

Monthly Chartbook

February 2005

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In betwixt and between...stuck between Pollyanna and a Grizzly Bear

The question that everyone putting capital to work in risky assets has been asking is, “**what is this market going to do?**”

Opinions vary, but we seem to be stuck in the middle of two distinct camps. One is seeming permanently bullish, something beautiful or surprisingly good is just around the corner. Members of this camp include Larry Kudlow and Joseph Battipaglia. Read: Forward p/e of 20 times \$75 dollars in earnings equals good times for all!

The other camp is manned by such notables as Robert Prechter, Jr. In this camp, they claim we are in a cyclical rally within a bear market that will take us to DJIA 5000, or roughly eight time earnings before the pain is complete.

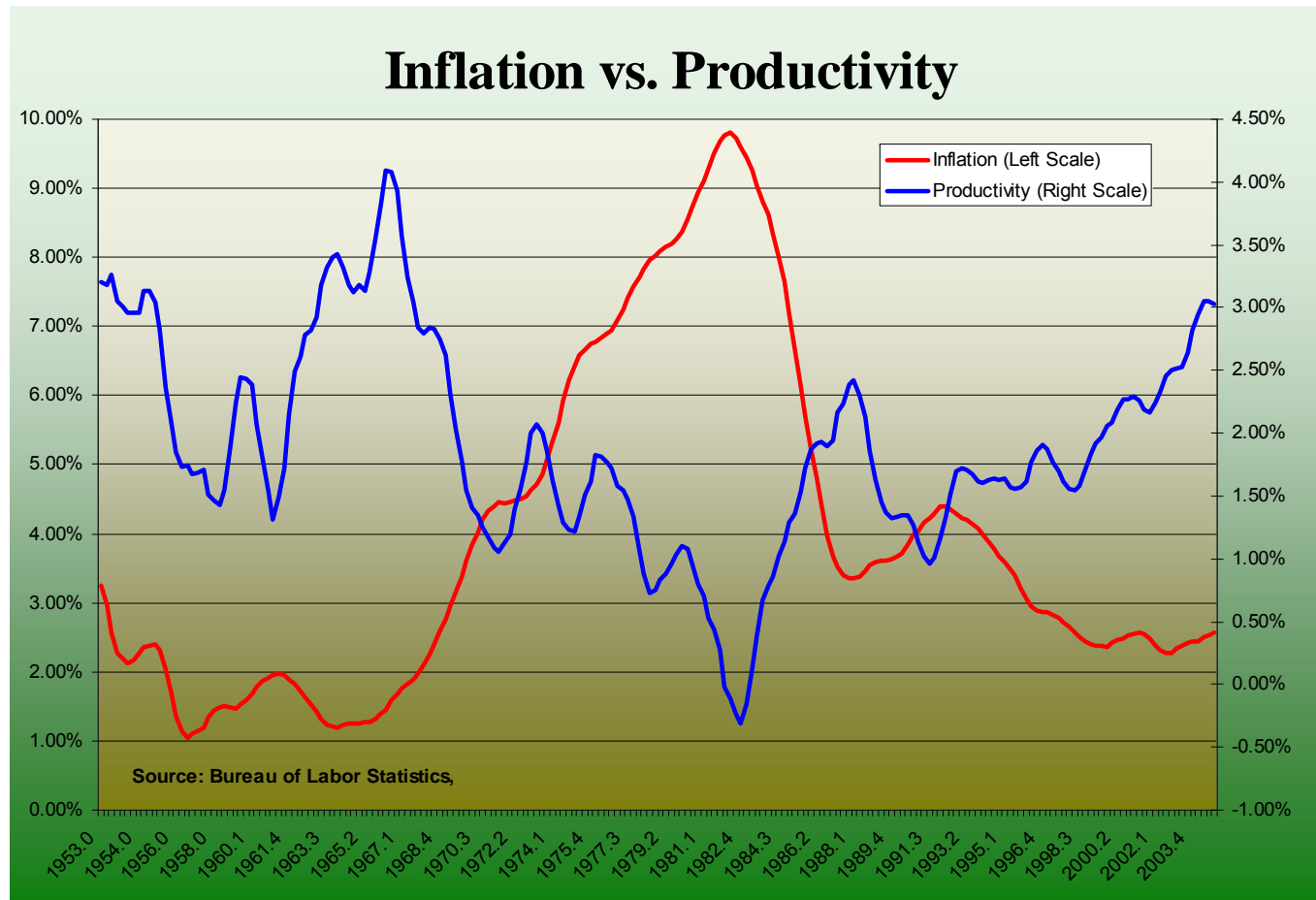
What we are struck by is our agreement with some of the contentions of both camps. The equity risk premia in the market is low, and forward returns may be below average. But with earnings and interest rates at current levels, the multiple on the market has historically been high.

Bottom line:

We contend that this market is neither grossly undervalued or overvalued; and, with inflation near its long-run average, we should be enjoying a high teens price/earnings multiple.

Opportunities do not abound and latent risk exists. Interest rates should be higher, the dollar should be weaker, and the trend in equity prices in the coming years will be dominated by market perception of earnings.

Macro-economic Research



The battle being fought between inflation and productivity is one that bears watching. It is difficult to determine which “destroys” which. It seems to us that weak labor conditions and above average productivity have kept a lid on the core rate of inflation.

Macro-economic Research



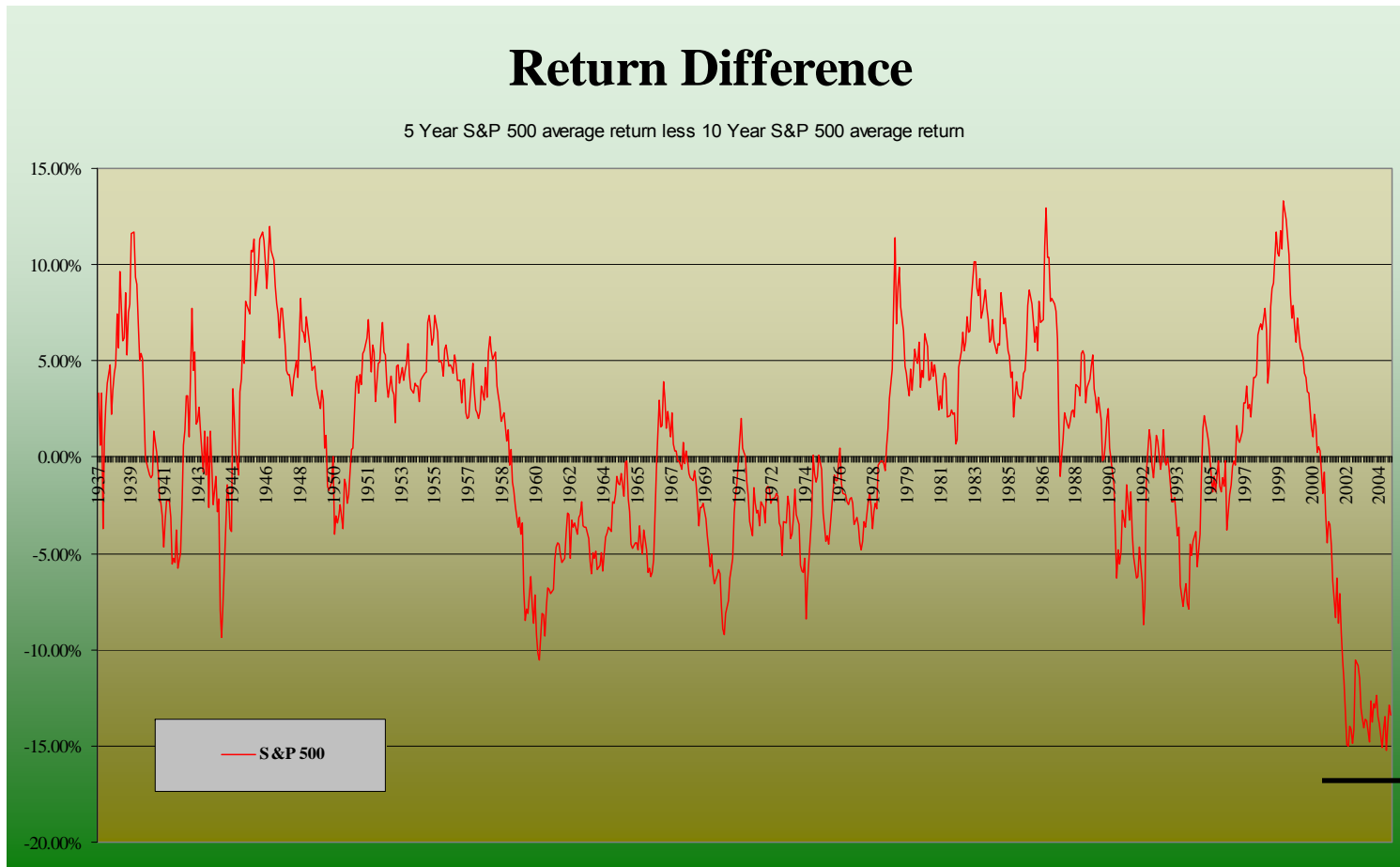
While the aggregate size of the deficit is of concern, as a % of GDP it is not. We believe that the perceived lack of private savings in the USA is a measurement error. Indeed, the one-time Microsoft dividend boosted the savings rate, highlighting the problem we perceive.

Macro-economic Research

Date	S&P 500 Total Market Cap Billions	Current Dollar GDP Billions	Ratio
9/30/1998	8158.667	8953.8	0.911196
12/31/1998	9986.602	9066.6	1.101472
3/31/1999	10513.396	9174.1	1.145987
6/30/1999	11226.72	9313.5	1.205424
9/30/1999	10572.338	9519.5	1.110598
12/31/1999	12305.97	9629.4	1.277958
3/31/2000	12778.044	9822.8	1.300856
6/30/2000	12530.955	9862.1	1.270617
9/30/2000	12641.79	9953.6	1.270072
12/31/2000	11735.976	10021.5	1.171108
3/31/2001	10398.797	10128.9	1.026646
6/30/2001	11000	10135.1	1.085337
9/30/2001	9437.128	10226.3	0.922829
12/31/2001	10466.686	10338.2	1.012428
3/31/2002	10502.248	10445.7	1.005414
6/30/2002	9090.569	10546.5	0.861951
9/30/2002	7519.443	10617.5	0.708212
12/31/2002	8107.398	10744.6	0.754556
3/31/2003	7819.301	10884	0.718422
6/30/2003	8968.669	11116.7	0.806774
9/30/2003	9207.646	11270.9	0.81694
12/31/2003	10285.45	11472.6	0.896523
3/31/2004	10438.88	11657.5	0.895465
6/30/2004	10646.74	11814.9	0.901128
9/30/2004	10490.58	11967.0	0.876626

The Economy just hasn't preformed as poorly as the equity markets have. Fair value (in our opinion) is .9 to 1.1 for the ratio, depending on the stage of the cycle.

Macro-economic Research



Since the beginning of Ibbotson and Associates Stocks, Bonds, Bills and Inflation, never has the difference between the 5 year return and the 10 year return been this negative for this long. The real economy (sales, income, earnings) has performed quite well for the same period.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1203.6	Trading range	↔	1140-1290	June 2005
Ten Year Treasury	4.359%	4.65%	↓	4.25%-5.15%	6 months
Inflation (all Urban)	2.90%	3.15%	↔	2.75%-3.375%	9 months
Fed Funds	2.50%	2.50 – 3.00%	↑	2.75 – 3.3750%	6-9 months
S&P 500 Earnings	\$59.55	\$63.24	↑	\$60 - \$65	June 2005
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

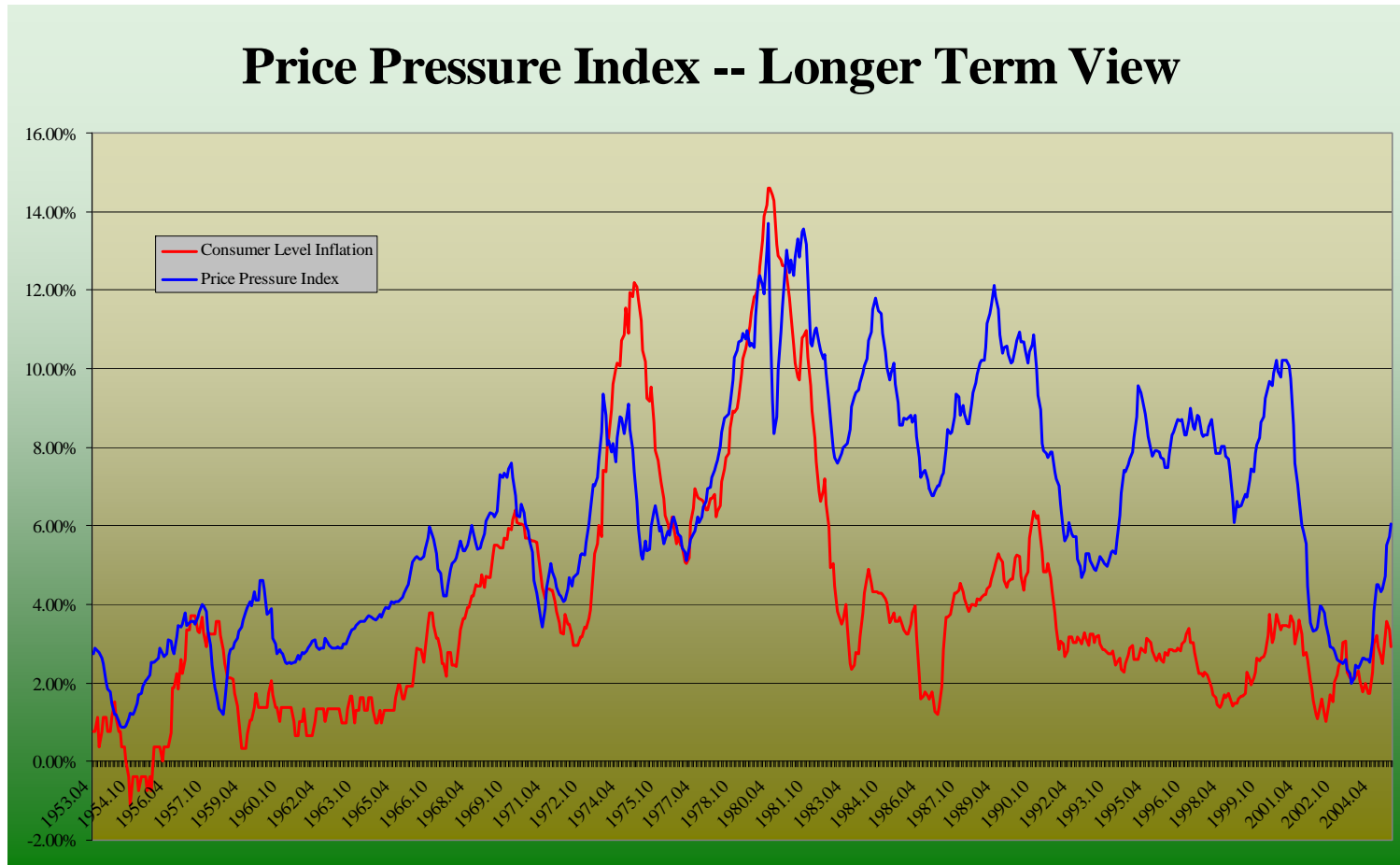
Inflation expectations

Inflation remains a risk.

While commodity prices and a weak dollar have been the focus of those looking for inflationary gremlins, labor market conditions are our point of focus at the present time.

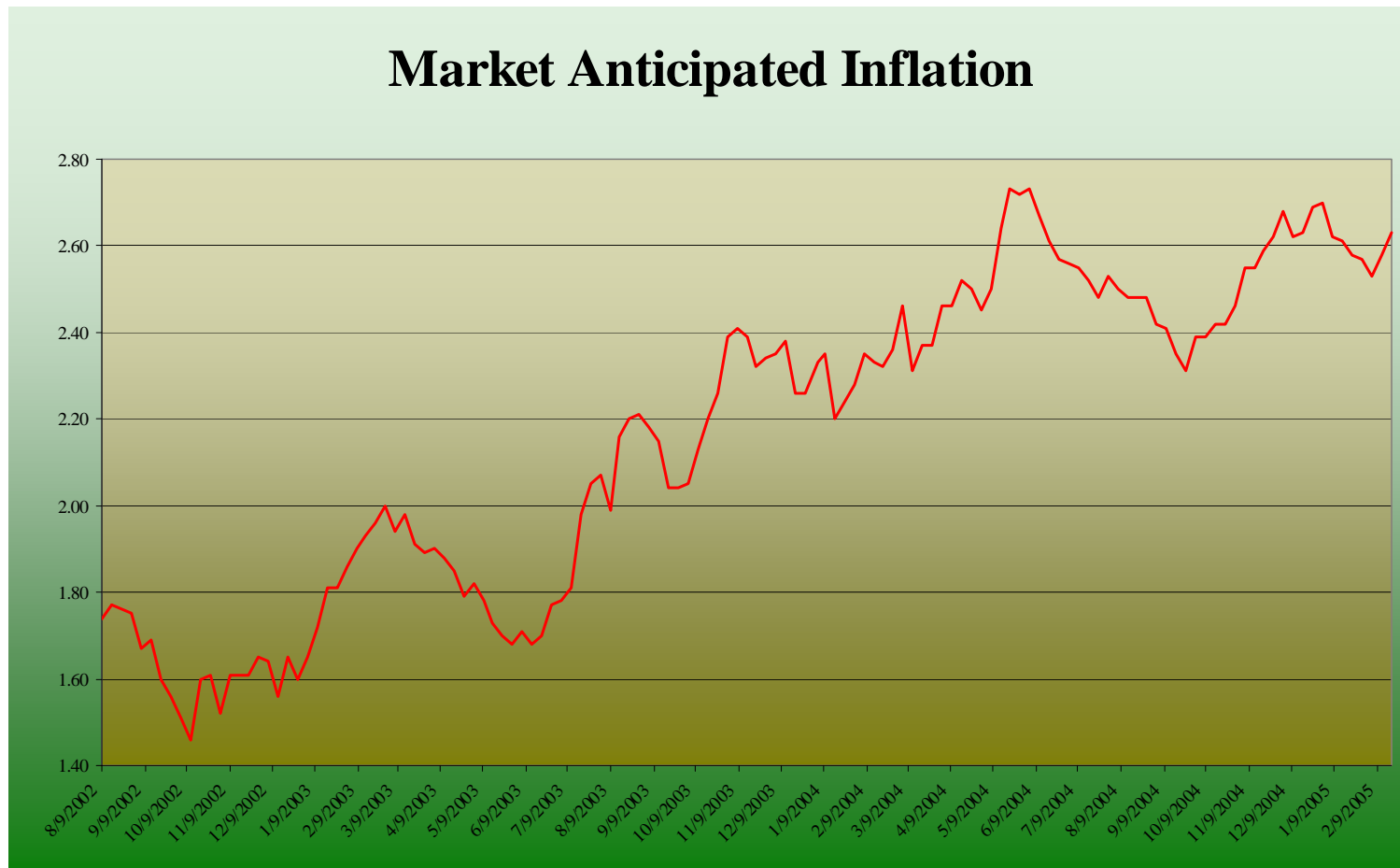
It is well documented that labor markets in the USA have been weak in this recovery vis-à-vis past recoveries. While the labor recovery has been spotty, there is a risk that the sustained recovery in labor conditions will accelerate. This has negative implications for both inflation and interest rates. We will expound upon this concept in future editions of the chartbook.

Inflation expectations



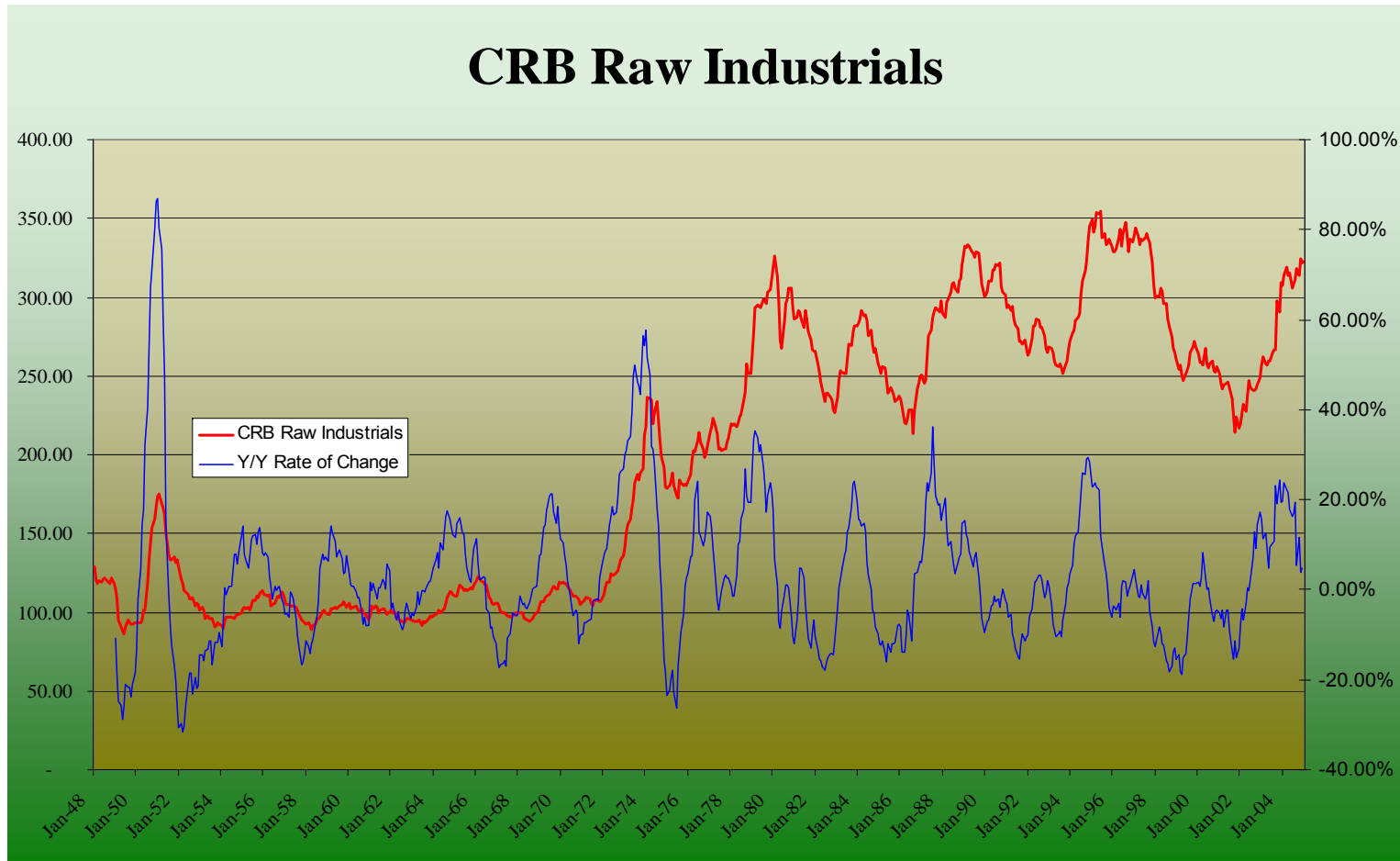
We use the price pressure index as an indicator of inflation and interest rates. At the present, a great deal of risk remains and we are avoiding long dated bonds.

Inflation expectations



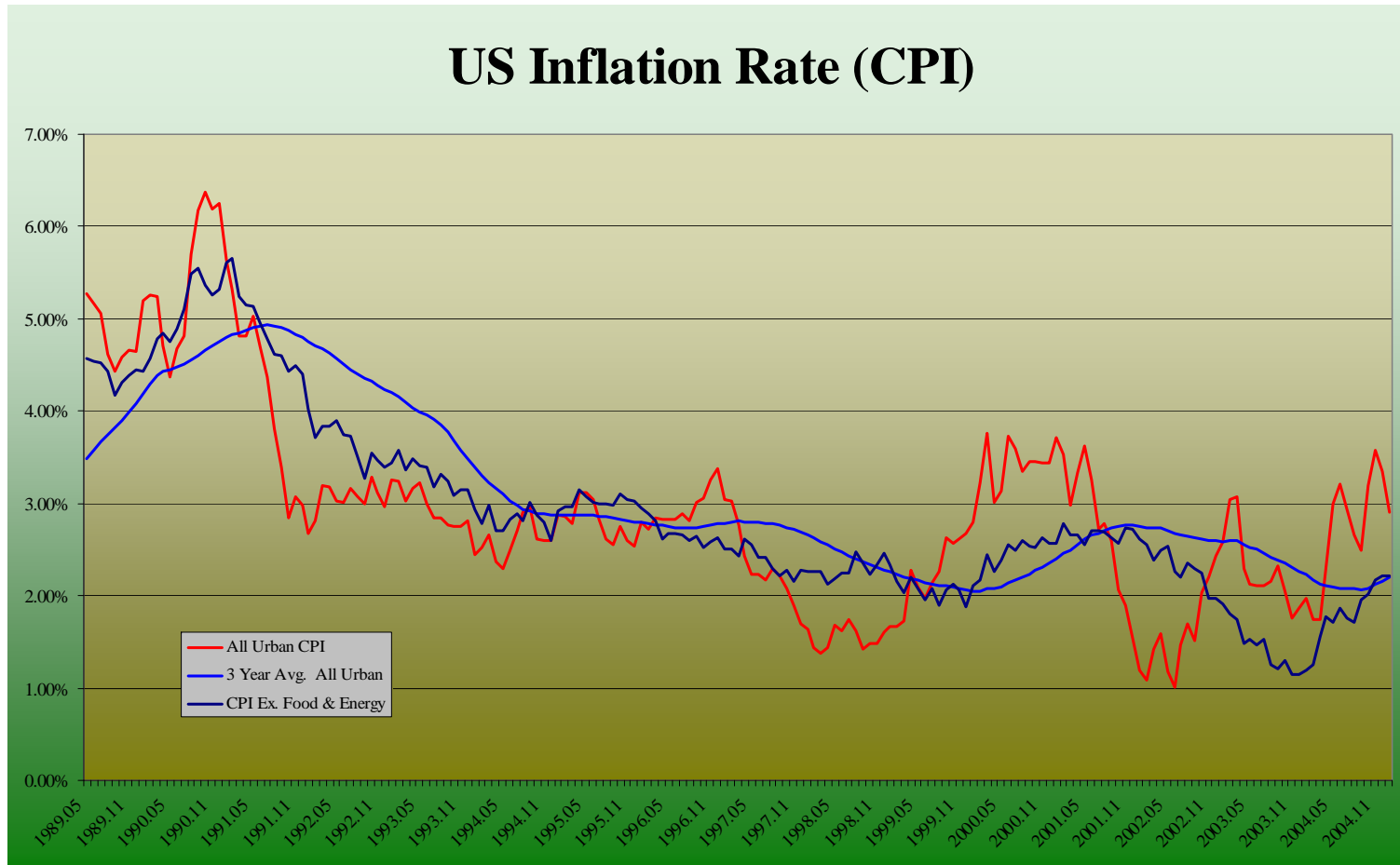
Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting higher but moderating inflation, with an implicit forecast of 2.6%. In our opinion, stable and expected inflation levels are as important as the aggregate level.

Inflation expectations



While the Y/Y percentage increase in commodity prices has moderated, the trend level remains higher. Robust commodity prices are indicative of continuing global recovery.

Inflation Expectations



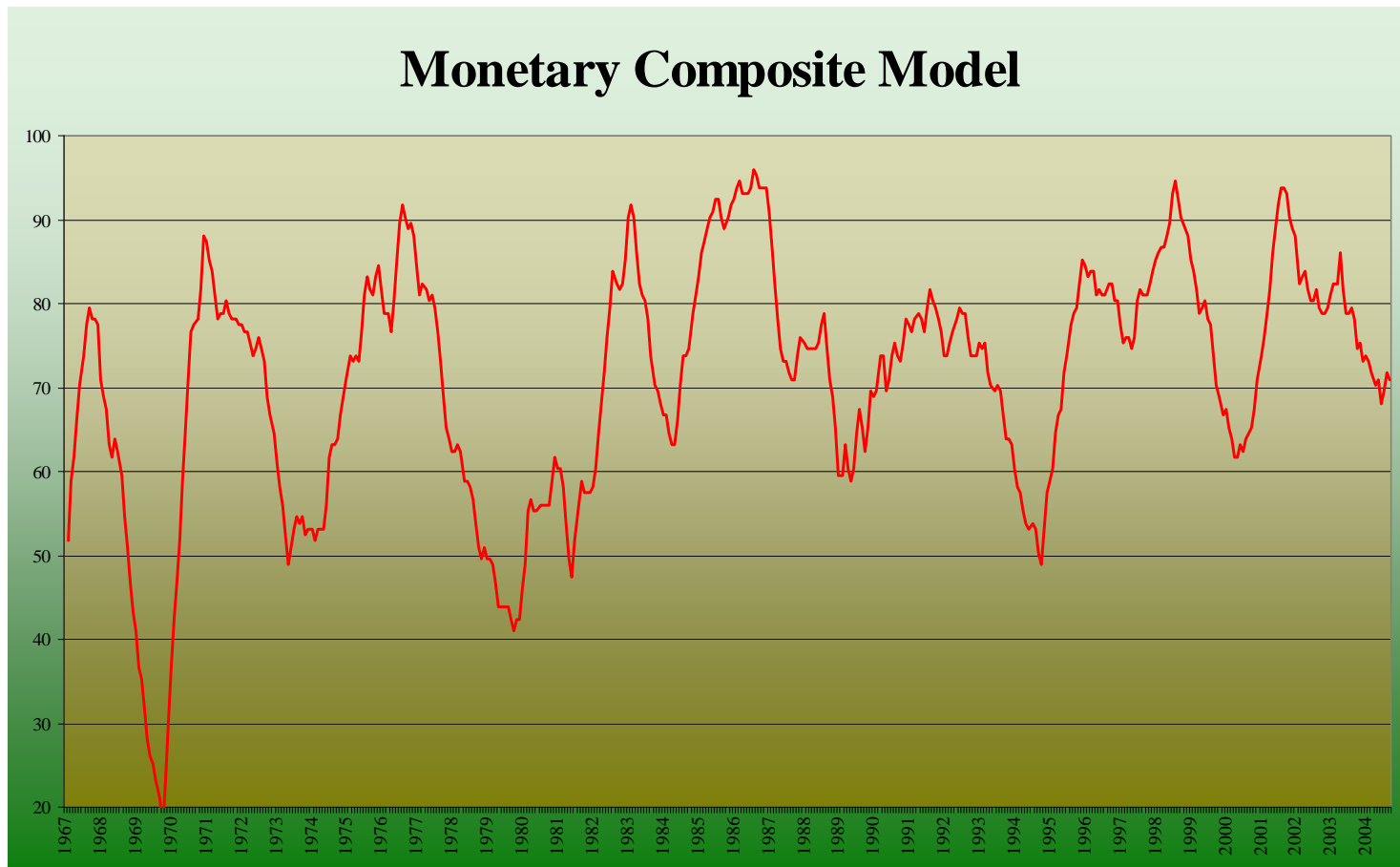
For all the talk of the difference between the core rate of inflation (ex. Food and Energy) and the All Urban CPI, the core rate of inflation has been accelerating over the past year.

Federal Reserve Watch

In the short term we anticipate that the Federal Reserve will continue to move short rates higher via the Fed Funds rate. How much higher will depend on the trend levels of inflation in the coming months. While it is normal for the Fed Funds rate to be at a slight premium to the rate of inflation, the Fed may view a rate equal to the rate of inflation as neutral at the present time. If so, with the core rate of inflation at 2.21% and the all urban rate at 2.90% we may be getting close to neutral.

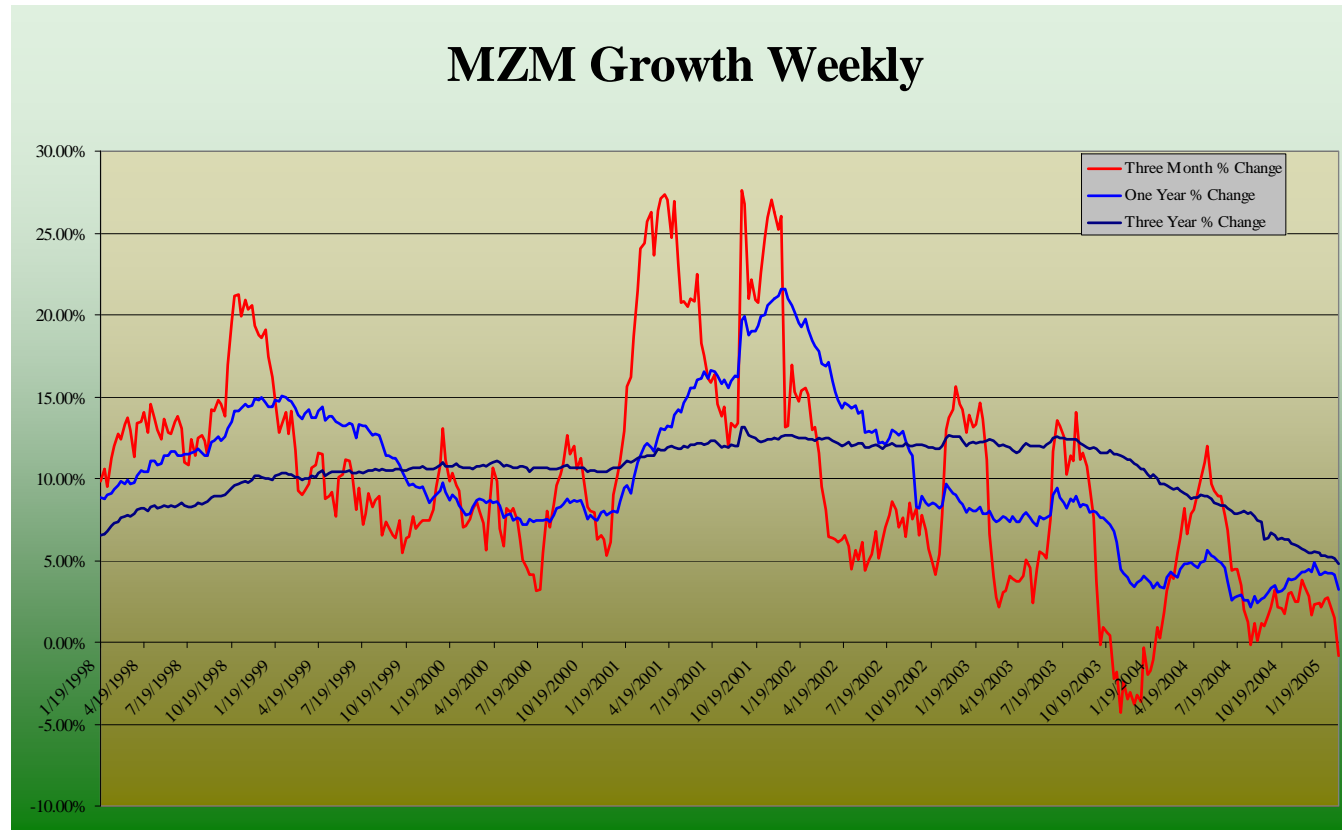
To be clear, we are not forecasting the end of the tightening cycle, but perhaps a more measured pace as real short term rates approach a more neutral range.

Federal Reserve Watch



A value above 50 indicates the Fed's policies are accommodative, but the trend is just as important. With the monetary composite model at present levels, our opinion is that monetary policy is neutral at the present time, neither bullish or bearish.

Federal Reserve Watch



Slowing MZM growth has moved inversely with the higher Fed Funds rate. Additional liquidity is tightening, but not sharply versus real economic growth.

Federal Reserve Watch

As we documented in last months Chartbook, the Fed's action has not been as effective as desired due to the demand for our longer-term Treasury bonds by Asian nations which has had the effect of keeping our long-term interest rates lower than they should be.

If bond rates were in keeping with their historical relationship with inflation, they would be significantly higher...

Security	Recent	Based on Historical relationship
1 year Treasury	2.67%	3.97%
10 year Treasury	4.19%	6.04%
Aaa corporate	5.47%	7.62%
Baa corporate	6.15%	8.50%

Although we do not believe this relationship should dictate exactly what interest rates should be at this point in time, it is very apparent that the natural rates are far higher than current rates. **This is a major risk to bonds, financials and real estate. If this relationship corrects to the normal spread quickly, it would cause painful dislocations in the markets.**

Outlook

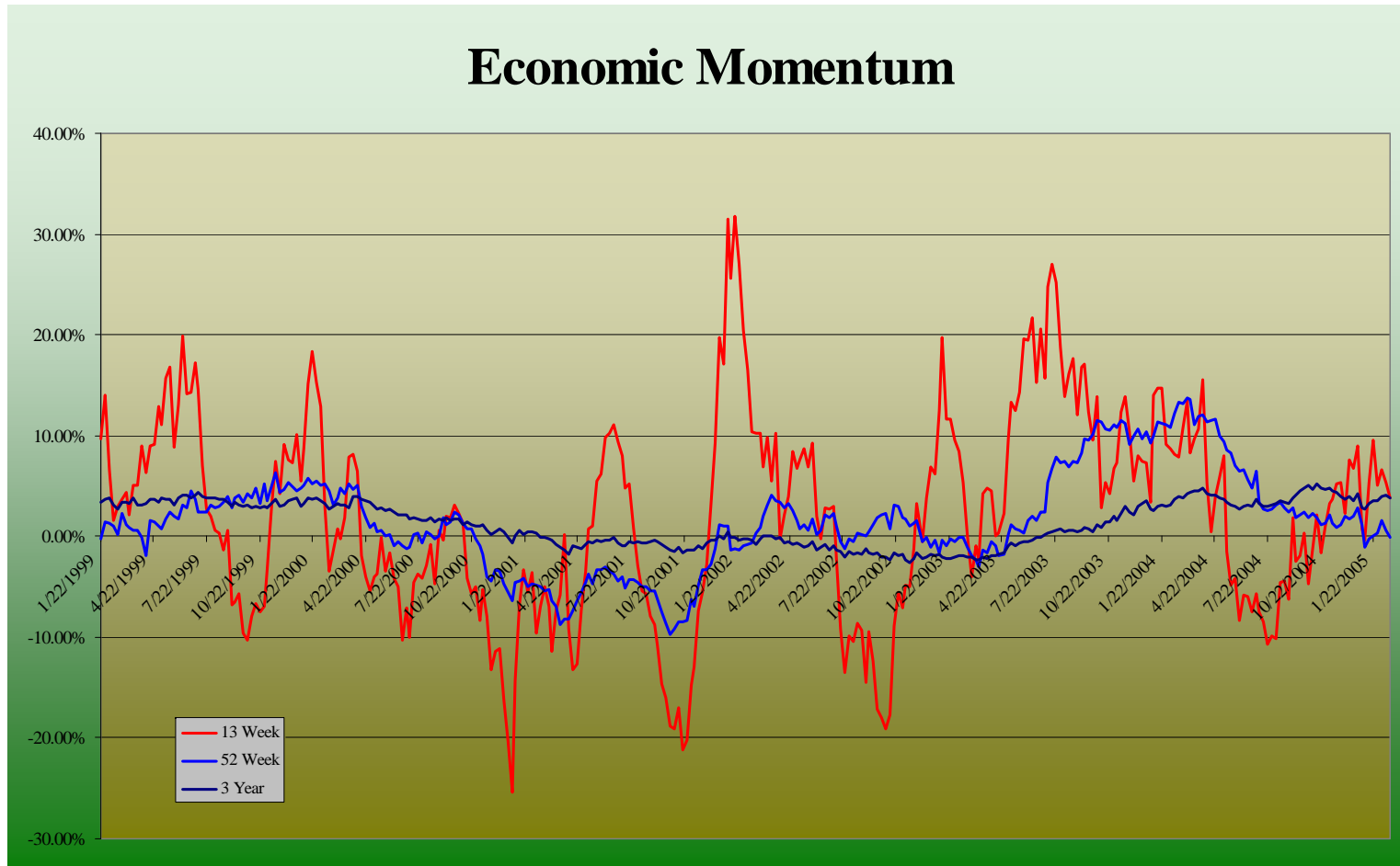
Slowing growth in conjunction with moderate levels of inflation and improving labor markets should sustain the recovery. Many risks are present, but in sum we believe that sustained recovery will support moderate appreciation in the equity markets.

Outlook & Forecast



The labor markets are behaving like the tortoise from Aesop's fable of the Tortoise and the Hare. Slow but steady. This stealth improvement may sneak up on the market and may lead to rates rising from current levels.

Outlook & Forecast



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

Sustained growth remains the status quo. Moderate growth will insure the recovery continues if the Fed is not forced to chock off the recovery.