INVESTMENT
STRATEGY UPDATE

March 31, 2004

HISTORY RHYMES – A STATUS REPORT

Bob Farrell, the now retired strategist at Merrill Lynch, used to say that history doesn't repeat itself, rather, it rhymes. Such is our investment outlook for the next few years, as we expect a similar stock market experience to that which occurred during the second half of the 1970s. There had been a very tough bear market during 1973 and the first half of 1974. But it was followed by a substantial stock market rise which lasted most of the next two years. Subsequently there came a several-year period of recurring cyclical bull and bear markets, with relatively modest net progress overall. So where are we currently, by the 1970s scenario?

Stocks have risen a long way since the October 2002 bear market bottom, and with good reason. We are in the midst of a synchronized global economic expansion – the first since the 1980s. The Federal Reserve Board has pursued a highly stimulative strategy, resulting in very low interest rates and substantial excess liquidity. Also, there is the precedent of favorable stock market returns during presidential election years. And, there has been a notable lack of attractive investment alternatives. So, while we seem to have entered a temporary corrective period, our expectation is that further gains lie ahead.

We do have some longer-term concerns, however. For one thing, with the significant rise in stock prices since the bottom, valuations are once again on the high side, albeit not yet extreme. Furthermore, the level of consumer debt seems too high, the federal budget deficit continues to rise, and job growth remains at an unsatisfactory. But most of all, we worry about the potential for a pick up in the inflation rate, which would lead the Federal Reserve Board to shift its policy to a restrictive stance.

Cyclical inflationary pressures are beginning to build, in our opinion. But at least for now, reported inflation remains low. So the Fed has kept short-term interest rates well below what would even be considered as a neutral interest rate policy. Parenthetically, that may be one of the reasons behind our weakening dollar. Be that as it may, the economy continues to show good strength in most sectors. But typically, the Fed does not raise interest rates until there has been significant improvement on the employment front, and that has yet to occur – a function of outsourcing and productivity gains.

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We believe the economic recovery has reached a stage where companies are likely to strive for future growth by expanding their businesses. Therefore, we think the current trend of productivity improvement will soon give way to job creation. And as the employment numbers improve, we would expect the Fed to begin the process of backing off these extremely low interest rates. But we also think the Fed is unlikely to raise interest rates meaningfully until after the presidential election, and perhaps not even until next year. Alan Greenspan is noted for his gradualism. Furthermore, he does not want the Fed to be perceived as affecting the election outcome.

We have heard predictions that once the Fed begins to raise interest rates, the stock market game will be over, but we disagree. Stocks have shown that they can continue advancing, even in the face of rising interest rates. What really needs to be watched for are indications that the Fed's members are seriously beginning to worry about future inflation. Then, interest rates will be raised in earnest, and that is when the stock market is likely to undertake its first meaningful cyclical decline since the bear market bottom.

Election Year Musings

"It's the economy stupid," so said presidential candidate Bill Clinton when summarizing the key issue of his 1992 election campaign. Indeed, the state of the economy is considered by many as the most important factor in determining whether an incumbent president will be successfully reelected. And that is the primary reason behind the so-called presidential election economic cycle. In modern times, only Jimmy Carter and George H. Bush failed to heed the message, and neither won a second term in office.

George W. Bush, on the other hand, has not ignored the lessons of history. Like numerous presidents before him, he took steps to provide sufficient stimulation to ensure a favorable election-year economy. And indeed, the economy has responded quite nicely. Incumbent presidents tend to be reelected during good economic times because of the general sense of well being among the electorate. In other words, if the majority of voters are comfortable with their personal financial situations, why would they want to take the chance of messing things up by changing horses midstream? So by historical precedent, one would expect President Bush to succeed in his reelection bid. Yet this time, there is another factor at work. In the past, when the economy was good, workers were prospering, but that has not been the case to date in this economic recovery.

So we think that John Kerry and the Democrats are right to focus on jobs as a central campaign issue. Not that we believe a Democratic administration would have any greater success in stimulating job growth, because the problem is largely structural. But a campaign focused on jobs might ring well with most voters, who unfortunately have little basis on which to measure whether economic-based campaign promises are realistically doable. At any rate, unless there is a meaningful near-term pick up in job growth, or unless this Republican administration pulls a rabbit out of the hat (i.e. a timely capture of Osama bin Laden), President Bush is in for the political fight of his life. From our standpoint, this year's presidential election outcome is far from clear.

And what if President Bush were to lose? In actuality, we would expect little change in economic direction under a new Democratic administration. For one thing, it seems highly likely that the Republicans will retain control of both legislative bodies. Therefore, it is also probable that the primary tax initiatives and programs of the Bush administration would remain in place, for at least a while longer. Nonetheless, we would be concerned about the protectionist pressures that would likely be put upon a new Democratic administration by the labor unions and other parts of its constituency. Could a Republican Congress resist such pressures?

And what of the financial markets? While we think that investors might react negatively, at first, to the increased uncertainty of a new administration, the stock market has actually fared best in the past during periods of political gridlock. That fact is well demonstrated in the Merrill Lynch chart shown below. Since the mid-1950s, stocks have shown a compound annual growth rate (CAGR) of some 3%, on average, when a single party controlled both Congress and the presidency. But stocks appreciated at a much greater rate of 9.7% during periods of divided power. Perhaps the prospect of nothing being accomplished outweighs the uncertain outcome of a definite agenda. In other words, investors might actually react better to an environment in which our politicians are effectively precluded from doing any harm.

Political Gridlock Is Good for Financial Markets

	White House	**House**	**Senate**	**S&P 500 CAGR**
2001-Present	Republican	Republican	Republican	-4.30%
1995-2000	Democrat	Republican	Republican	19.20%
1993-1994	Democrat	Democrat	Democrat	2.70%
1987-1992	Republican	Democrat	Democrat	10.30%
1985-1987	Republican	Democrat	Republican	13.90%
1981-1984	Republican	Democrat	Republican	5.40%
1977-1980	Democrat	Democrat	Democrat	6.00%
1968-1976	Republican	Democrat	Democrat	1.20%
1961-1967	Democrat	Democrat	Democrat	7.50%
1955-1960	Republican	Democrat	Democrat	8.30%
		Average	**One Party**	**3.00%**
			Gridlock	**9.70%**

Source: Merrill Lynch

Still, it remains our belief that the extent and timing of Federal Reserve Board actions regarding interest rates are likely to have the greatest market-moving consequences over the coming months, barring unexpected events.

<u>So What's an Investor to Do?</u>

First, go with the flow. The end of this bull market phase may be coming into distant view. But short-term corrections aside, we think that stocks are likely to continue moving higher for a while longer, until investors perceive that the Fed is backing off its reflationary thrust.

Second, be price sensitive. This is not going to be a 1990s type of one-directional market. Good companies may not translate into good stocks if they become too expensive. Don't be afraid to take profits.

Third, reduce beta (volatility) as the market moves higher into this summer. Be willing to leave some upside potential on the table. And, be willing to temporarily hold some cash reserves. (Yes, we are aware that there is a near-zero current return on cash.)

Fourth, pay attention to sectors. Some groups are early cycle, while others move later. Also, be aware that although the former bull market leaders often lead the first advance off the bear market bottom, they also usually become bogged down as time moves on. We suspect the Nasdaq is nearing the end of its relative outperformance.

Fifth, and unique to the current environment, be very leery of owning long-term bonds. While our prior forecast of rising interest rates has turned out to be somewhat premature, it is only a matter of time, in our opinion. Inevitably interest rates will rise, and when they do, bond prices will decline. The only reason interest rates would not rise over the coming year, would be if the economic recovery breaks down. And we consider that highly unlikely.

And finally, remain in a positive mindset. The great bear market is over. While the stock market environment we perceive may not be as attractive as it was during the 1990s, we believe that the next few years will provide quite favorable returns to diligent investors.