Marathon Strategic News

500 Market Street, Suite 610, Steubenville, OH 43952 · (740) 282-5198 · Toll Free (866) 435-4224 · www.mstrategic.com

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Commentary by Nicholas Terezis, CFA

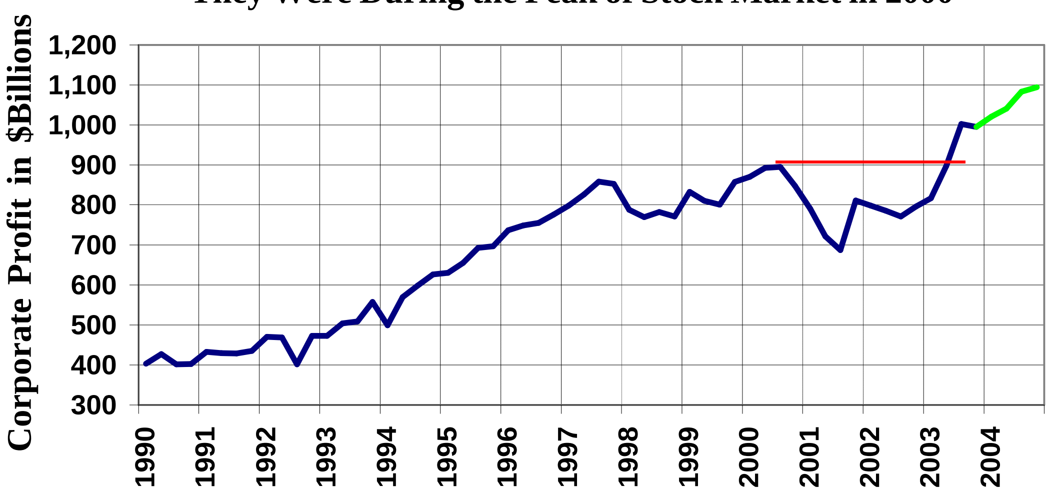
Economic Outlook

The economy is in the middle of an expansion sweet spot, and it is now growing at a rate that most economists consider to be its economic potential. In many ways, one could argue that the current economic environment seems to approach what is described in many textbooks as a Golden Age: strong gross domestic product (GDP) growth, robust corporate profits, high productivity, low inflation, and low interest rates.

In fact, all sectors of the economy are now growing, and the Federal Reserve Board will likely begin to raise interest rates by the middle or end of this year. Contrary to many opinions, the interest rate increases should be a gradual and elongated process that soothes rather than roils financial markets. Even though interest rates are likely to increase, monetary conditions should still remain economically stimulative for quite some time. This accommodative monetary policy should be bullish for both the economy and the stock market. Further, I believe that by the end of the year economists will most likely begin to speculate that this expansion has the potential to last for a long time.

Having a strong, long economic cycle does not mean that the stock market will progress without volatility. One of the only certainties about the stock market is that there will always be <u>un</u>certainty and volatility. Although there have only been ten recessions since World War II, there have been 45 stock market declines of at least 10%. In other words, if future stock market volatility were to resemble historical volatility, then investors on average should expect to see momentary stock market declines of at least 10% almost every year.

Corporate Profits for US Companies are Higher Now Than They Were During the Peak of Stock Market in 2000



Source: Federal Reserve Bank of St. Louis and Marathon Strategic Advisors, LLC estimates. Note: All 2004 numbers are estimates. "Corporate Profits" are "Corporate Profits with Inventory Valuation and Capital."

The majority of stock market fortunetellers will claim that stock market performance is directly dependent on the deafening volume of daily "news" items. The fact is that almost every discrete piece of daily "news" amounts to nothing more than noise (volatility)! Recent examples of this noise include unsubstantiated speculation on: deflation fears, inflation fears, high unemployment, low unemployment, war on terror progress and failures, terrorist threats, presidential election results, and the pervasiveness of mutual fund scandals. The main factor that will drive the stock market higher or lower is the strength of US GDP and its impact on corporate profitability. I believe that GDP and corporate profits will continue to be strong. Further, I believe it is likely that there will be more short-term upward corporate profit surprises than downward ones.

As I have stated many times before, no one can successfully "time the market." The best course of action in both bull and bear markets is to maintain a long-term buy-and-hold investment strategy. Investors must keep their emotions in check, ignore "investment news" that is really noise, and be patient and optimistic. I believe that the big picture, long-term outlook for the US economy and stock market is very strong.

Questions & Answers

Recently, I have been asked the following questions.
Perhaps all investors would benefit from these responses.

Should we worry if the Federal Reserve Board begins to increase interest rates?
Any upward adjustments in the federal funds rate at this stage of the business cycle should be taken as good news to long-term investors. It will be the best indication that the Federal Reserve believes that the current economic expansion is sustainable.

How will bonds perform over the next few years?
I am not optimistic on the total return of bonds during the next few years because I think that interest rates are likely to increase faster and higher than what most people might imagine. At today's rates, US Treasury bonds can no longer be viewed as providing a risk-free return. In fact, I believe that intermediate and long-term bonds are currently offering something closer to return-free risk.

However, having a diversified portfolio is very important for all long-term investors, because no one ever knows with certainty what will happen in the future. I do not recommend that investors move from bonds to stocks, and then back to bonds as market prices gyrate. Investors should have an investment and asset allocation strategy that remains constant throughout all market cycles. Having said this, I believe that the portion of an investor's portfolio that is allocated toward bonds should have a lower duration in this environment. In other words, investors should focus on owning short-term bonds and avoid long-term bonds.

Why is unemployment "stubbornly high?"
It is not! Over the past 30 years unemployment has averaged 6.4%. During this time the lowest rate of unemployment was 3.8% (at the peak of the stock market bubble in 2000) and the highest rate of unemployment was 10.8% (during the recession in 1982). Today unemployment is better than average at 5.7%! America's fixation on unemployment is currently politically driven.

The reason that unemployment is not lower has little to do with politics and much to do with the nature of our economic system. Businesses will always seek the most productive use of resources. Any attempt by the government to protect American labor from this natural tendency increases inefficiency in our system and reduces corporate profitability. The fact that the US economy can be a nimble juggernaut is one of the greatest factors that assures our long-term global economic dominance. The US economy continuously undergoes major structural transitions (such as out of the steel industry and into new cutting-edge technological industries). Protectionism, regardless of the reason it is instituted, will ultimately harm everyone, because it makes us less competitive in an ever-increasingly competitive world.

How will the stock market perform for the remainder of this decade?
No one knows, of course, but here is an interesting observation: the stock market's performance thus far in this decade (starting in 2000) has been bleak. Even after last year's large gain, the S&P 500 had an annualized loss of 5.34% through December 2003. My opinion is that the outlook for stocks during this decade should be favorable based in part on a fundamental principle of economics called reversion to the mean. Reversion to the mean is the tendency for investment returns to adjust (revert) back to their long-term average given enough time. For example, even after the 2000-2002 bear market, the S&P 500 index averaged an annualized return of 11.07% for the past 20 years. This is close to the historical average return of about 10%.

In light of the stock market's negative returns since the year 2000, I believe that there is a good chance that stocks will revert to the mean and perform reasonably well over the remaining six years of this decade. For stocks to simply break even during the decade, they would need to average 1.79% a year from 2004 to 2009. For stocks to earn an average annual return of 5% during the decade (about half the long-term average), they must average 9.14% a year going forward. For stocks to achieve the historical average annual return of 10% during the decade, they would have to generate an annualized return of 16.64% annually going forward.

You always say to diversify. Why?
The primary advantage of having a diversified portfolio is that it reduces risk and can provide smoother, more consistent investment returns. Diversification also provides balance to a portfolio. In other words, you won't achieve the maximum possible return with a diversified portfolio, but you won't suffer the worst possible return either. A diversified portfolio provides exposure to different asset classes that have low correlations with each other. This tends to smooth volatility, and helps generate extra return for a given risk level.

Everyone is talking about investing in China. Should I be invested there?
Despite some admirable market reforms, China is still a communist country, and it has virtually no modern history or tradition of private property rights. This can be a very scary proposition to capitalists. What happened to Yukos Oil Company in Russia could very easily happen to Chinese companies. On a whim, the Russian government suddenly decided to seize 40% of Yukos' shares, which were owned by its Chairman!

Also, China has far less financial transparency, disclosures, and accounting standards than developed countries. While China holds great opportunity, investors should own a very, very small portion of their portfolios in Chinese stocks, and *caveat emptor* (buyer beware) should be the primary posture for nonprofessional investors.