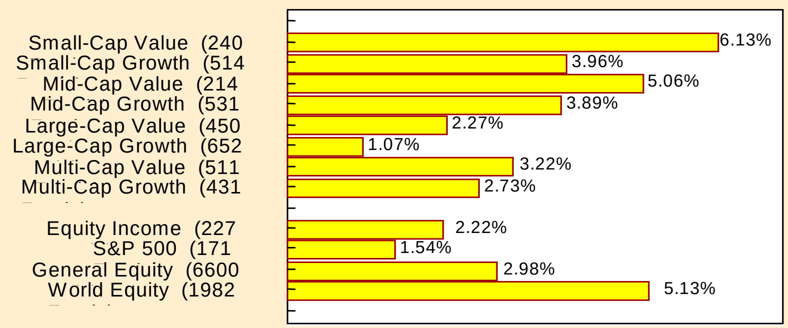
Niemann Capital Management, Inc.

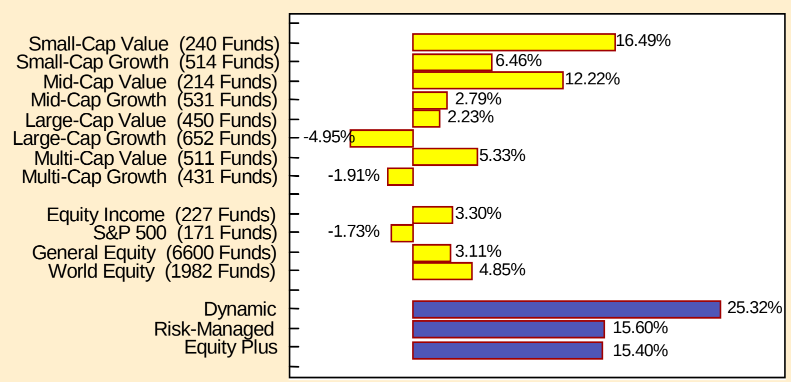
First Quarter 2004 Review

Thanks to a nice burst in the final week of March, most measures of U.S. share prices closed in the black for the first quarter 2004. According to Lipper, 6600 diversified U.S. equity funds ground out an average 2.98% return so far this year (labeled General Equity in the chart “Mutual Funds: 1st Quarter 2004” nearby). Once again small to mid-cap companies led the way, and value strategies bested their growth counterparts. Capturing the difference between the 6.13% return of Small-Cap Value and the 1.07% of Large-Cap Growth is what active management is all about!

Mutual Funds: 1st Quarter 2004 (Lipper Analytical Services)



Mutual Funds: 5 Year Annualized (Lipper Analytical Services)



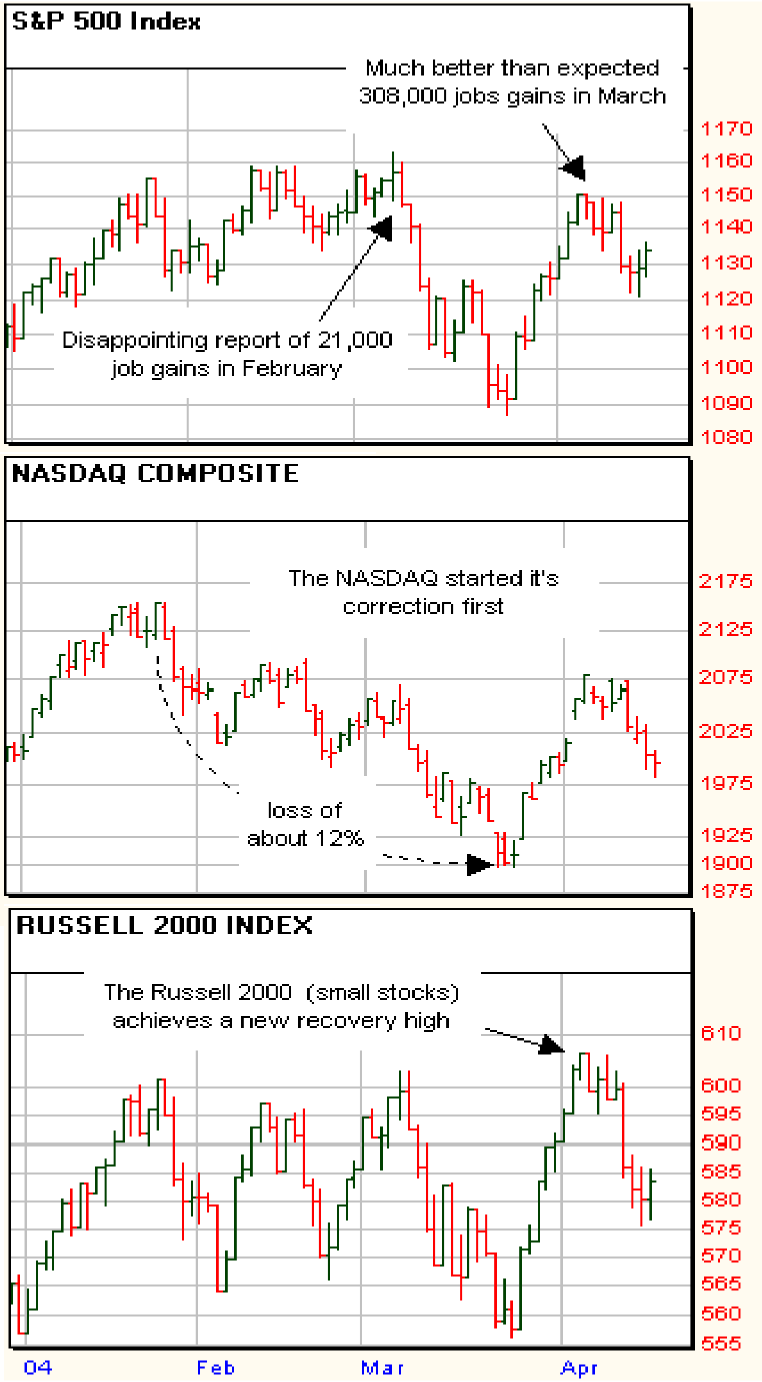
Real Estate was the best performing sector at 11.91%, but that nice return is already gone – as we’ll discuss a little later.

Foreign markets remained ascendant as “World Equity” returned 5.13%, and even stronger gains were banked in Emerging Markets 9.02%, Japan 13.82% and the Pacific Region at 10.5%. As in the U.S., shares of small-cap foreign companies led the way.

A Great Run

The end of Q1 marks the 4th anniversary since both smaller company shares and value-oriented strategies have been the clear leaders of U.S. equity markets. Their superior performance over this time has been significant, as a glance at the chart “Mutual Funds: 5 Year Annualized” emphasizes. When we first uncovered the shift from large-cap companies to small, and growth to value in early 2000, little did we know it would lead to the substantial returns our mutual fund portfolios have enjoyed for the five-year period just ended (and that’s *net of everything*, except taxes). The question is how much longer can we expect this trend to continue?

Small companies usually do well early in an economic recovery and they remained true to form this time. Earnings in the group have bettered larger companies for 13 consecutive quarters, and we expect this trend to extend into 2004. At the same time, most investors have finally caught on and put money to work in small stocks, so average share prices are no longer undervalued. Remember, share prices typically reach their peak before earnings. It’s been a great run over the past four years, but all things being equal, we’re expecting small-cap shares to relinquish their leadership role in the months ahead and begin to perform more in line with the market.



Inflection Point

In our last *Review* (Q4 2003) we advised, "Frankly, you all are going to be pretty happy with the returns inside this *Review*. Enjoy them because the easy money - for this cycle - is most likely *behind us*."

That remark turned out to be a little too prescient for my taste! As you can see in the charts (left), before their quick levitation at the end of March, U.S. markets were in the red for Q1. Note the continued choppy up and down action over the past couple of months. Our markets are undergoing a consolidation of prices following last year's sharp advance. However, this is more than a simple correction phase. We have reached an Inflection Point in this cycle – a juncture at which we might catch a glimpse into the future of this bull trend. Let me try to lay it out for you.

First, the fundamental backdrop is terrific. The Blue Chip Survey expects 2004 profits to be up 18.2%, CPI to average 1.9%, and GDP to run at 4.7%, the best since 1984. This quarter's earnings are coming in better than expected with 90% of companies surprising to the upside an average 6.3%. Interest rates are very attractive at 4.5% on the ten-year, and mortgage rates near their lows of the past 40 years. It doesn't get much better than this (and that's why those tiny hairs on the back of our contrarian necks are standing on end)!

At the same time, all we've heard over the past several months is that the recovery in the U.S. was *"jobless,"* and would falter for lack of the self reinforcing properties of an expanding work force. No one bothers to mention our unemployment rate is *about half* of Europe, or that our GDP is running at about *4 times* theirs. Shares sold off after the disappointing February Employment report released on March 5th.

The conventional bull case for stocks is that combined with already great earnings, all that is needed is a clear upturn in unemployment to boost share prices through their highs. Solid new highs (above 1180 in the S&P 500) should remove lingering doubts on the durability of the economic expansion, clearing the way for another good move in stocks. So when we finally got the robust jump in new jobs on April 2, the one-day rally and subsequent sell off in stocks flashed an interesting "tell." Market action subsequent to the release of that March Employment report provides ammunition for the bear case - that stocks just might have all the good news already built into share prices. This would be particularly true if the incumbent were to lose the election.

Mad Ravings of a Market Tactician

As bulls, we need to explain away the failure of stocks to rally on good news. Fortunately, this can be done when one understands that at this point in the cycle, good news is really bad news, and bad news can be pretty good! Let me explain. Generally, rising interest rates are bad for shares prices, while falling rates are good. According to the *playbook*, the Fed (Federal Reserve) should have already hiked rates a bit by now in response to very strong earnings. Yet they haven't: in part because strong productivity has allowed mature companies to grow without hiring many new workers, and in part to counter continuing geopolitical risks.

So the surprisingly good news of much better than expected 300k+ job gains for March was really *bad news for stocks* – since it raises the specter of a Fed rate hike. Anticipating the Fed, bond markets sold off hard (rates increased) taking stocks with them. Interest sensitive REITs gave back all their gains year to date and then some. Take this logic a step further and you'll see the bad news we're looking for is a Fed rate hike! This rate hike should turn out to be *good news* – since it will confirm the Fed sees the job gains and economic expansion as sustainable. Historically, our stock markets advance for a year after the first rate hike.

Add a Dose of Politics

The definition of the word itself says it all. It comes from the Greek. *Poli* – meaning many, and *tics* – defined as blood sucking insects. Since the profession isn't going away anytime soon we have to figure it into our thinking on the markets. This will be a very important political year. While there are many points of contention, those that affect investors should be crystal clear to any but the most partisan. The following table, lifted from *Barron's* who in turn sourced Ned Davis Research, looks back at election years since 1900 and documents what happens to stocks when the incumbent president is re-elected, or not.

Months during Election years	Incumbent Wins: Avg Gain	% of Time Market is Up	Incumbent Loses: Avg Gain	% of Time Market is Up
January – May	1.78%	60%	-4.53%	40%
June – December	14.70%	94%	4.24%	60%

Clearly from a *tactical* point of view, investors need to be prepared for different outcomes. But there is more at stake than a stock market rally over the next six months.

Consecutive broadsides of a bursting stock market bubble in 2000 and Sept 11 should have put the U.S economy flat on its back. Japan lapsed into a 15-year recession/bear market after the NIKKEI bubble burst in 1989. One and a half decades later that market is still 70% below its high. The only reason the U.S. economy hasn't crumbled is the fiscal stimulation provided by the President's tax cuts. Yes, Greenspan played the monetary role rather well, but consider that Japanese interest rates have been around 1% for years while their economy and stock market continued to languish.

Enter the challenger who says he will repeal the tax cuts underpinning this expansion. Even worse, he wants to cut taxes for the middle class by raising them on the "rich." Since he defines rich as anyone making $200k per year, he really means raise taxes on small business – creators of two thirds of the jobs in this country. Somehow these policies are supposed to inspire "confidence," but his long voting record *left* of Kennedy doesn't suggest anything good for small business.

All of which makes this inflection point in stocks so interesting. History suggests the market should firm up in May as Bush gains momentum with the approaching election. Should the incumbent stumble for whatever reason, it's more likely that the market will begin to sell off in earnest by this fall. Stay tuned!

Saving Them from Themselves

Mutual fund and variable companies continue to apply new trading policies and fees in response to various investigations into their conduct. This scandal has turned out to be even worse, and more widespread, than anyone thought. Turns out executives at some of these companies actually sold capacity for rapid trading in their funds to outside investors. Should you want to check out all the dirty linen, there is an in depth article in Fortune that is worth a read.

More companies are instituting practices that will have a material impact on investors who use their products. Sun Life of Canada, for example, has put into effect a "one trade per calendar month" policy on their variable products that will impact our ability to manage risk. In another case a current holding in our Equity Plus portfolio, *Fountainhead Value,* recently applied a 1% redemption fee to any position held less than 180 days. Policies like these may save the guilty parties from themselves, but in the end they will hurt investors. If you have questions on how these polices may affect your account, contact your advisor for more information. As always, part 2 of our current ADV is available on request.

Thank you for your continued confidence,

Don Niemann
President, CIO
Niemann Capital Management, Inc