

# Monthly Chartbook

## April 2005

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## **Energy, Earnings & Inflation**

Three words that scare the bulls and cheer the bears.

Consider:

### **Energy**

- Contango in the Crude Oil futures markets (forward prices higher than spot prices) will encourage the build of supply.
- Backwardation (forward prices lower than spot prices) was a disincentive for petroleum producers to provide any additional supply.
- SPR (US Strategic Petroleum Reserve) is rapidly approaching its full capacity.
- Iraq represents and estimated 1.0-1.5 million bpd in spare OPEC capacity being brought online in the next few years.

## **Energy, Earnings & Inflation (cont)**

- Electric power generation/private diesel generators in China are fueling marginal demand for energy in China.
- China has 20+ megawatts of electric capacity coming online between now and 2009 in the Three Gorges Hydroelectric dam alone. Hundreds of electric projects are underway.

## **Earnings**

- Earnings growth momentum is slowing, but continues to advance.
- Peak earnings momentum has passed, but not the peak in the absolute level of earnings.
- Modest earnings growth = modest market returns.

## **Energy, Earnings & Inflation (cont)**

### **Inflation**

- No doubt, there are inflationary pressures in the system and pricing power is evident.
- Energy prices settling down (Crude oil \$42-\$50), (Gasoline \$1.50-\$2.00) are *critical* to the forward path of inflation.
- Prices are sticky, and any moderation of Energy prices will take some time to filter down to broad inflation measures.
- Accelerating inflation after a moderation in energy prices would be worrisome.

# Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
<b>S&amp;P 500</b>	<b>1156.85</b>	<b>Trading range</b>	↔	<b>1130-1270</b>	<b>Next 6 months</b>
<b>Ten Year Treasury</b>	<b>4.201%</b>	<b>Higher</b>	↓	<b>4.25%-5.25%</b>	<b>6 months</b>
<b>Inflation (all Urban)</b>	<b>3.15%</b>	<b>3.25%</b>	↔	<b>2.75%-3.375%</b>	<b>6 months</b>
<b>Fed Funds</b>	<b>2.75%</b>	<b>3.00 – 3.25%</b>	↑	<b>3.00 – 3.50%</b>	<b>3 months</b>
<b>S&amp;P 500 Earnings</b>	<b>\$58.55</b>	<b>\$62.56</b>	↑	<b>\$62 - \$65</b>	<b>June 2005</b>
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

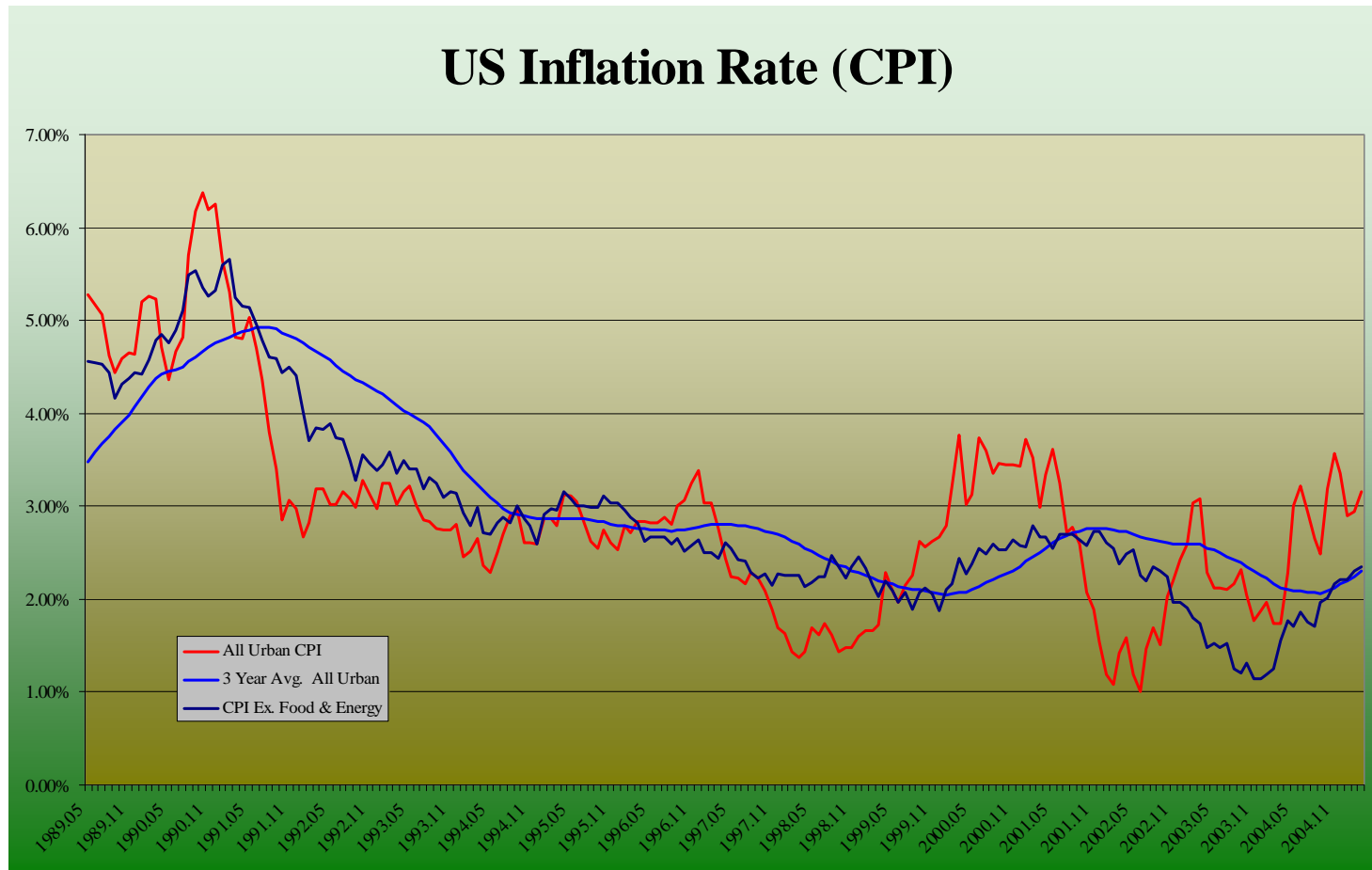
## **Inflation expectations**

The conundrum is that cyclical inflation is bearish for bonds, but that has not been the case this cycle.

Inflation remains a risk if capacity and supply do not meet the higher demands in the energy markets.

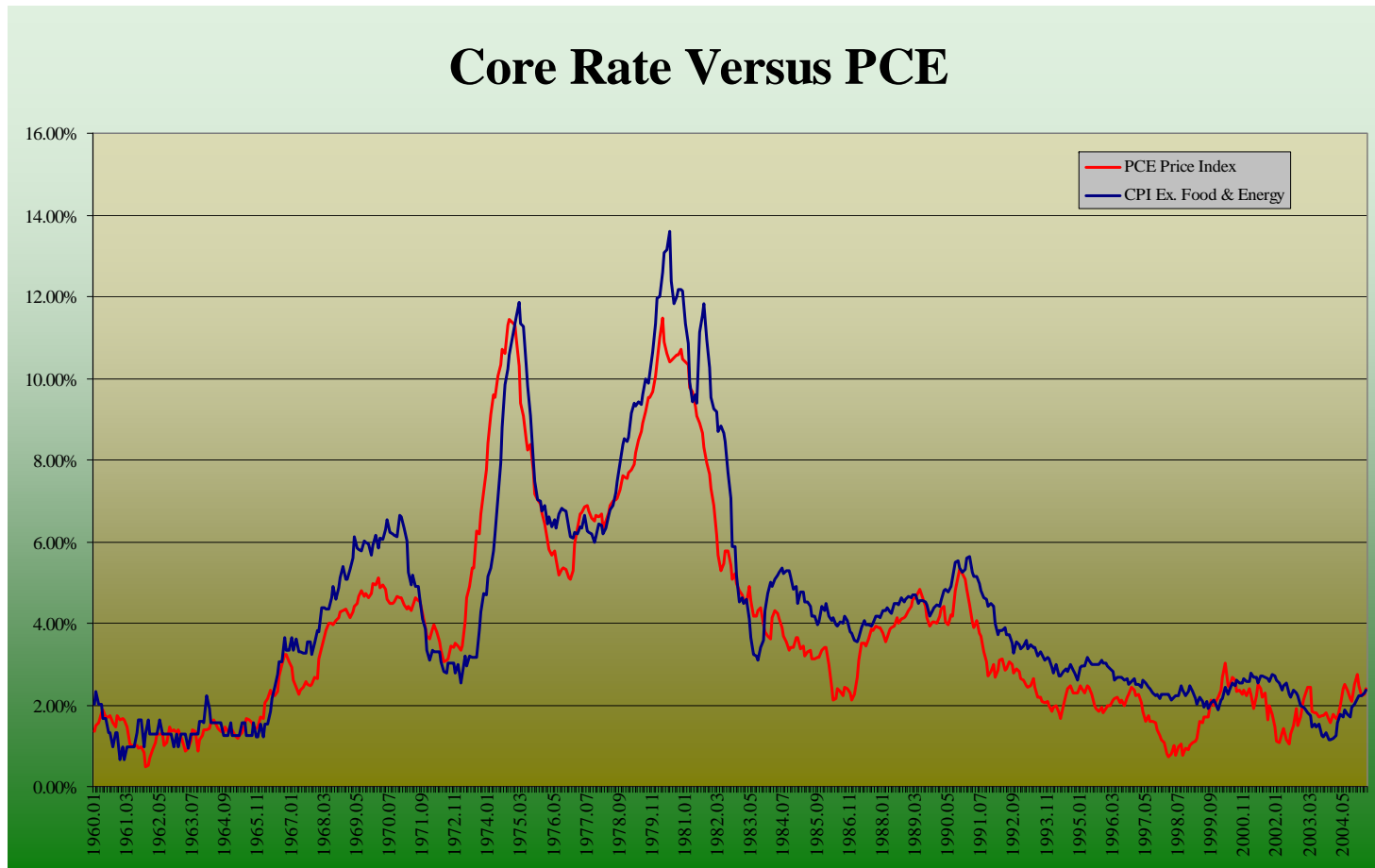
Slow but steady labor market improvement, if it accelerates, is another macro risk to inflation.

## *Inflation expectations*



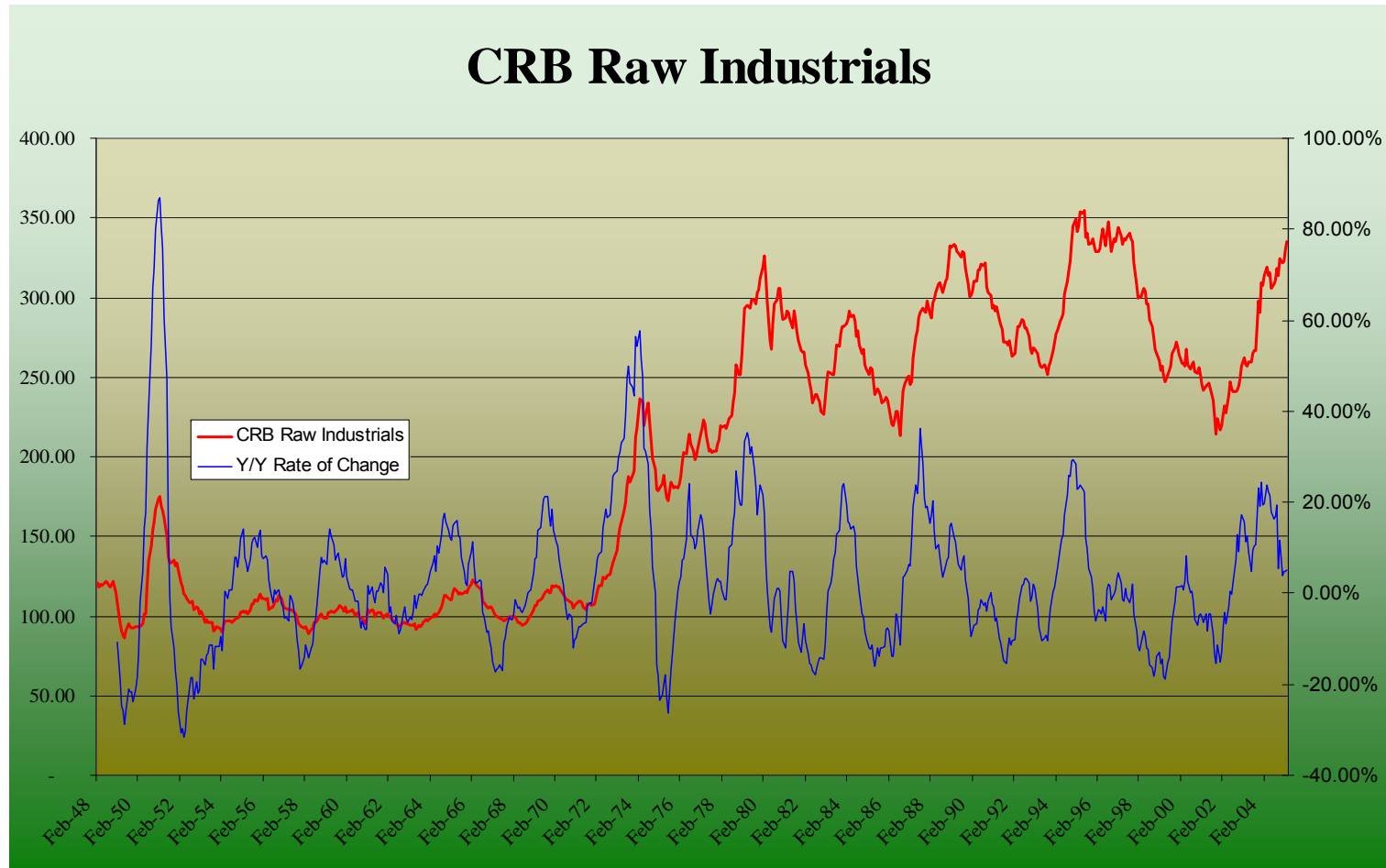
Broad measures of inflation continue to exhibit a strong, cyclical upturn driven in part by record energy prices. The core rate of inflation continues to follow the lead of All Urban CPI.

## *Inflation Expectations*



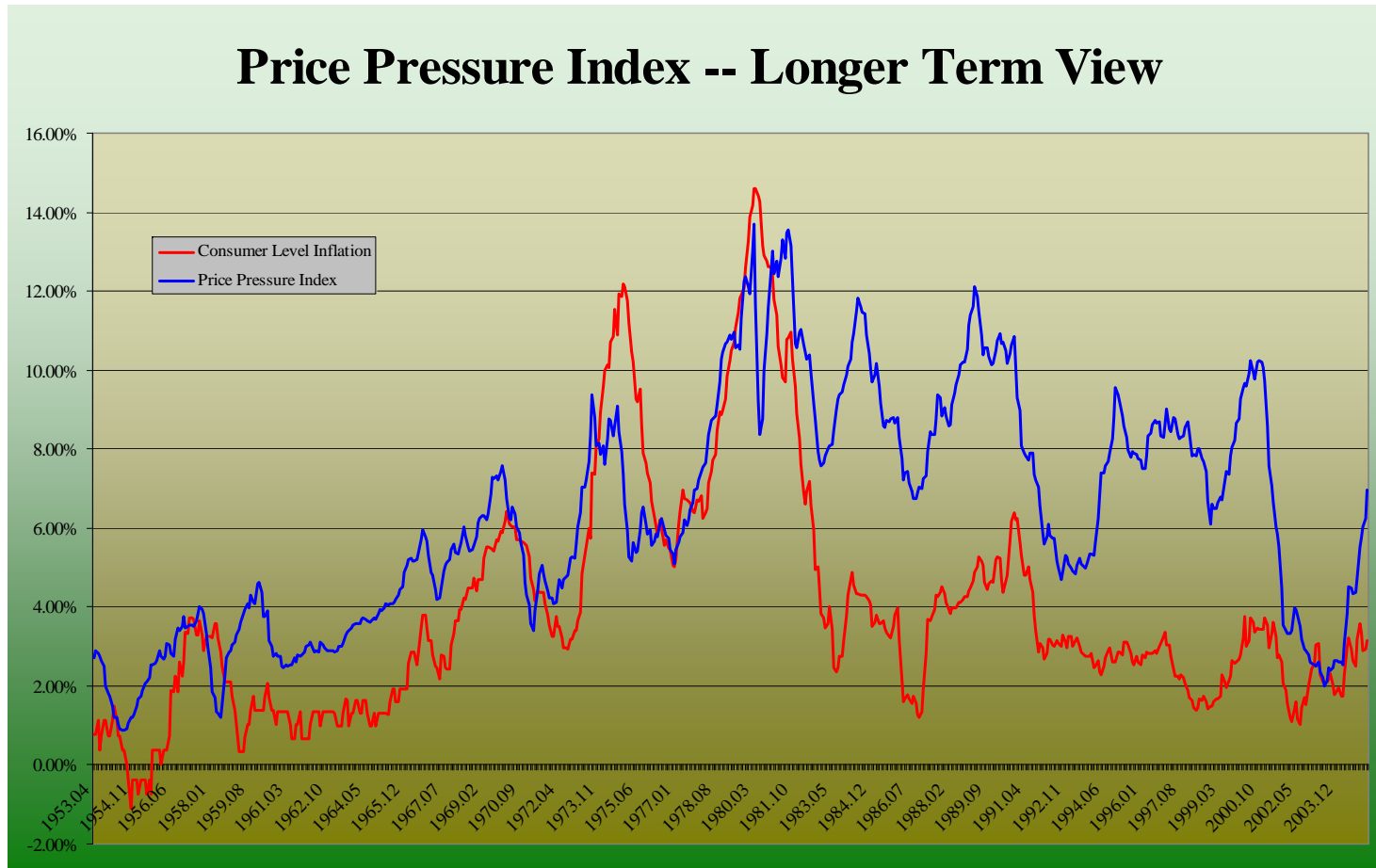
Dr. Greenspan's professed favorite inflation number, the Personal Consumption Expenditures Price Index (PCE) is ringing in last month at 2.40% versus a peak of 2.74%. Hardly run away inflation.

## *Inflation expectations*



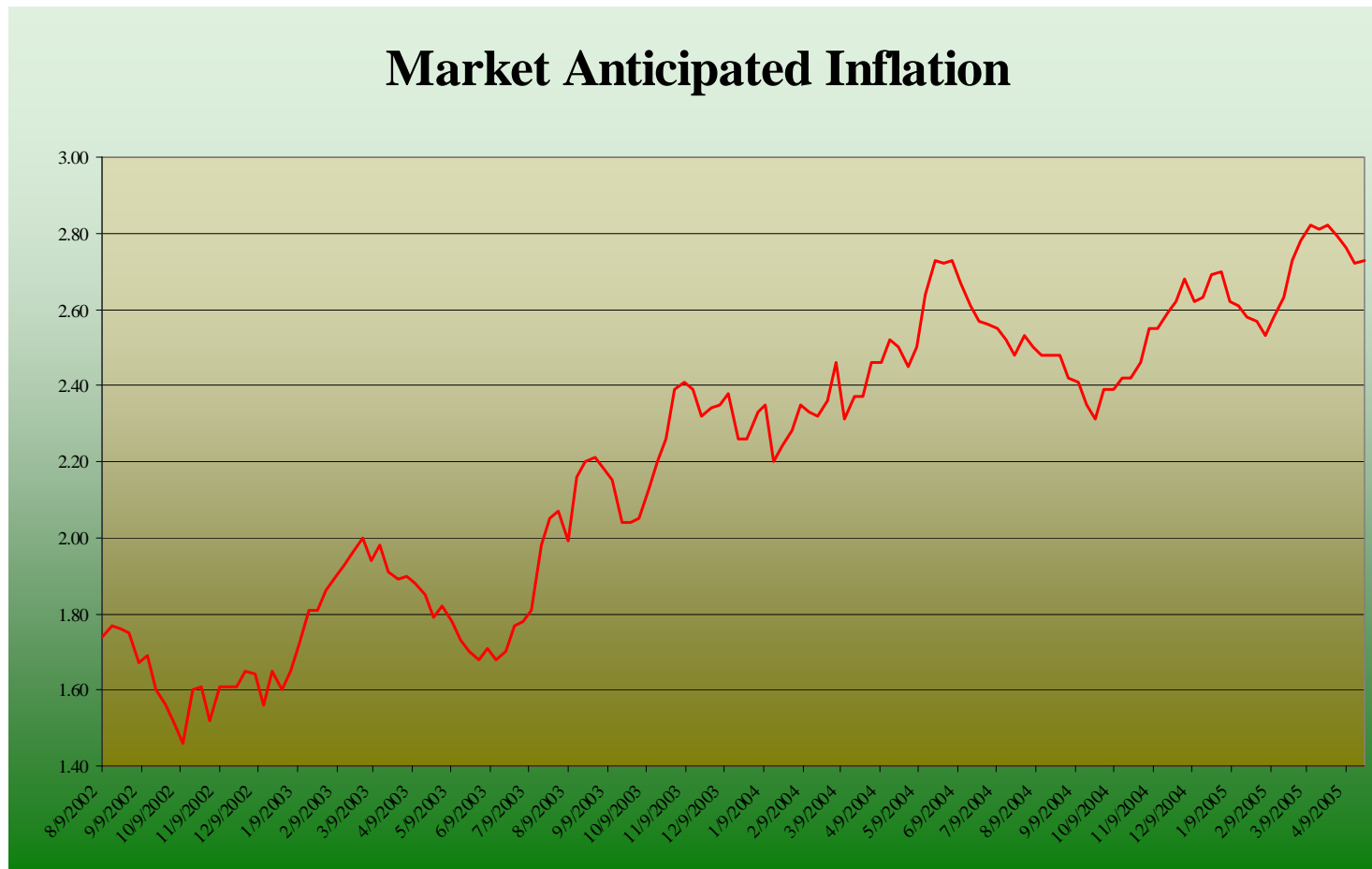
The Y/Y percentage increase in commodity prices continue to moderate. The price signals being sent to suppliers are being met even as global demand grows.

## *Inflation Expectations*



Price pressure remain.

## *Inflation expectations*



Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting higher but moderating inflation, with an implicit forecast of 2.73%, down from 2.8% last month. In our opinion, stable and expected inflation levels are as important as the aggregate level.

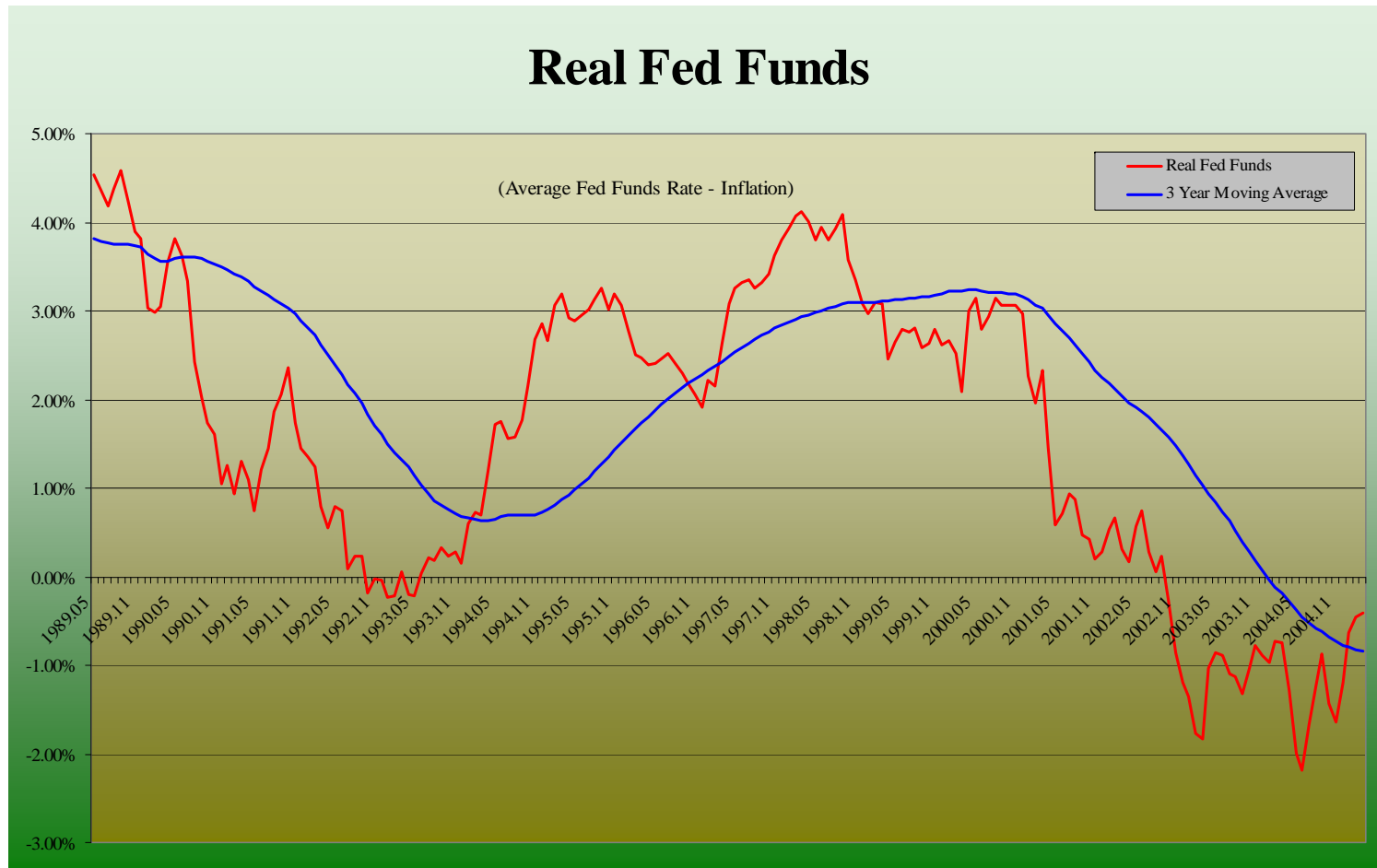
## Federal Reserve Watch

Market watchers have been parsing every release from the Fed, reading speeches from Fed governors they have never heard of trying to determine how hot the battle against the cyclical upturn in inflation is.

Greenspan doesn't want to go out with an inflation problem, but we don't believe that they want to manufacture a recession either.

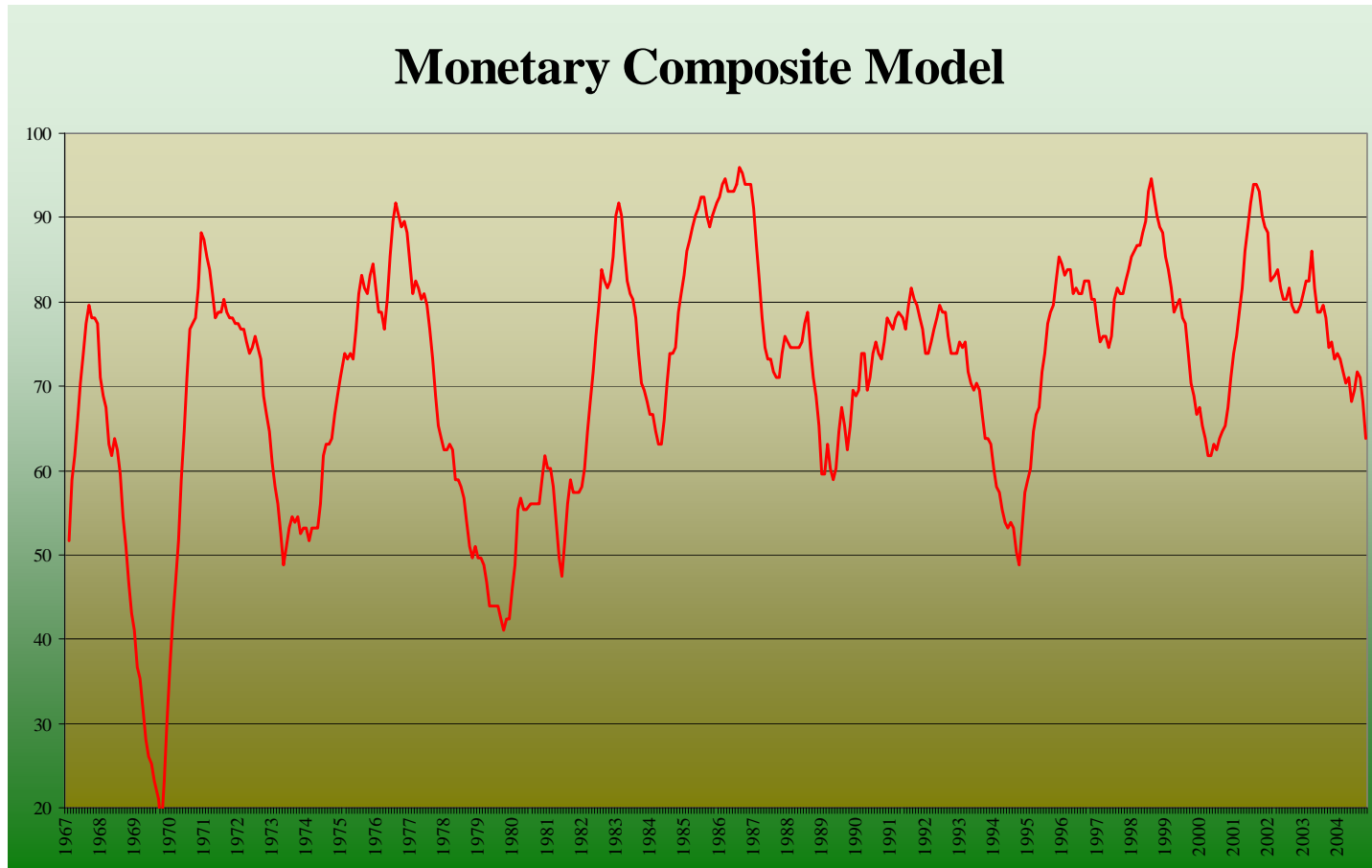
Real short term Fed Funds remain negative, but short term market rates are no longer negative across the board.

## Macro-economic Research



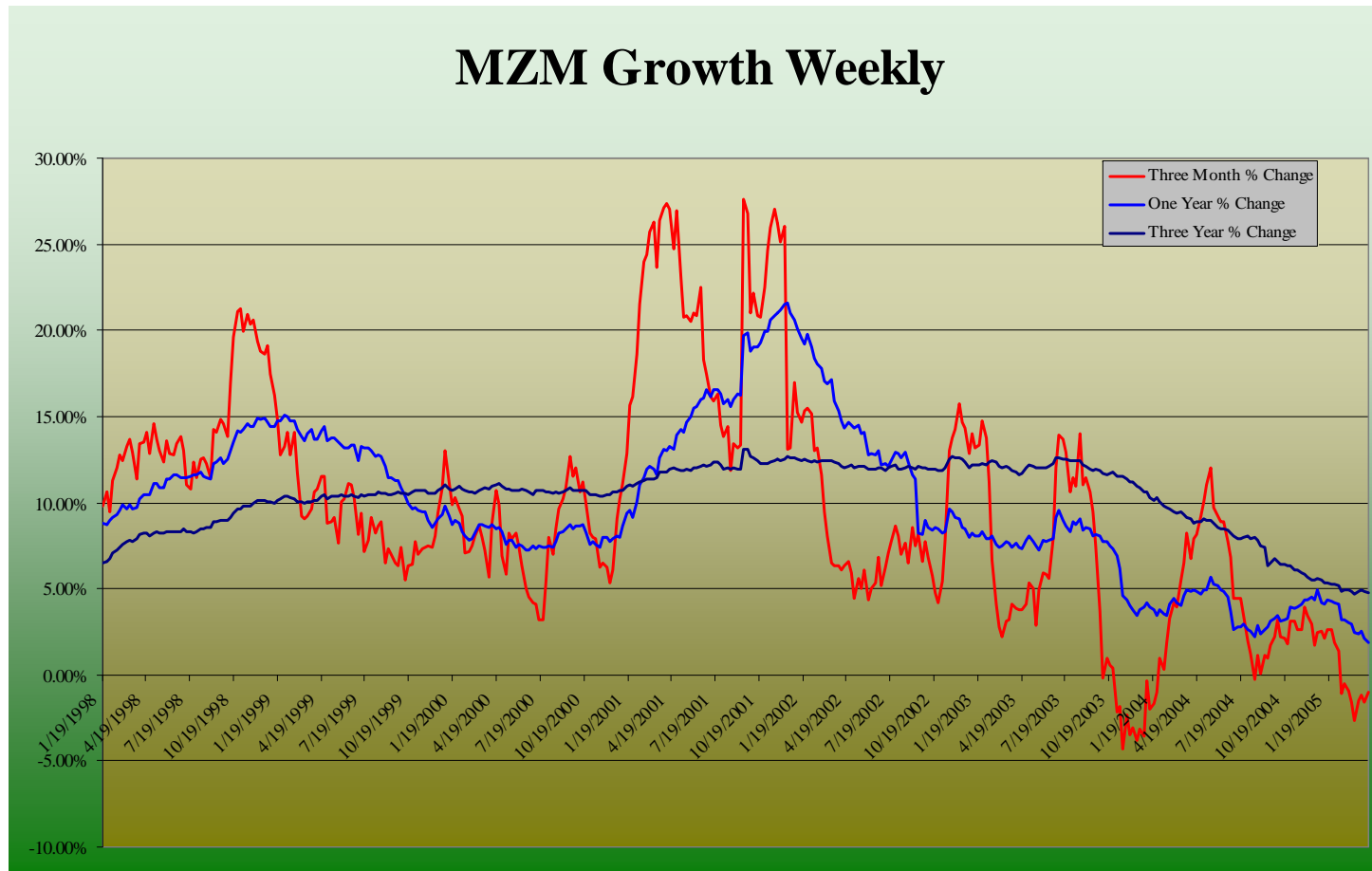
When will the Fed blink? In the past they have kept on raising rates until a crisis results ( Orange County, LTCM) Rates are fast approaching neutral and the pace of rate increases past neutral is key.

## *Federal Reserve Watch*



A value above 50 indicates the Fed's policies are accommodative, but the trend is just as important. Monetary conditions & liquidity are deteriorating.

## Federal Reserve Watch



Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices.

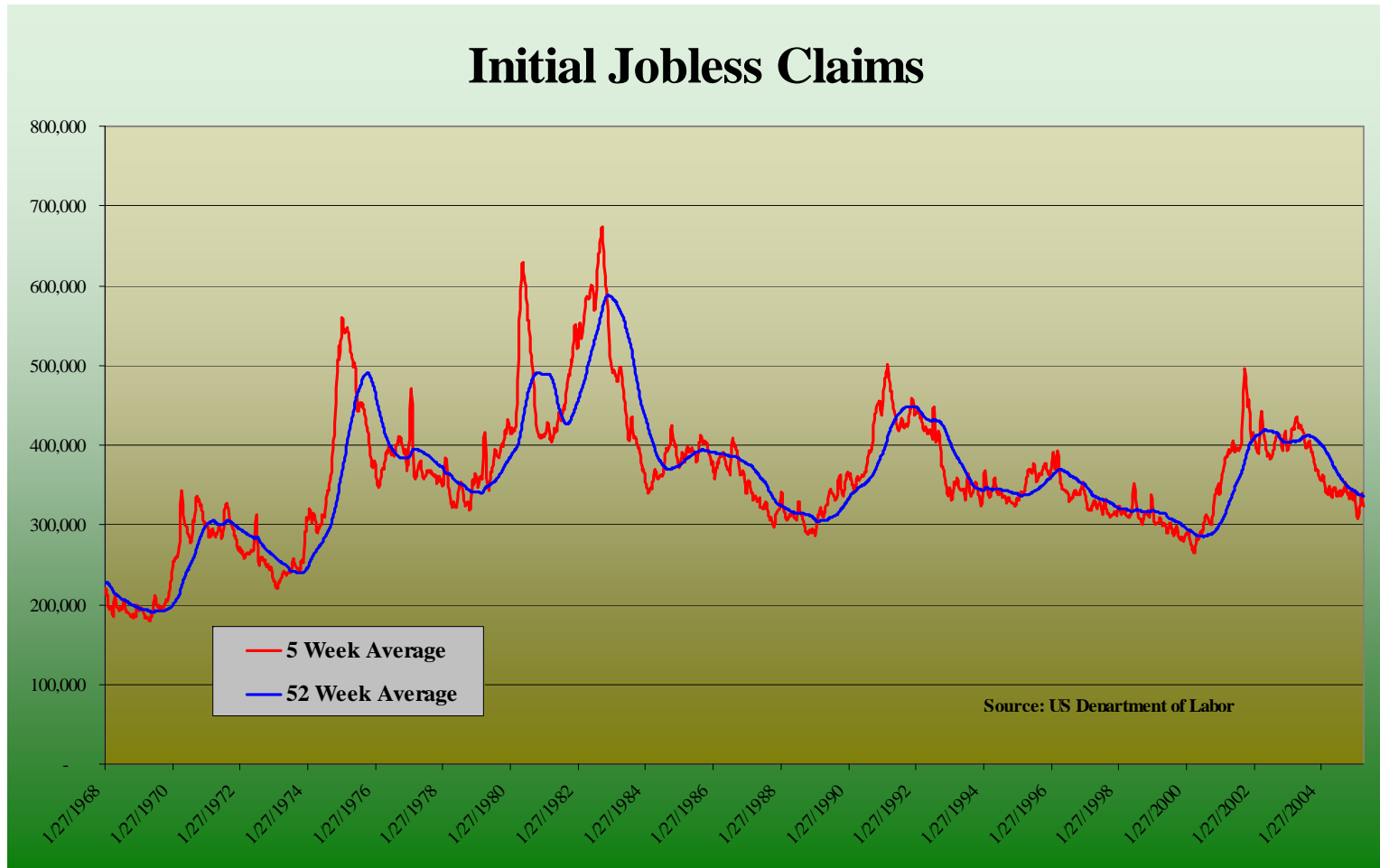
Broad liquidity is contracting, a growing economy needs growing liquidity just to maintain the status quo.

## Outlook

Record energy prices, slowing earnings momentum and a cyclical rise in inflation has this market spooked.

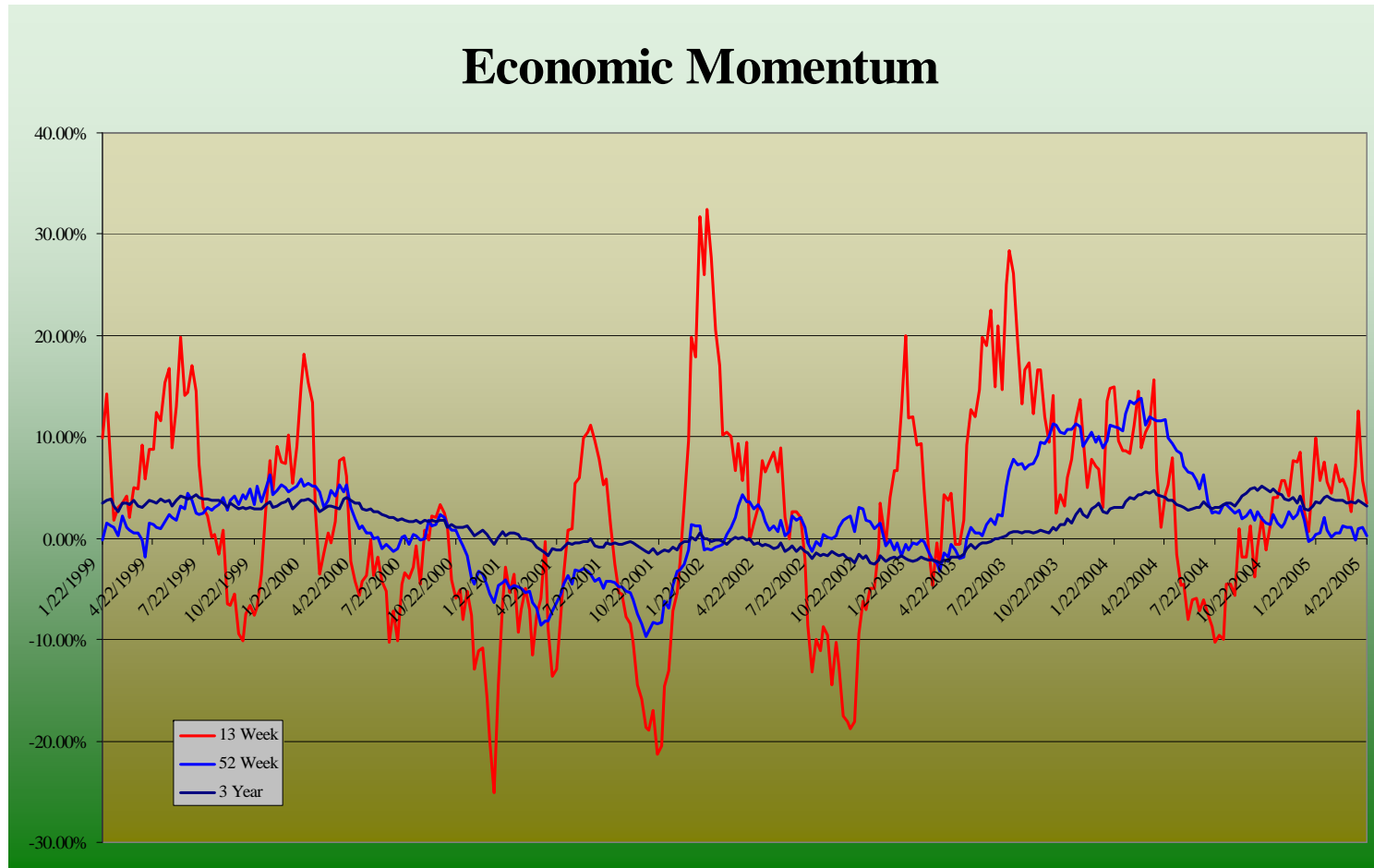
With signs of continued growth, moderating energy prices and low absolute levels of interest rates, either the stock market is forecasting recession or the level of equity prices should move up.

## Outlook & Forecast



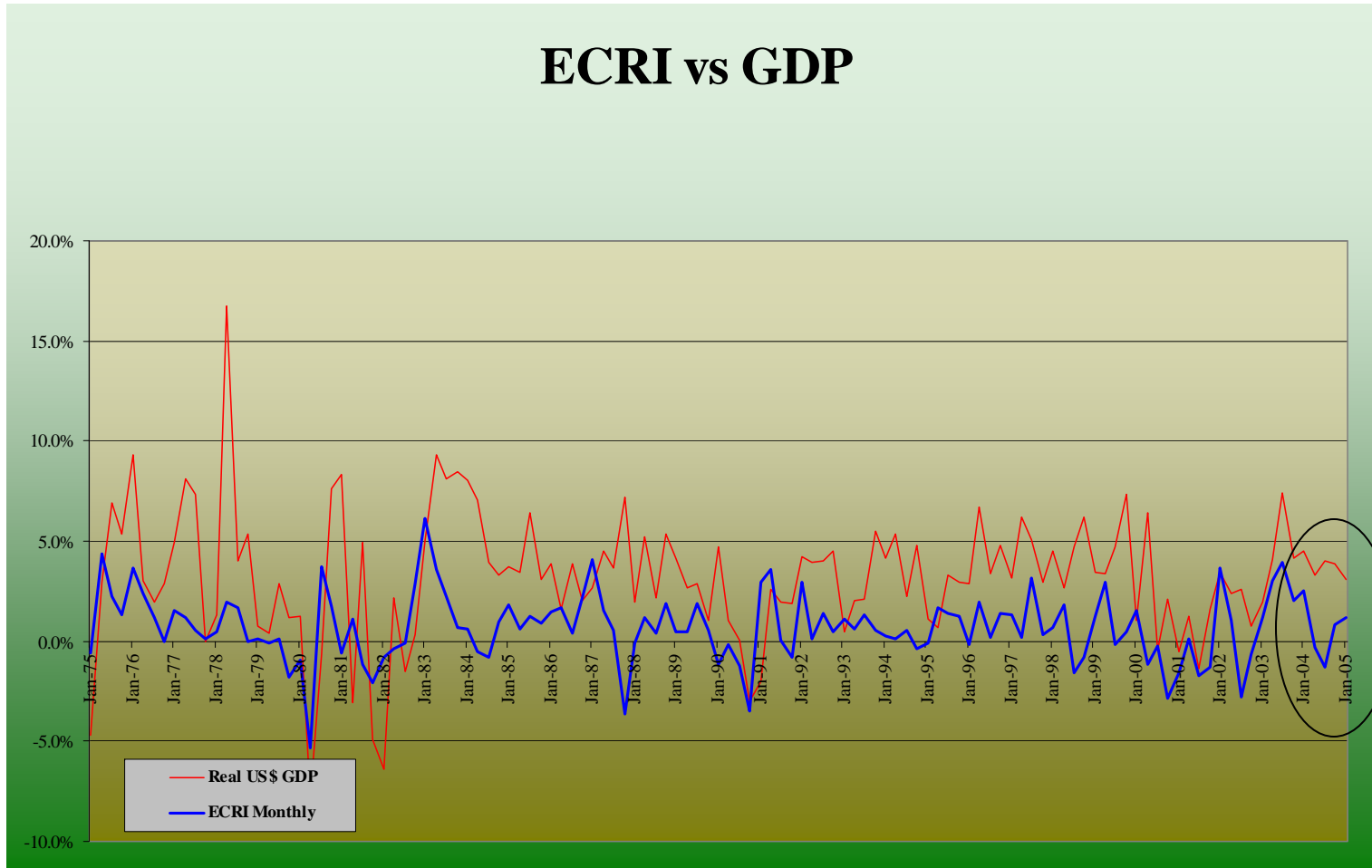
Jobless claims continue to be below the 350,000 level consistent with robust labor conditions over past business cycles and shows steady improvement over time.

## Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: [www.businesscycle.com](http://www.businesscycle.com)).  
At this stage of the business cycle, growth has moderated but continues an upward trend.

## Outlook & Forecast



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**ECRI versus Real US GDP indicates to us that the “soft patch” has passed.**