappointment.

In spite of lots of investor bullishness and tons of money flowing into equity mutual funds, stock prices have made little progress so far in 2004. The Dow Jones Industrial

Average was down 0.2% during the first half, the S&P 500 was ahead by 0.4%, the NASDAQ Composite rose by 2.2%, and the Wilshire 5000 was ahead by 3.2%. Contrary to what we thought at the beginning of the year, small capitalization and lower quality stocks did better than larger capitalization higher quality issues. The Russell 2000, a proxy for smaller cap issues, rose by 6.2% during the first half. Stocks rated B- and lower in our data base were up by 9.2% on average, compared with the average return of 2.4% for S&P A+ rated stock. This small cap, low quality stock market leadership started to fade during the second quarter and MBI continues to favor large capitalization, high quality issues over smaller cap, lower quality stocks. In the long term, we believe that a well diversified portfolio includes all caps and most qualities of stocks.

While we do not expect much overall progress from the stock market averages through the election, volatility should remain high. The volume of stock trading has declined while the percentage of that volume done by program traders has increased. More worrisome is the impact of hedge funds. Due to their lack of disclosure and transparency, it's hard to tell *what* hedge funds are doing, but there are a lot more of them with a great deal more money to "invest" than ever before. Often leveraged and heavily incented by short-term performance benchmarks, hedge funds can influence the market more than ever. The fact that they have mostly underperformed their performance benchmarks this year, makes their performance chasing all the more worrisome.

Big moves up and down are likely but with little net change until after the election when we could experience a "relief rally." Until November 2<sup>nd</sup>, the road ahead looks relatively flat but with many a speed bump. Nevertheless, stocks in general are likely to provide better returns than bonds and cash during the remainder of 2004.

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I recently gave a speech to the AIG Advisory Group where I discussed the investment outlook and the historic and possible future impact on the economy and financial markets of presidential elections. My PowerPoint presentation and selected comments are available on our website: [www.montgomerybros.com](http://www.montgomerybros.com). We can also send you a copy.

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Some charts courtesy of Baseline and Briefing.com