

Monthly Chartbook

December 2004

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Review 2004

Consumer inflation almost doubled on a year-over-year basis during 2004 from 1.82% to 3.58%.

The Federal reserve increased short-term rates by a full percentage point during the second half of the year.

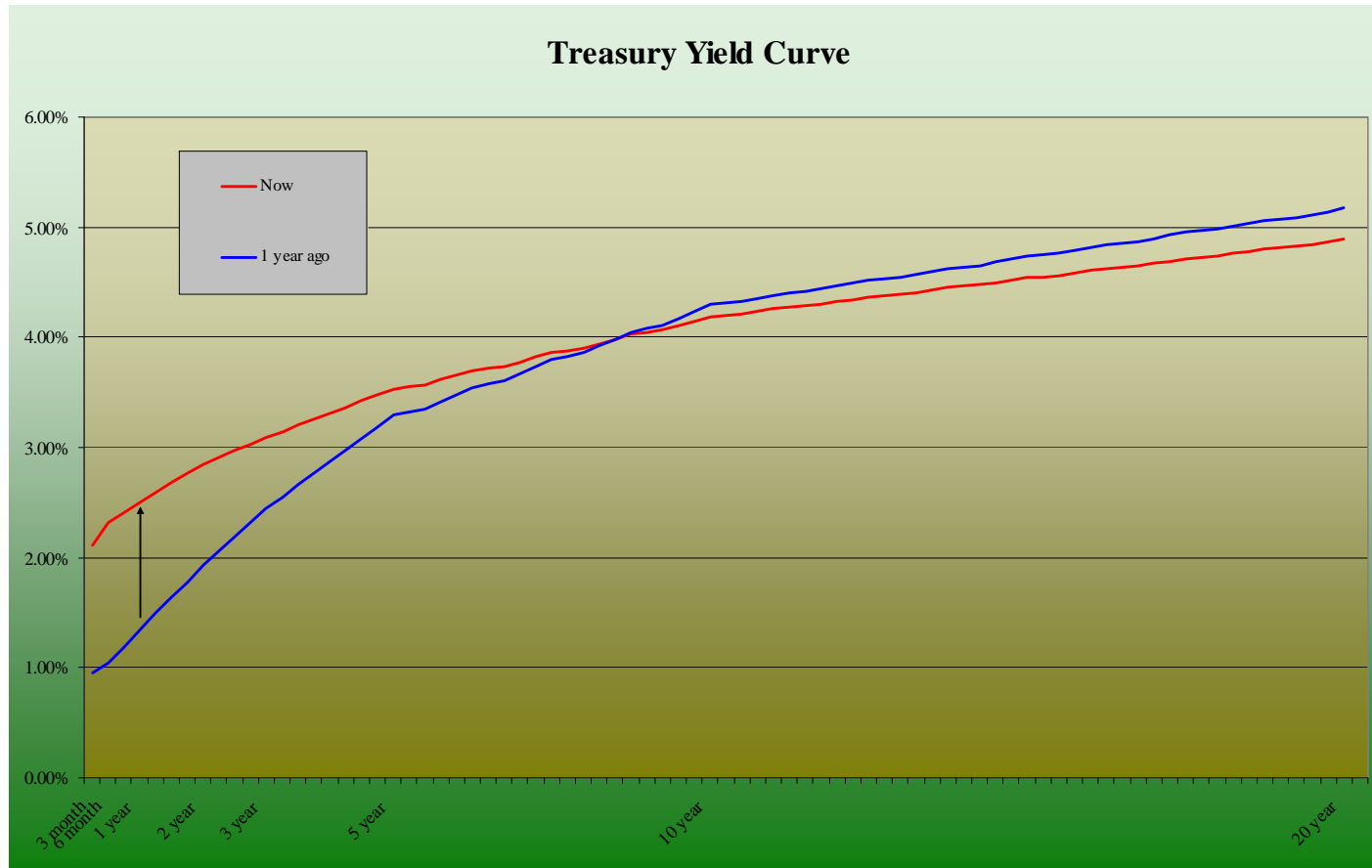
Longer-term interest rates ended the year approximately where they began it, much to the consternation of many (including us) who had predicted these rates would rise.

During 2004, the S & P 500 returned 10.88%, and we feel the United States equity market is neither significantly over- nor under-valued.

The sectors providing the highest returns for the year were real estate and energy; semiconductors provided the lowest return for 2004.

Jobs continue to be the missing piece for a total recovery, as all signs point to increased employment except the jobs numbers themselves.

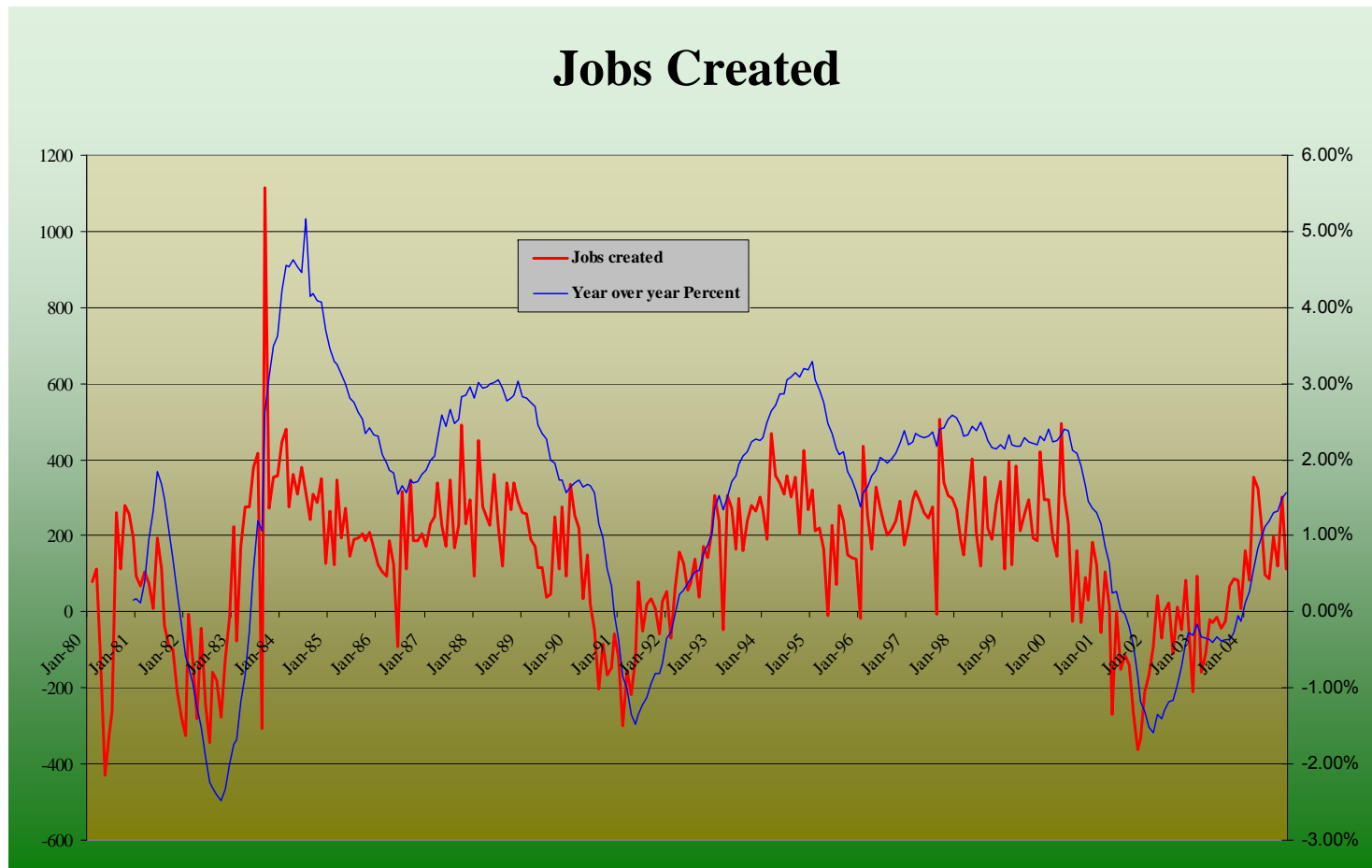
Macro-economic Research



The yield curve has flattened in the last year.

Distant interest rates are lower now than they were a year ago, even before the 1% point increase in the Federal funds rate.

Macro-economic Research



There have been two brief periods of strong job growth in the last year, and analysts had hoped each would indicate a sustained trend. Although each month since September of 2003 has provided positive growth, year-over-year job growth has been very choppy and inconsistent with historical recoveries.

Macro-economic Research

Outlook 2005

Inflation will continue to increase, but not at the rapid rate of the past year.

The Federal reserve will raise short rates to continue to remove some of the recent economic stimulus and bring interest rates more in line with historical rates of inflation.

Capital market returns over the next 3-5 years will be modest– within 5 to 7% on an annualized basis.

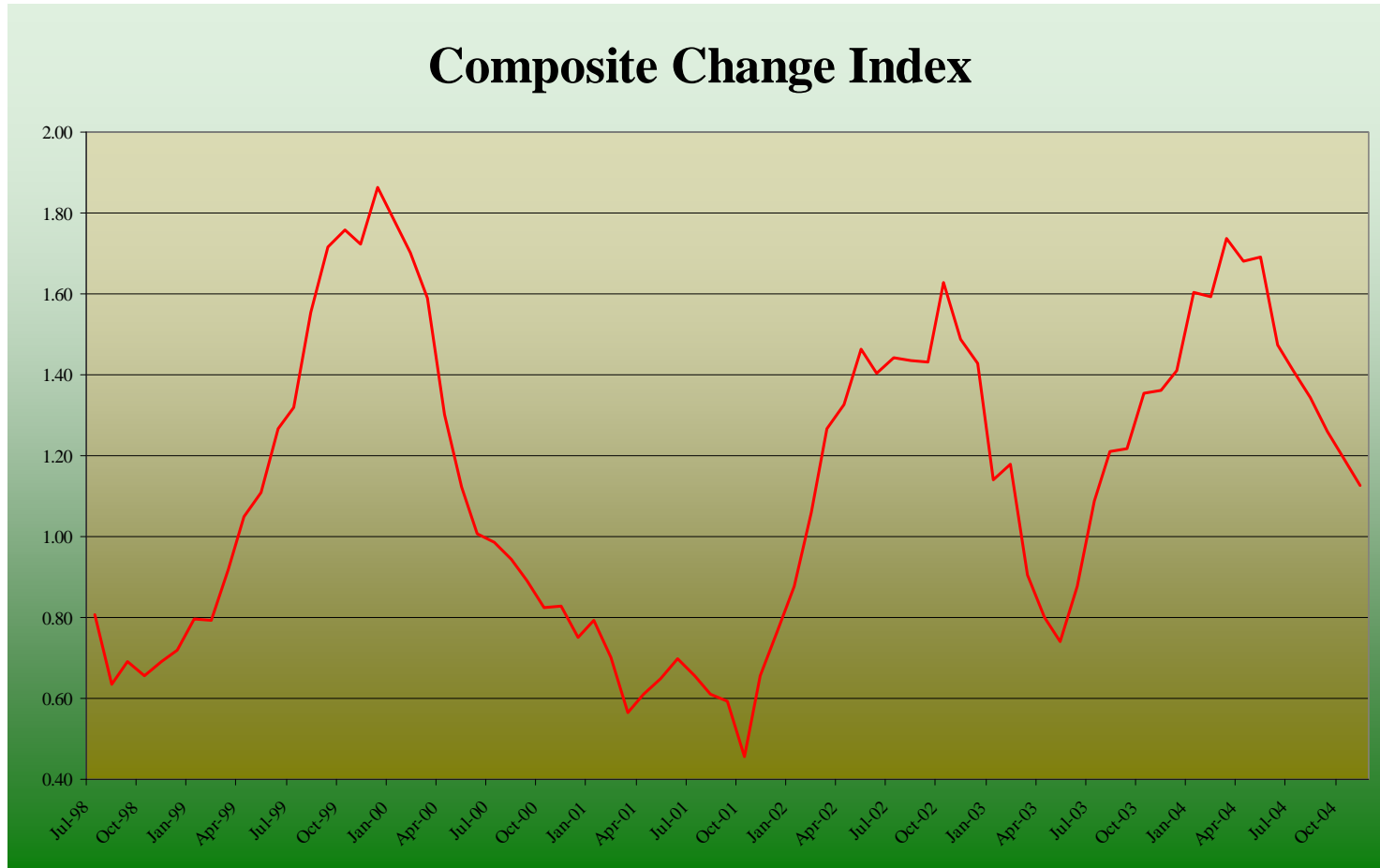
Given the current economic outlook, a Price / Earnings ratio between 14 and 19 times trailing earnings is reasonable.

Earnings momentum has slowed, but conditions are appropriate for the level of earnings to continue to increase. A slow but steady increase in company earnings is just what is needed to push the PE ratio to the upper end of the aforementioned range.

Real estate, energy and some finance appear to be over-valued sectors, while pharmaceuticals look to be undervalued. However, sector momentum can determine short-term returns in the same way that fundamentals can, and the momentum in pharmaceuticals is negative.

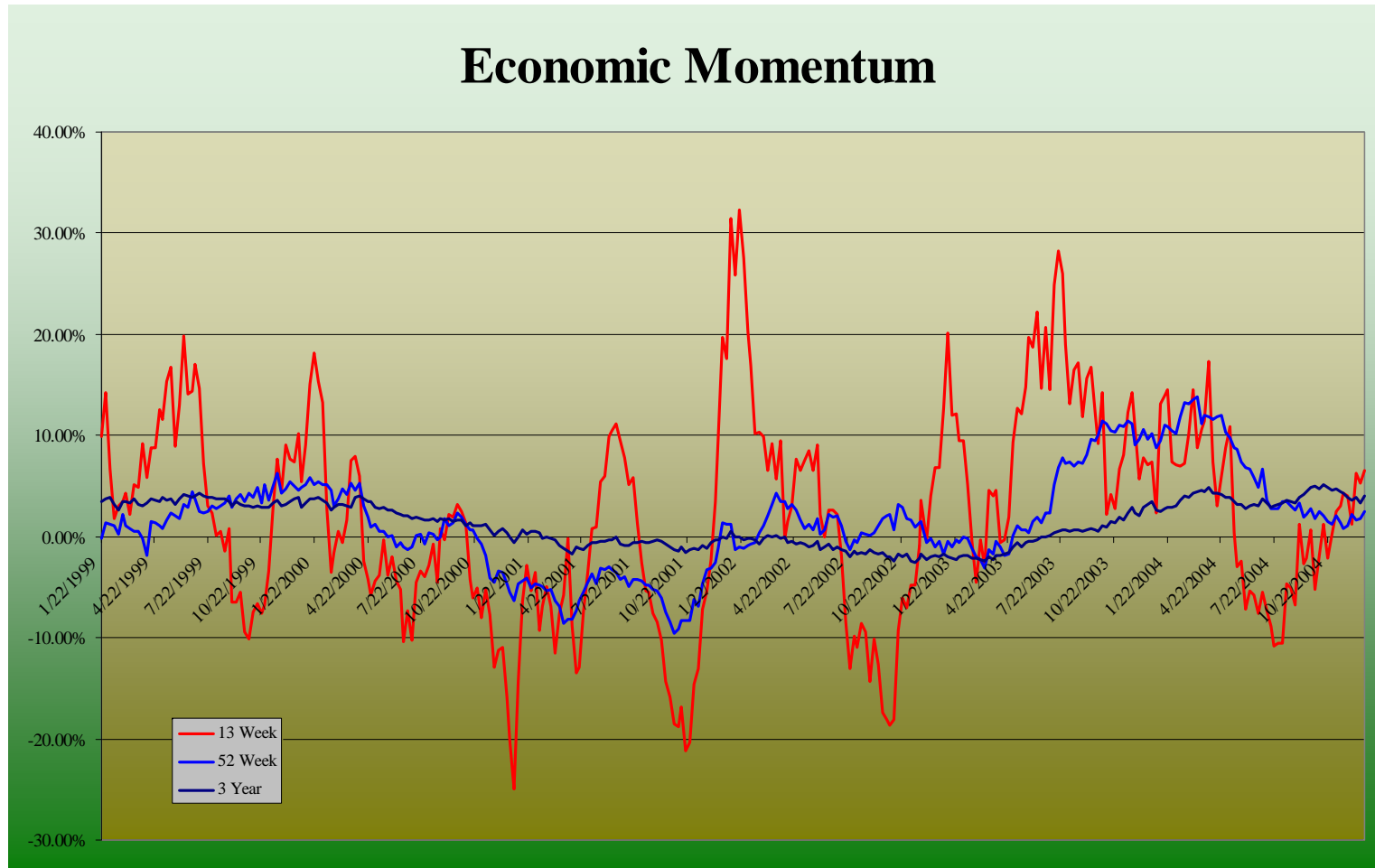
Job growth will continue to be moderate; while growth will continue, we will not have consistently strong reports until the latter half of the year.

Outlook & Forecast



Although the composite change index trend is down, values over 1.00 are considered bullish. Earnings growth for the cycle may have peaked, but positive growth continues.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).

The 13 week rate of growth bottomed out this summer and appears to be leading the 52 week time series upwards.

Macro-economic Research

Biggest opportunity

Pharmaceutical companies

As with all opportunities, there are problems and bad headlines surrounding business decisions, potential losses of revenue and lawsuits.

But, the valuations for even the large, established companies are cheap, and many pay significant dividend yields.

However, growth, margins and return on equity are lower than they have been historically, making the firms less of a bargain than they would otherwise be at these pricing levels -- the lowest since the Clinton healthcare proposals in the early 1990's.

Macro-economic Research

Risks

There are two major macro-economic risks that could impose significant disruption to the US and the global economy.

- 1) petro-terror event
- 2) interest rate shock

A petro-terror event would send the price of oil higher while there is increased demand for the commodity as the global recovery continues; it would also introduce speculation about future events and the future price of oil. The demand was not the only factor that drove prices higher this fall – there was a “terror premium” for the un-known threat of disruption of supply.

Regarding interest rates, the longer-term rates have remained lower due to demand from the Asian central banks. In some cases this is an effort to manipulate currency supply and demand, and in others it is simply a store of value. The risk here is that these positions could be un-wound, and longer term rates in the US would respond accordingly. The largest concern is how quickly this might occur and what the potential damage to fixed income portfolios would be.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1213.55	Trading range	↑	1150-1250	June 2005
Ten Year Treasury	4.22%	4.65%	↔	4.25%-4.875%	6 months
Inflation (all Urban)	3.58%	3.15%	↔	2.75%-3.50%	9 months
Fed Funds	2.25%	2.25 - 2.75%	↑	2.5 – 3.0%	6-9 months
S&P 500 Earnings	\$58.07	\$62.13	↑	\$60 - \$65	Sept 2005
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

Inflation expectations

Review –

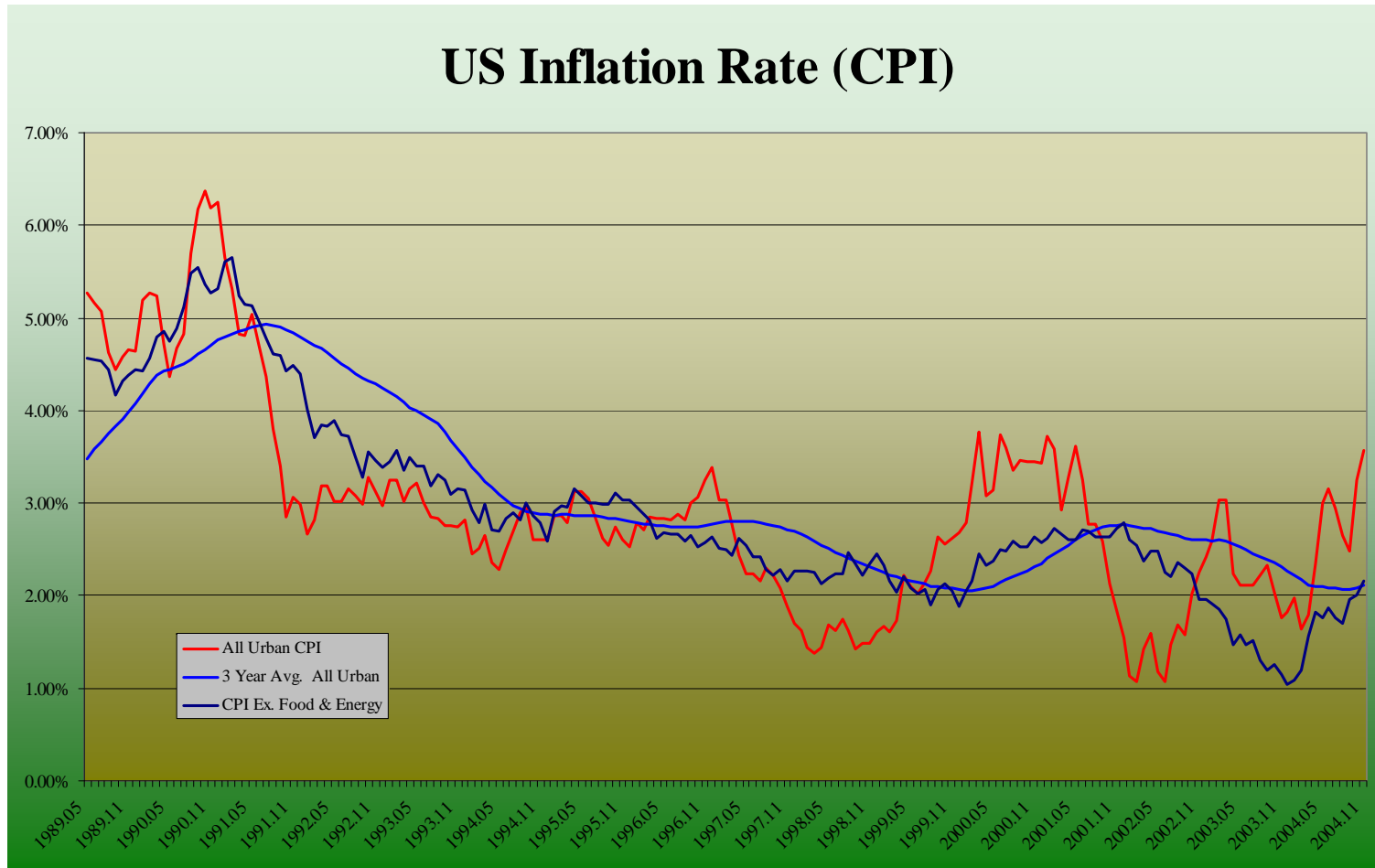
Inflation began 2004 at a 1.82% rate on a year-over-year basis and has increased dramatically to 3.58% as of the end of November.

This was driven in part by higher energy prices, but not entirely, as the increase in commodities prices on an annualized basis was over 11% this year.

Outlook –

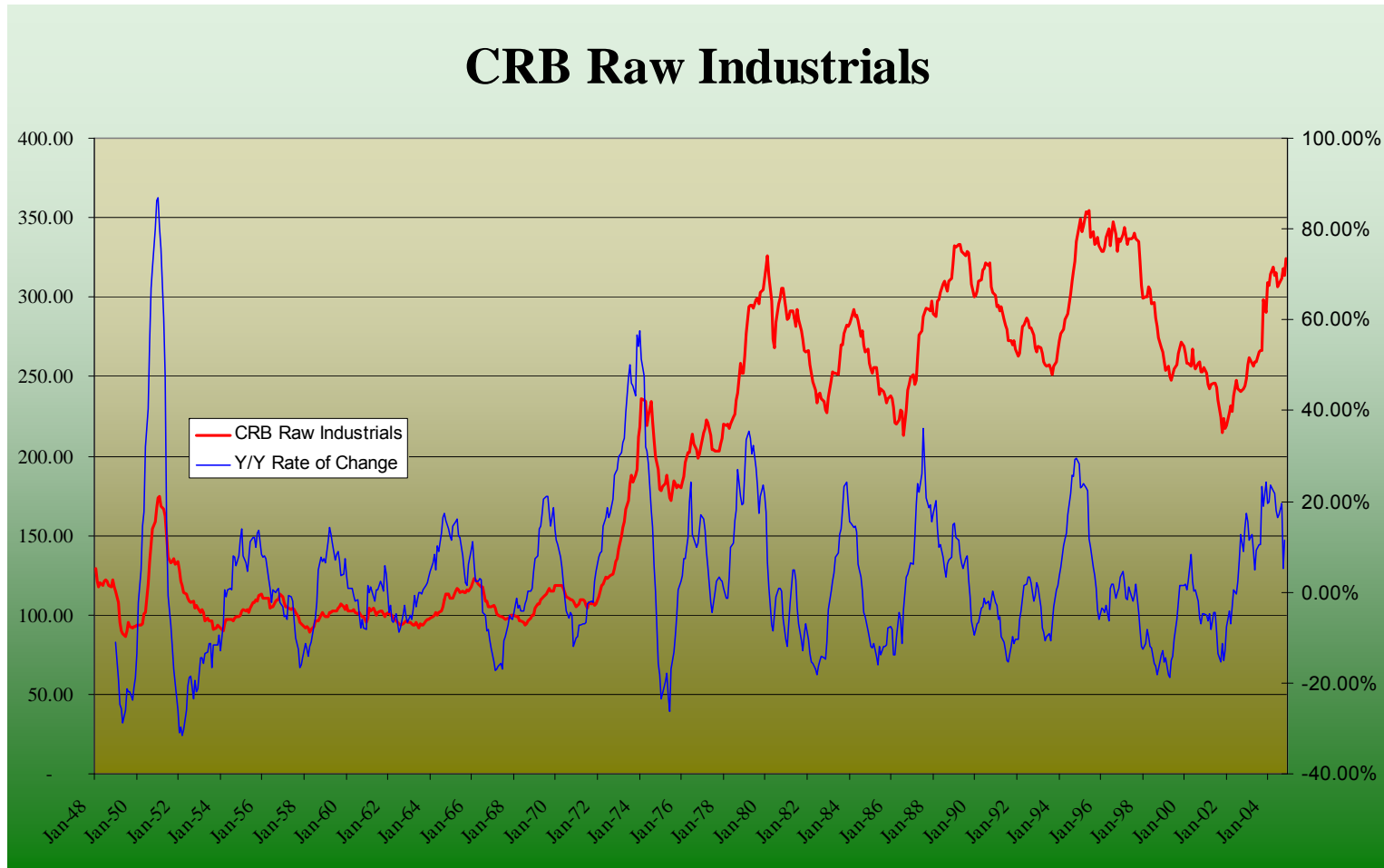
We believe the rate of growth for inflation will moderate somewhat during the coming year, but prices will continue to increase at a higher rate than recent years.

Inflation Expectations



Year-over-year inflation doubled in the previous twelve months from 1.82% to 3.58%.

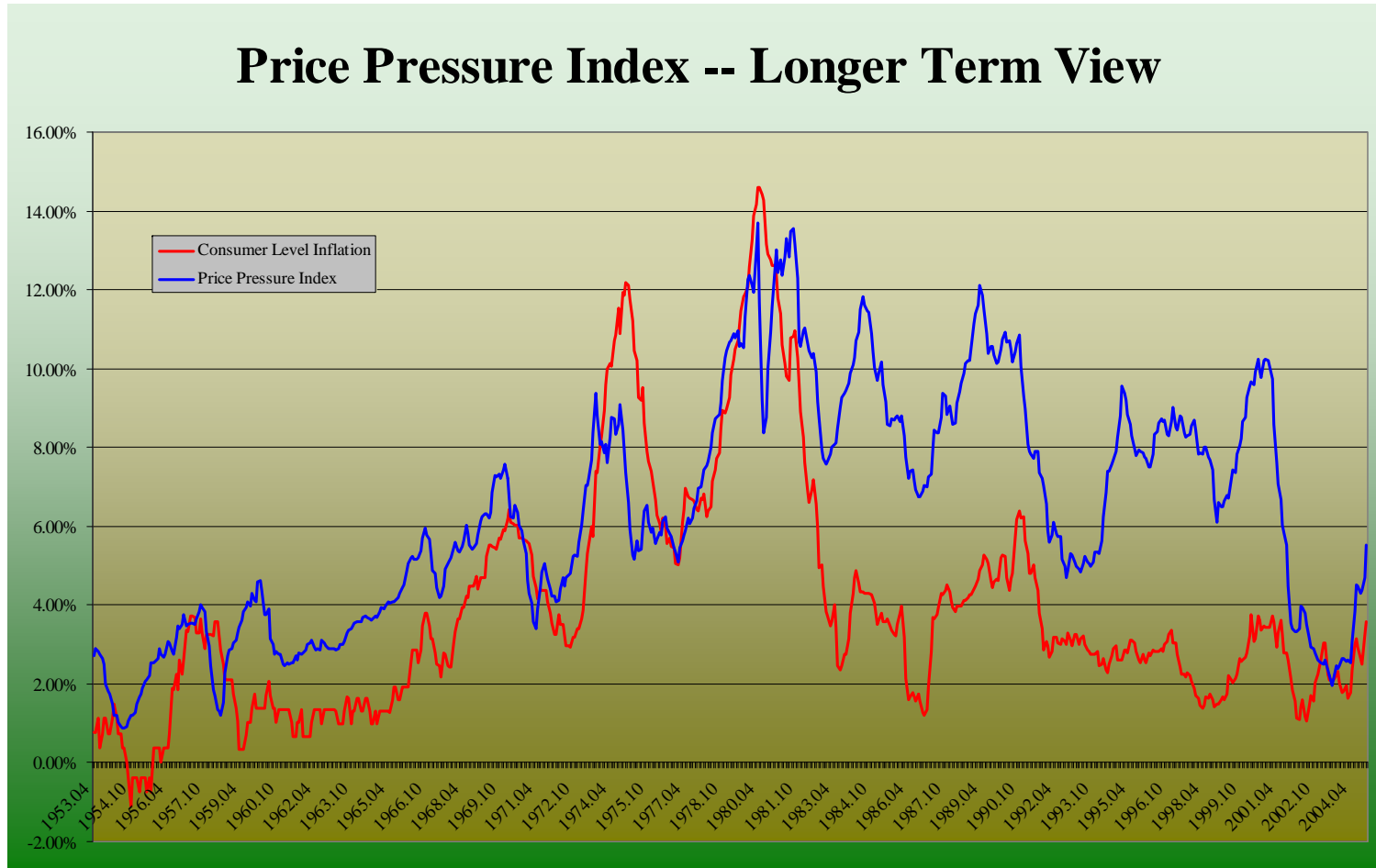
Inflation expectations



Commodity prices have increased 11.6% during 2004 (through November), and over 30% since January of 2003. These cost increases often take time to work their way through the supply chain.

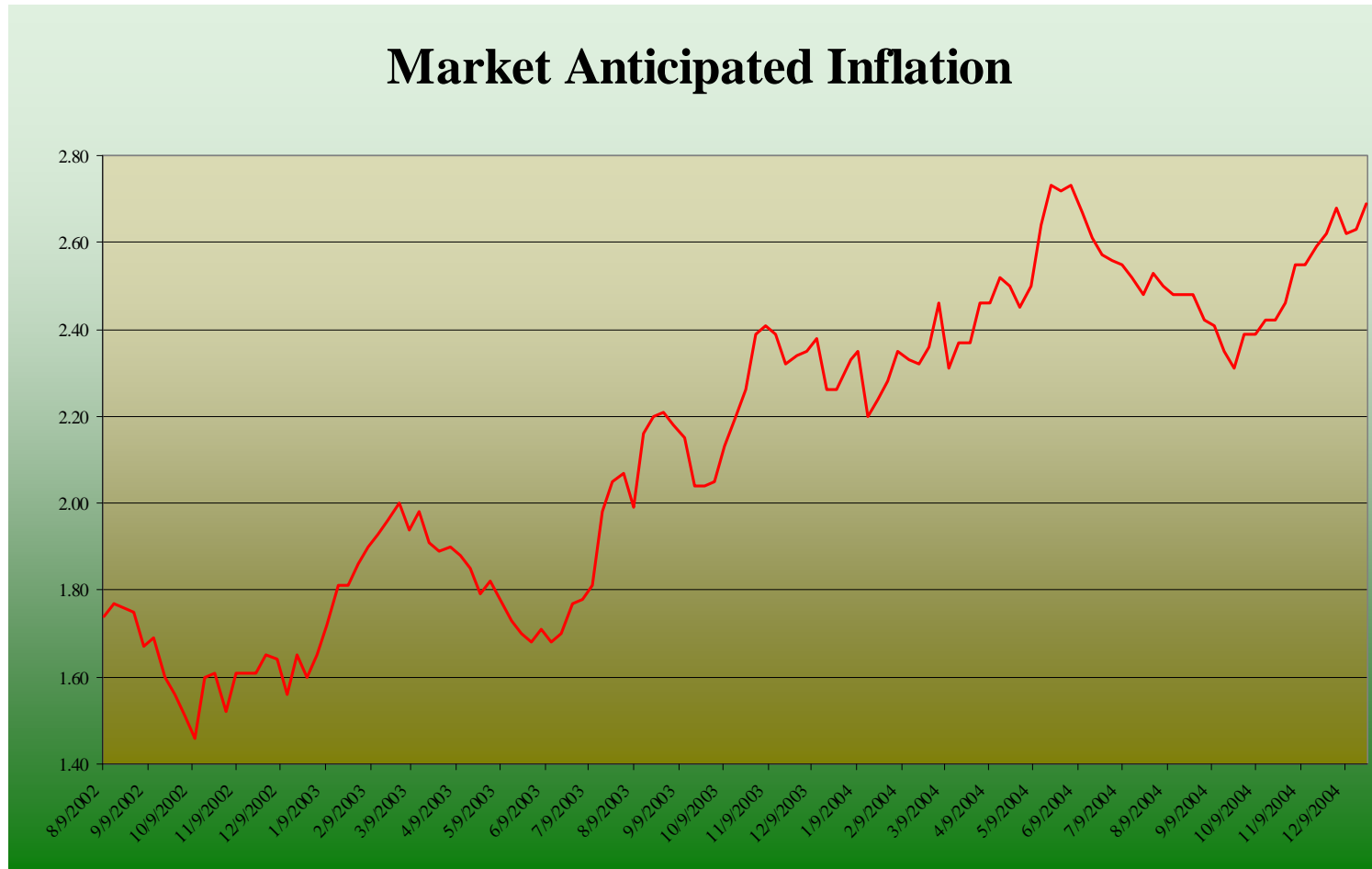
We are optimistic about future inflation because the rate of price increases has diminished in the latter half of 2004.

Inflation expectations



The price pressure index has increased significantly in recent months reflecting both the cost of energy and the cost of raw materials. Yet, inflation pressure remains reasonably low relative to past business cycles.

Inflation expectations



However, the market assumes even higher interest rates. The rate indicated represents an annualized ten-year rate of inflation based on analysis of TIPS bonds.

Federal Reserve Watch

Review –

The Federal reserve increased rates five times in 2004 by $\frac{1}{4}$ point each time beginning in June. These increases in short-term rates were accompanied by almost no movement in the yield for 10 year Treasuries.

The rate of growth for money supply has also been decreasing over the previous three year period as the Fed works to offset some of the imbalance associated with policies designed to ward off a recession and potential problems associated with 9/11.

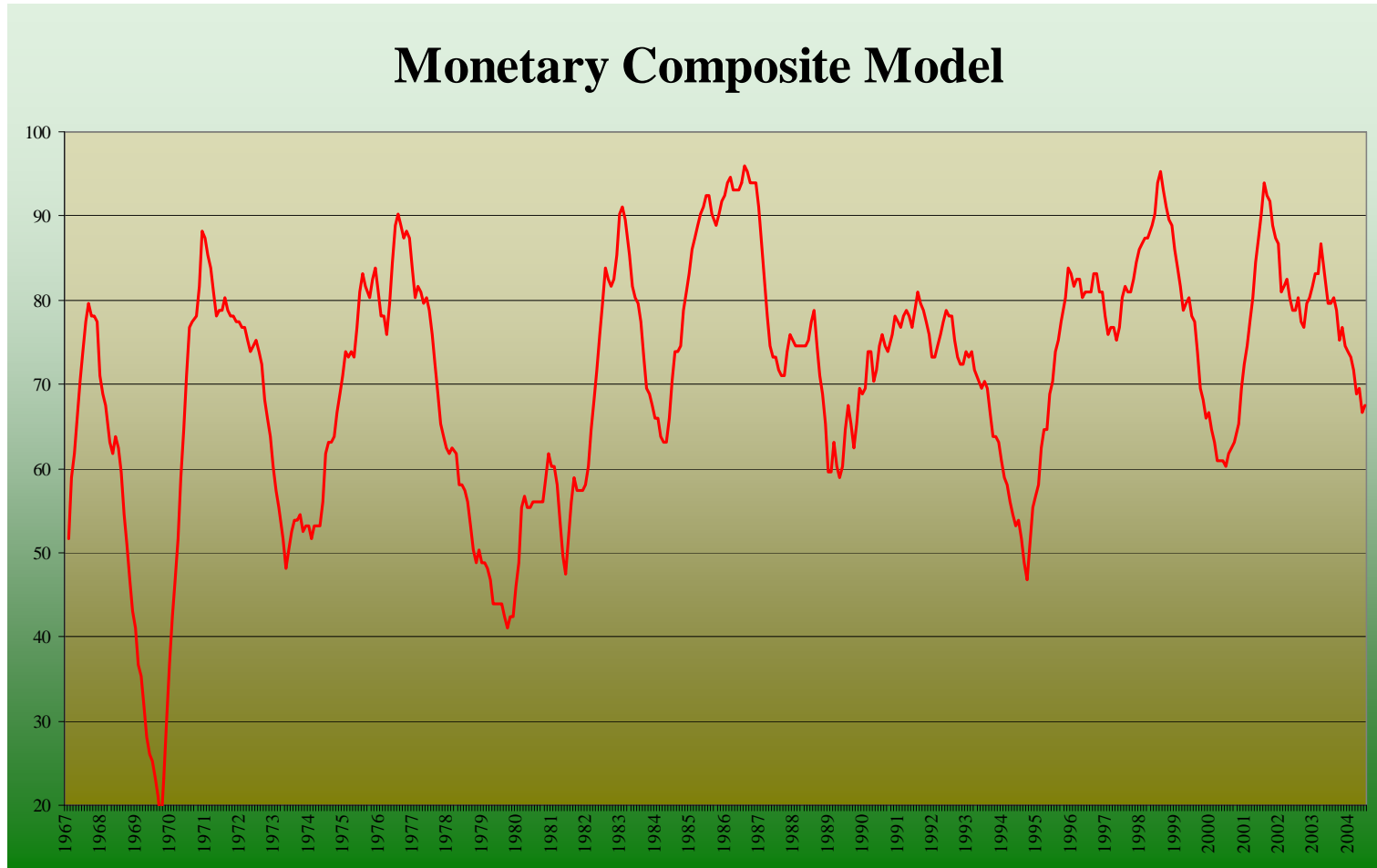
Outlook –

The Fed will continue to move short rates into a more neutral range with respect to inflation (historically, the Federal funds rate is slightly higher than inflation).

The most disconcerting potential shock to the US economy is the threat of Asian countries ceasing to use our Treasuries as both a store of value and a means to peg their currencies to the US \$. Although we do not believe this is likely, the relationship explains why the yield curve has flattened and longer-term rates have not moved up.

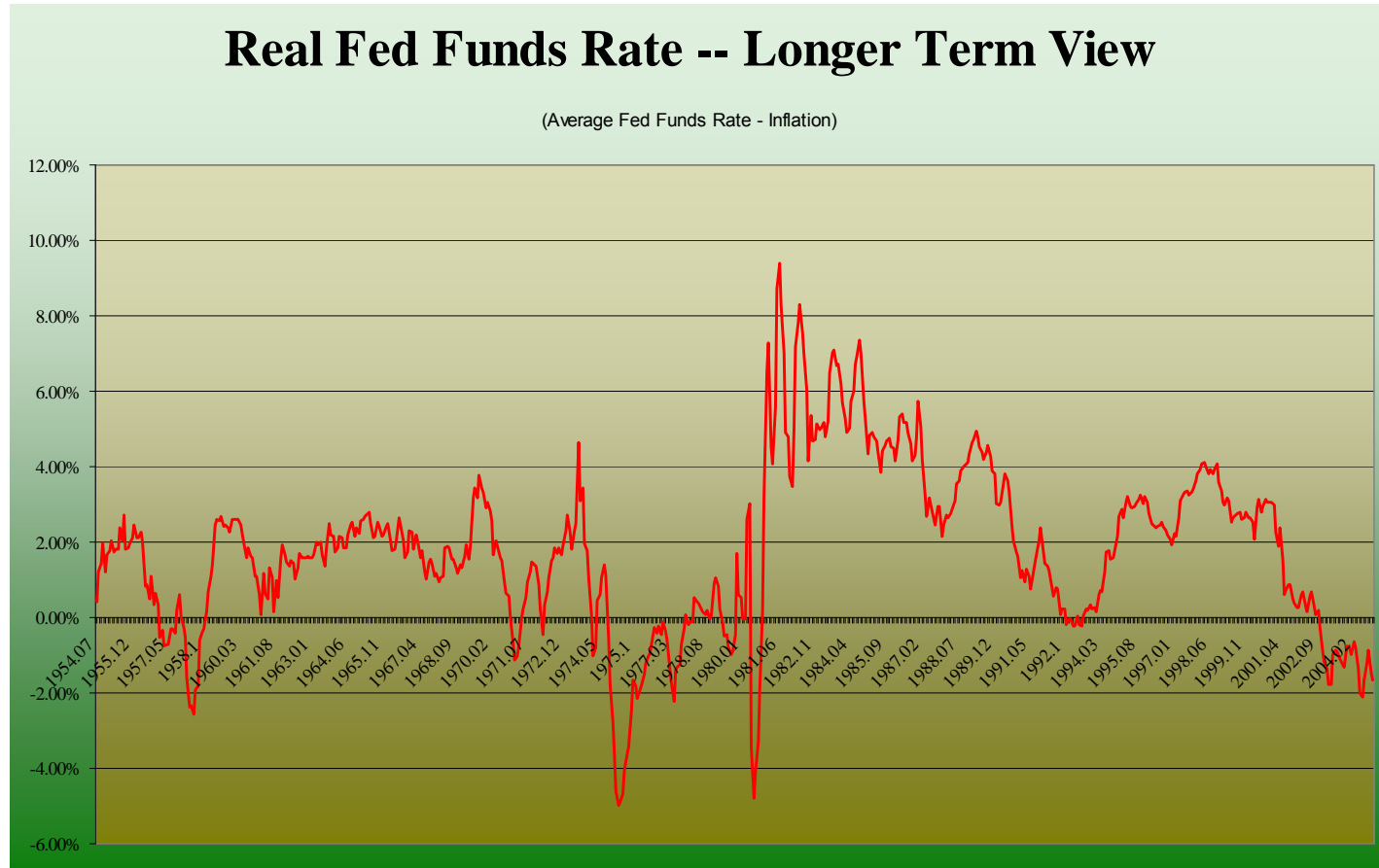
The normal spread of the ten year US Treas. is 2.8% higher than inflation, which implies a yield of 6.38% (versus the current 4.2% rate). We will continue to avoid long dated US bonds under circumstances where we rely on the “kindness of strangers”.

Federal Reserve Watch



Even though the monetary composite indicates the Fed's policies are accommodative (with a value above 50), the trend is down as both interest rates are being raised and money supply growth is moderating.

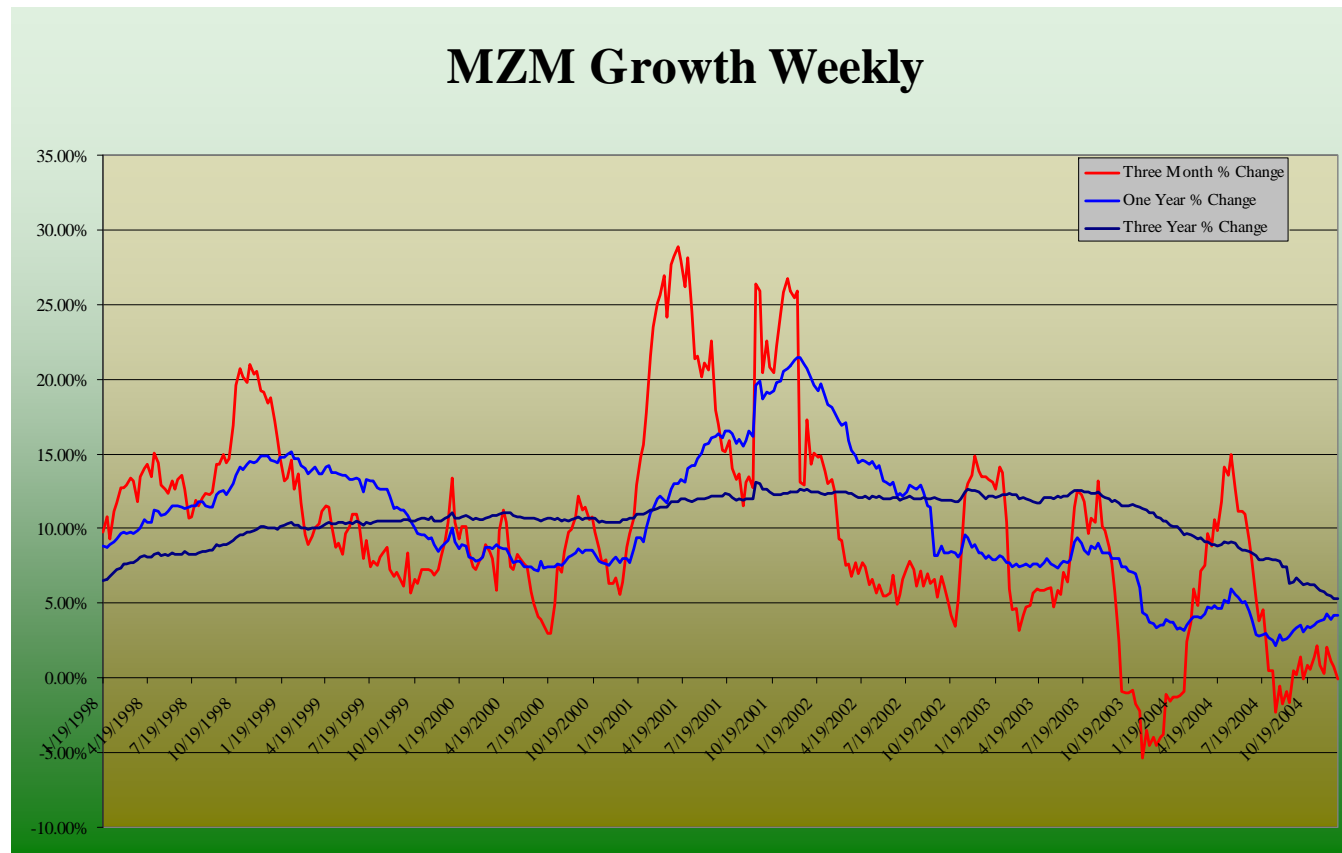
Federal Reserve Watch



Real Fed funds have been negative since January 2002 (a 26 month period), and the three year moving average has been negative since the beginning of 2004. Any cash that investors have held since for the past three years has not kept up with inflation.

The last period of time the real rate of interest remained negative was the 41 months between September of 1974 and January of 1978.

Federal Reserve Watch



The increase in the 13 week growth rate of money supply (as measured by Money Zero Maturity) has lifted the 52 week rate of growth slightly.

The three year rate is still trending down as monetary growth is being removed as an economic stimulus.

Final Thoughts

We remain Cautiously Optimistic

The ideal scenario for 2005:

No significant terror events, and Iraqi elections offer hope in the Middle East.

Earnings for companies grow at a steady 10 - 12% rate; market PE between 18 and 20.

Inflation returns to between 2.75% and 3% per year.

The Federal reserve raises short rates to 2.75% - 3%, and longer-term rates (as measured by the ten year US Treasury) slowly increase to 4.75% - 5%.

Money supply growth and economic momentum are each in the 2% - 3% range for the year.