



ASSET MANAGEMENT COMPANY

FIRST QUARTER 2004

## Current Market

The first quarter lacked much news to propel stocks significantly in either direction. Last year's rally occurred as high expectations were priced into U.S. stocks, and January's earnings reports mostly delivered. But once again, terrorism reared its ugly head in Spain and spooked the markets in March. For the 1<sup>st</sup> quarter, the S&P rose 1.7% and the Dow was down 0.9%.

When looking at the factors that influence markets, there is much to be optimistic about. Inflation is relatively low for now and productivity is strong. Consumer confidence is increasing and there are some signs that the stubbornly soft labor market may finally pick up. Oil prices have been stable (albeit slightly higher) despite skyrocketing demand (more on this later) and there is a likelihood that strong corporate earnings will continue. The combination of these will probably underpin stocks overall for at least the short term, but there are some potential bumps in the road to be aware of.

So far this year, some of the best returns have come from commodity producers and with good reason. To put this in perspective, in China twenty years ago there were sixty private passenger vehicles total. Today, China manufactures that many in minutes. It is estimated that when—not if—the Chinese in the coastal regions (approx. 166 million) achieve the same percentage ownership of automobiles as South Koreans have today,

the world will need two new Saudi Arabias to satisfy their gasoline demand.<sup>1</sup> In light of this, it is possible that we see increasing oil prices from current levels, especially if the dollar continues to fall.

Apart from high oil prices, the growth in China and India also helps account for the jump in the CRB index, which measures a broad mix of commodity prices. As more work is outsourced to emerging market countries, it has created a growing middle class that is now capable of consuming like never before. This dynamic has put upward pressure on the prices of many raw materials, a trend that may not abate for quite some time.

## Bumps in the Road

While these trends are certainly inflationary for U.S. consumers, productivity gains and producing offshore have helped offset much of this pressure because technology and cheap labor have helped companies produce more output per unit of cost. However, these efficiency gains can only absorb rising input costs up to a point before we see inflation creep into finished goods. Add to this an environment in which world governments are doing everything possible to keep their currencies weak to stimulate exports and the probability of inflation becomes high. To an extent, we believe that it is already here, but the Bureau of Labor Statistics (who

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<sup>1</sup> Source: BMO Nesbitt Burns Inc.



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calculates CPI using a funky methodology) tells us that it is not. Either way, the threat from rising prices is potential bump in the road number one.

Potential bump number two is unemployment. While unemployment is not high, companies overall are not looking to hire at present because of excess capacity in many industries. When consumers are concerned about the job market they tend not to spend heavily, especially when they are already carrying a record amount of debt. So the economic future is anything but certain and will probably not see explosive growth like it did in the 90s anytime soon.

The third bump in the road is terrorism as the recent events in Spain reminded us. Free societies will continue to make headway rooting out terrorist leaders and their henchmen, but it is impossible to control security 100%. It is a near certainty that there will be ongoing terrorist activity destroying innocent lives and affecting markets along the way.

### **Investment Strategy**

To cope with all this, we intend to keep the bonds invested mostly in short-duration issues and we'll seek yield pickup in corporates and in bonds with call features. We have a consistent allocation to foreign stocks using exceptional managers and we pay a lot of attention to valuations for the individual stocks and to manager

performance and philosophy in the mutual funds. Our objective is to generate positive returns with low volatility over time and across a variety of market conditions.

The prospects for our investments continue to be promising. We have more exposure to gold and natural resources than normal, but the upside potential for both is tremendous. We don't expect this year's returns to look anything like last year's, but we still see plenty of opportunity in many investments. If a change in strategy is needed in your portfolio either through a change in your personal finances, a change in your risk preferences, or if you have questions about your current advisor, please contact us to set up a *no obligation* review.