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The Market's Up. Why Do We Feel Blue?

By PAUL J. LIM

THE second quarter proved to be, well, a conundrum for mutual fund investors.

On paper, the quarter was rather successful. The average domestic stock fund, for example, advanced 2.8 percent, reversing a slide of 2.3 percent in the first quarter. Among general domestic stock funds, the gain for the quarter was 2.4 percent.

The gains were fairly widespread. Money was made in small-company and blue-chip stock funds - and in growth-oriented and value-oriented portfolios. And both stock and bond funds posted solid gains, on average, in contrast to the first quarter, when both lost ground. Stock and bond funds benefited from an unexpected fall in long-term interest rates, which Alan Greenspan, the Federal Reserve Board chairman, called a "conundrum."

And some of the big winners - again - were real estate sector funds, which soared 13 percent, on average, in the quarter; utilities funds, up 7.5 percent; and natural resources funds, up 2.4 percent, as crude oil futures prices hit $60 a barrel in the quarter.

Yet investors emerged from the second quarter less optimistic than they were at the start of the year, when many stock and bond funds were in the red.

Despite a slight improvement in June, the UBS Index of Investor Optimism remains substantially below its level in the first quarter. That may explain why net new cash flows into stock funds were down 38 percent this year through May, versus the corresponding period last year, according to the Investment Company Institute, the mutual fund industry trade group.

"I'm shocked at the level of apathy - perhaps even pessimism - about the market, given the current environment for stocks," said Jonathan Golub, a United States equity strategist at J. P. Morgan Funds. "The public has this thing really, really wrong."

Part of the public's dour mood may be attributable to the perceived gap between the performance of the equity markets and real estate. While the average sales price of an existing single-family home shot up nearly 13 percent in the 12 months through May, the stock market "is stuck in a trading range," said Robert Doll, chief investment officer for Merrill Lynch Investment Managers.

But the real culprit may be the unpredictability of the markets themselves. "This was one of those quarters where no one was 100 percent prescient," said Andrew Clark, senior research analyst at Lipper, the fund tracker.

For instance, despite all the uncertainties surrounding inflation and oil prices, three things seemed rather certain at the start of the quarter.

For one, large-capitalization stocks were supposed to wrest control of the market from small-company shares, as often happens when stock market rallies mature.

Yet that didn't necessarily happen this spring. While large-cap growth stock funds posted solid gains of 2.8 percent, small-cap growth funds did even better, climbing 4.1 percent on average, according to Morningstar. Among value-oriented funds, those that focus on large stocks advanced 1.3 percent while small-company funds surged 3 percent.

Heading into the third quarter, mutual fund managers and market strategists were again predicting large-cap outperformance.

Another assumption entering the quarter was that international stock funds were supposed to beat domestic portfolios, as the dollar was expected to weaken against the euro. But political uncertainties in Europe, caused in part by the rejection of the European constitution by French and Dutch voters, strengthened the dollar. In fact, the dollar gained 7 percent against the euro in the quarter and 11 percent in the first half of the year.

The dollar's unexpected climb reduced the value of foreign holdings by domestic fund investors. The average European stock fund, for example, fell 0.5 percent in the quarter, though international stock funds over all still managed gains of nearly 0.4 percent.

"The dollar rallied when it wasn't supposed to," said Russel Kinnel, Morningstar's director of mutual fund research. "That was a bit of a surprise."

An even bigger surprise, he added, was that "bonds rallied when they weren't supposed to."

Heading into the quarter, one of Wall Street's biggest assumptions was that stocks would beat bonds. Long-term interest rates were expected to climb, reducing the underlying value of older bonds in fixed-income mutual funds and giving equities an advantage.

But despite two additional increases in short-term interest rates by the Federal Reserve Board in the second quarter, yields on 10-year Treasury securities actually fell, to 3.94 percent at the end of June from 4.50 percent at the end of March. (Since the quarter ended, those yields have moved back up to around 4 percent.)

As a result, the average taxable bond fund gained 2.1 percent in the quarter and was up 6.6 percent over the 12 months through June. Long-term government bond funds also did well, returning 5.8 percent in the quarter. That brought their 12-month gains to 14 percent.

So much for the end of the bull market in bonds. A growing number of market analysts say investors could be in store for a sustained period of historically low long-term interest rates.

Consider William H. Gross, managing director of Pimco, the asset management firm based in Newport Beach, Calif. While Mr. Gross, who manages the Pimco Total Return bond fund, says it's a "slam dunk" that the Fed will increase short-term rates at least once more in the next few months, he thinks that

10-year Treasury yields will remain stuck in the 3 percent to 4 percent range for the next few years.

The domestic economy is slowing, and Mr. Gross says he thinks the federal government has exhausted the traditional tools to fuel faster growth, such as further tax cuts.

The global appetite for Treasury securities, meanwhile, especially from China and other Asian nations, continues to grow, he said. "There's a new bully on the block and that's the Asian buyer of Treasuries," Mr. Gross said. "Unless you can get on the right side of the bully, you're going to get beaten up."

Because of his forecast for low-but-stable long-term rates, Mr. Gross is now recommending a strategy that few thought safe at the start of the year. He says bond investors should gravitate toward longer-maturity bonds as opposed to short-term issues, which are typically regarded as safer plays in an environment of rising rates.

"It's a new reality," Mr. Gross said. "Under these circumstances, a bond holder should be thinking about being long duration as opposed to having a shorter duration."

As for the broad investment landscape, he says he believes investors should brace themselves for a sustained period of modest, if not mediocre, gains in both the stock and bond markets, with total returns in the mid-single digits.

Is there anything on the horizon that could shake the markets out of their doldrums in the second half of the year?

Mr. Doll of Merrill Lynch said the equity markets were likely to vacillate until investors had a clearer sense of when the Fed might stop tightening monetary policy. "All eyes are on the Fed," he said, "and how far they are going to go and how long it's going to take them to get there."

He says he believes that the Fed will probably stop once the federal funds rate, which banks charge one another on overnight loans, rises to 3.5 percent. That would imply just one more rate increase, since that target rate is now at 3.25 percent. But others still believe the Fed will continue raising rates to 4 percent, or higher.

Whatever level the rate reaches, conventional wisdom says that when the Fed stops tightening, a rally could ensue in the stock markets, maybe one that is similar to the year-end rallies of 2003 and 2004.

But history shows that periods immediately after the end of Fed rate increases aren't always rosy. Although stocks went on a tear after the Fed stopped raising rates in 1989 and 1995, equities have more typically lost ground during such times. Ned Davis Research studied Fed tightening cycles back to 1920 and found that the Dow Jones industrial average was down 4.9 percent, on average, six months after the Fed stopped raising rates. A full year after the end of rate increases, stocks were typically down 3.9 percent.

If history plays out, investors face ample risks well into 2006.