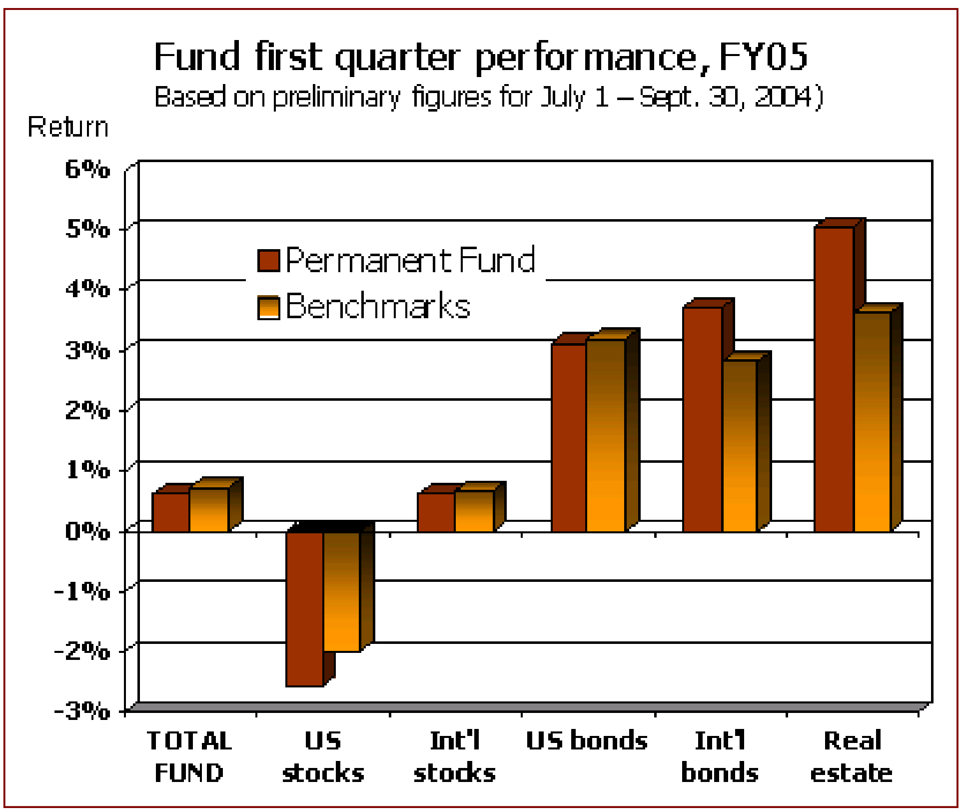
Unexpected market performance

The most remarkable thing about the markets this past quarter was that they behaved as if the last year's strong growth hadn't happened. U.S. stocks have gone almost nowhere this first quarter of the fiscal year and 10-year U.S. treasury yields are back to where they were a year ago. And yet, some market indicators are going up. Growth of the Gross Domestic Product (GDP) index has been robust (the best in 15 years and tied with the peak of the dotcom bubble). The annualized core rate of consumer price inflation has virtually doubled to 2%, lowering investor's buying power and causing the hysteria over deflation to disappear from headlines. And demand for oil drove prices up 35% during the quarter.

The market consensus for the first quarter of fiscal year 2005 was that stocks would have positive returns while bond prices would weaken during this period, in effect balancing out for a net positive total return. Instead, the opposite happened. All of APFC's asset classes posted positive returns except U.S. stocks. Technology stocks in particular were expected to lead the market, but in fact have been among the worst performers. It added up to an unimpressive 0.61% total return for the Fund (about 2.5% annualized) as the markets are stuck in narrow trading ranges of limited returns.



The future is more unclear than usual
Investors use the markets to determine the future value of money and commodities, extrapolating present trends forward as if they are going to continue. But what the market is saying about the future is at odds with what the economic statistics are saying about the present. Often these two things send the same message, and the contradiction is creating uncertainty among investors. They are being forced to choose between what the economy is saying and what the market is saying.

It is unusual to see annualized GDP growth at a "dotcom" rate without stocks perking up, or to see growth at nearly twice interest rates. And in the real estate market prices remain high, even with some evidence that consumer demand cannot sustain this pace. Alternative investments appeared in the press with increased frequency as hedge funds gained cachet, despite some large funds having difficulties.

On the corporate governance front, the wheels of justice grind exceedingly slowly but they have been grinding. Martha Stewart started her jail term. Frank Quattrone, formerly with Credit Suisse First Boston, was sentenced to 18 months for obstructing justice and witness tampering. The first of the Enron trials began, and the Securities and Exchange Commission continued investigations in several segments of the financial industry.

Stay tuned and expect the unexpected. With the elections, the war on terror, the abnormally low price volatility, and many other matters still unsettled, the markets are unlikely to stay within the same narrow price ranges that we have seen recently.

An interesting trend to watch
Stories have been coming out of Western Europe suggesting that there are some tentative signs of structural economic reform. German union members were asked to work longer hours for no additional pay. Retirement ages were raised. There were layoffs at the state controlled airline in Italy. Pension reform was adopted in France and threatened elsewhere. There were strikes over wage freezes in Germany. The steps are modest but the trend change is eye opening. If Europe becomes competitive, it's one more source of competition for the U.S. and that could affect domestic markets.

QUESTIONS OR COMMENTS?

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