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THE MIDDLE PATH

**“ Caught up in circles...
Confusion is nothing new ”**

Cyndi Lauper
Time After Time, 1984

Ah, Cyndi, if you only knew how right you can be sometimes! What a month!

This April saw the Vanguard Total Bond Index Fund shed all its gains for the year as a result of fears of rising interest rates. The same fears drove the stock indexes down into negative territory as well. Because our portfolios were more prepared for rising rates than most, our portfolios have usually fared better than the indices. Still, after that three year correction we all just endured, a little more upside would have been nice.

Investors are simply confused. There is so much extremely mixed news. Here are the thoughts which dominate the front part of my brain. (Never mind the back half, too reptilian.)

We are winning the global war on terror militarily and, at least temporarily, losing it politically. This is relevant to your portfolio because positive sentiment, especially consumer sentiment, is essential for a rising stock market.

My military contacts report that the current conflict in Iraq is generated largely by extremists who are attempting to gain leverage against security forces to influence or dominate the post-US Iraq. This is most obvious in the case of Al-Sadr, who is attempting to set up an Iran-centered theocracy after we leave. By all accounts we are slaughtering the extremists. Yet, all we hear about are our casualties.

In April the Jordanians foiled an Iran-based plot by Al Qaeda to detonate a combination of 71 lethal chemicals in downtown Amman, their capital city. They captured literally tons of chemicals and trucks converted to batter through the doors of the American Embassy before exploding. Possible casualties: higher than 9/11, perhaps as high as 80,000. This information has appeared in all the major news portals (try a websearch at CNN) but it has not received any major play. It does not fit our national mindset that this war is optional and that it is another hopeless Vietnam. Another example of our Vietnam mentality: the mixed public reaction to the recent death in combat of former pro footballer Pat Tillman.

Following their success in the Spanish elections and their success in manipulating the American media, the terrorists are sure to try for a terrorist event in the US just before the American elections in November. Their attempt may fail, or it may consist of one Afghani in a rowboat with a can of spray paint, but they will try.

“April is the cruelest month.”

T.S. Eliot, *The Waste Land*

Meanwhile the economy is booming. As employment increases, the last vestige of our past recession is fading away. Gross domestic product grew at an annual rate of 4.2%, following last year's 3rd quarter results of 8.2%. All-important productivity grew about 4%, and personal consumption grew at an annual rate of 3.8%. Business investment grew at an annual rate of 11.4%. All these numbers are simply superb. Without any other data, an economist from Mars would predict that we are a nation rocketing skyward, with a booming, growth-centered stock market.

Perhaps, without the war, we would be. By itself, this evidence suggests that we should become more daring in our investment allocation. If the war and other political issues suddenly resolved themselves favorably, we could find ourselves in a growth stock market where the S&P 500 Index is king.

Meanwhile, here comes inflation! (?) While we were enjoying the recovery of the first quarter, we were also seeing the first bat-squeak of demon inflation. Inflation is a dreadful thing because it chews through our purchasing power, and it tends to take on a life of its own as too much money in the system chases too few goods. The Commerce Department reported last week that we had a 3.2% annual rate of inflation in the first quarter. Although this is highly distorted by higher energy costs, it is further confirmation that the economy is booming. It also serves to warn us that higher interest rates may be just around the corner, and with them, a more challenging stock market.

**“ If fundamentals are so good,
why can’t stocks rally? ”**

John Roque, Analyst

The real estate bubble rolls on. The housing market has remained strong in the face of slightly rising rates. Meanwhile, my concern is that mortgage quality continues to erode. The eventual outcome of this MAY be the next big thing, another housing/mortgage crisis reminiscent of the 1980’s. In the face of rising accounting questions, the US government has begun to back away from its implicit guarantees to insure the products of government sponsored mortgage behemoths Fannie Mae and Freddie Mac. Meanwhile the crisis is not upon us and may never be. However, if the mortgage market **does** break, it will take bank stocks and real estate down with it.

And the stock market indices remain overvalued....

The S&P 500 Index has an average Price to Earnings Ratio of 26. The NASDAQ is even higher. This means that either earnings will grow dramatically in the next few months, which may well happen, or the stock market is overvalued. In any event, these numbers suggest caution. Last week we met with Michael Furlong of the First Eagle Funds and he mirrored our concerns.

Managers at the First Eagle Overseas and International funds are accumulating cash simply because they cannot find stocks priced attractively enough to buy. Other value fund managers are similarly flummoxed.

“ It’s beginning to look to us like the kind of market that both bulls and bears will find frustrating because equities aren’t likely to establish a consistent direction. ”

Charles Royce

The Royce Funds First Quarter Advisor Review

Let’s keep in mind that after last year’s superb recovery, a little breather is expected. If we are investors for decades, it is no great trial to wait for earnings to catch up. Staying on track with a long term diversified portfolio is distilled wisdom itself.

However, all this information suggests a very mixed, drifting investment environment. I still expect good results in the long-term, but meanwhile, I will be content to invest cautiously. I am inclined to choose a middle path between high-risk, high-return possibilities and the potential for politically-driven catastrophic loss. It is hard being patient. But in the long term, it is worth it. ■

You are invited to attend our seminar

“THE MIDDLE PATH”

Two times are available for your busy schedule...

TUESDAY, MAY 18, 2004 11:00AM-12:30 PM
(light lunch will be served)

WEDNESDAY, MAY 19, 2004 5:30-7:00 PM
(light dinner will be served)

Please call to reserve your seat!
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