

Quarterly Market Review

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Financial Markets and Economic Analysis, First Quarter 2005

Summary

The euphoria of the market after the November election turned out to be short lived, as all of the major indices turned in negative results for the first quarter. Job growth was positive during the first quarter as the economy added 159,000 jobs per month on average. However, the growth was uneven, with more than half of the growth coming in February, and a disappointing 110,000 in March. Underlying the jobs reports was little indication of wage inflation, though the Fed continued to worry about just that as two rate increases were decided upon during the quarter.

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There continued to be signs of job growth, although weak at best, and other positive economic indicators, but in the end the positive news ran headlong into rising oil prices, rising interest rates and a gradually weakening dollar. The indices started the year weakly, dropping steadily through the first month, before rebounding sharply through the first week of March. However, most of the indices retested their lows by mid-march, wiping out the rally in just two weeks. As politically charged as 2004 was, the first quarter of 2005 remained relatively devoid of any politics of note. President Bush continues to campaign for reform of the Social Security system, but little was accomplished in the first 90 days.

Domestic Equity Markets Overview

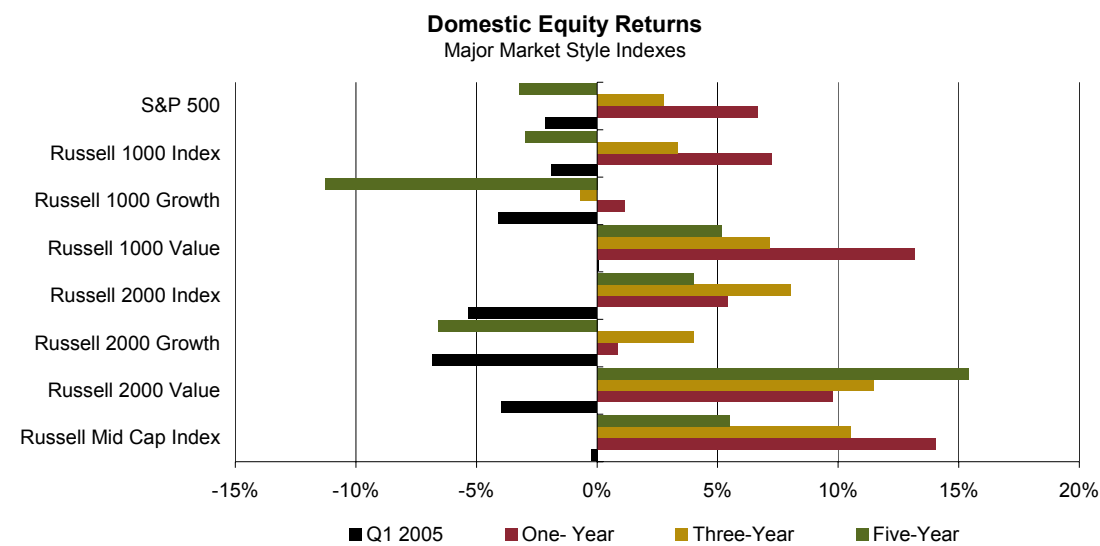
The first quarter of 2005 produced two unusual results in the major indices. First, the best performer was the Russell Midcap Value index, and second, the performance of the various style indices varied widely, depending on which family of indices were used. Value outperformed growth in all of the Russell indices; however, growth outperformed value in all of the S&P indices. This is due to the S&P growth indices having a much higher weighting to energy, the best performing sector, and much lower exposure to technology, financials and healthcare, the three worst performing sectors.

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	Russell	S&P	Difference
Large Value	+0.08	-2.43	2.51
Large Growth	-4.08	-1.86	-2.22
Small Value	-3.98	-2.38	-1.60
Small Growth	-6.83	-1.73	-5.10

Energy prices played a big role in the macroeconomic picture, but also were a big factor in the index performance for the first quarter. One of the prime reasons that large caps outperformed small for the second quarter in a row, was the 18% jump in the Energy sector for large caps, while small cap energy companies were up less than half of that amount. Technology continues to be the weak spot across the market cap spectrum, down substantially in the first quarter, and the only large cap sector with negative returns over the last 12 months. But investors should tread lightly on the recent trends and look more closely at the 10-year numbers for all of the sectors. Over that period, all of the economic sectors, except utilities, of the Russell 1000 have a positive return between 9.5% and 15%.

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International Markets Summary

The dollar firmed up substantially during the first quarter of the year, making the returns on international investments somewhat less attractive. Europe enjoyed a much better first quarter than the U.S. market in local currency terms, while the Pacific Rim was also slightly positive. Once those returns were converted back to dollars however, most, if not all, of the gains were eliminated and the regional indices ranged from marginally positive to down 2%. Of note in the developed markets were the Nordic countries, as Denmark was up more than 11% and Norway more than 9%, both in local terms. Ireland was the worst performer among the developed countries, down more than 7%, with Hong Kong also down nearly 4%.

Among the Emerging Markets, the exchange rate issues were less pronounced, and in dollar terms, most regions turned in positive results. Eastern Europe led the way with a nearly 6% return for dollar denominated investors. Latin America was relatively tame by comparison, but only after falling nearly 8% in the final month, ending the quarter up just 2.3%. There were some individual standouts among the emerging markets: Egypt (56%), Pakistan (27%) and Jordan (25%), all turning in astounding quarters.

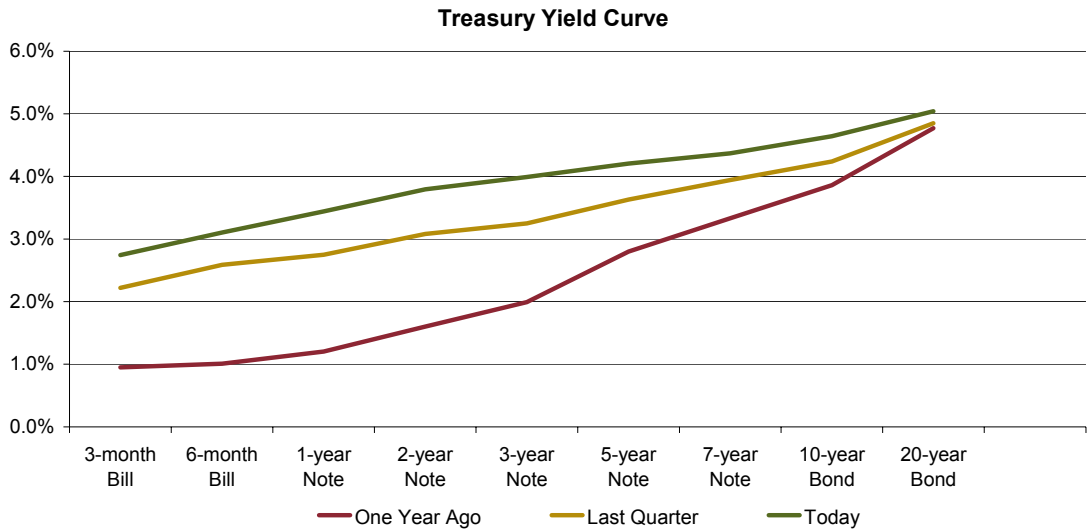
Fixed Income Summary

With two rate hikes from the Fed in the first quarter, there is no surprise that bond indices fell into the red, some sharply. The yield curve began to steepen during the quarter, courtesy of the two rate hikes, after more than a year of flattening. This created an unusual pattern in the indices, as longer term bonds, which normally react negatively to interest rate increases, outperformed bonds at the shorter end of the curve. Mortgages were the best performing sector in the taxable bond market, followed closely by Treasuries. The high-yield corporate sector was the hardest hit during the quarter.

Municipal bonds followed the same pattern as the taxable bond market, with the overall market nearly breaking even, down just 0.03%. The long portion of the market, more than 17 years, was slightly positive for the quarter, with the worst returns coming in the most heavily invested segment of the market, the 4-8 year maturities. Most retail bond managers have shortened maturities and durations away from this segment of the market, so most should post returns slightly better than the 0.75% loss of the Lehman Brothers 5-Year Muni Index.

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Outlook

The U.S. equity markets were down in the first quarter, despite a 20% increase in earnings for the S&P 500. First quarter earnings are expected to decelerate to about 8% growth year-over-year. Energy prices continue to press upward, but the inflationary pressures have not been felt yet. The weakness in the March jobs report takes the pressure off the Fed to step up its increases, but we will likely see two further rate increases during the second quarter. Barring a dramatic shift in investor sentiment, these headwinds will likely keep domestic equity and bond returns flat to lower during the second quarter.