

# Monthly Chartbook

## January 2004

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# Executive Summary

- The markets started the New Year off with a Bang, moving much higher quickly as signs of faster growth emerge.
- The markets have gone a long time without taking a breather. A period of consolidation is in order before we move sharply higher, and we would welcome a 5-10% correction.
- The S&P 500 is near fair value. Upside is limited by the amount of positive movement we have already had. We see the most value in Large Cap Growth ex. Technology
  - Global recovery continues
  - The number of jobs increases and growth continues with preliminary real GDP in at 4.0%, below the consensus expected rate of 4.4% but above the 3.3% long term average.
  - Earnings season has been very bullish, but earnings comparisons were versus a low base. Going forward earnings will be the driving factor in the markets value.

# Executive Summary

- The Weekly Leading Indicators (WLI) have spiked upwards in recent weeks, adding to our view that prospects for solid growth in 2004 continue.
- As the employment picture has improved and jobless claims have fallen, the employment pressure index has found a bottom. This adds to our view that the recovery will start adding significant jobs and take some heat off of this politically charged issue.
- The Federal Reserve Board has opened the door to raising interest rates-- something we have been warning people about. The Fed will not keep short term rates below inflation as soon as the jobless rate begins to decline significantly, election year or not.
- Things to watch for
  - **Presidential Election (What happens to Iraq if Bush loses?)**
  - **China/Japan/Asia (We buy their goods; they buy our debt. How long will this relationship hold?)**
  - **Commodity Prices ( Not just Oil and Gold, Lead, Copper, Timber, Cotton)**

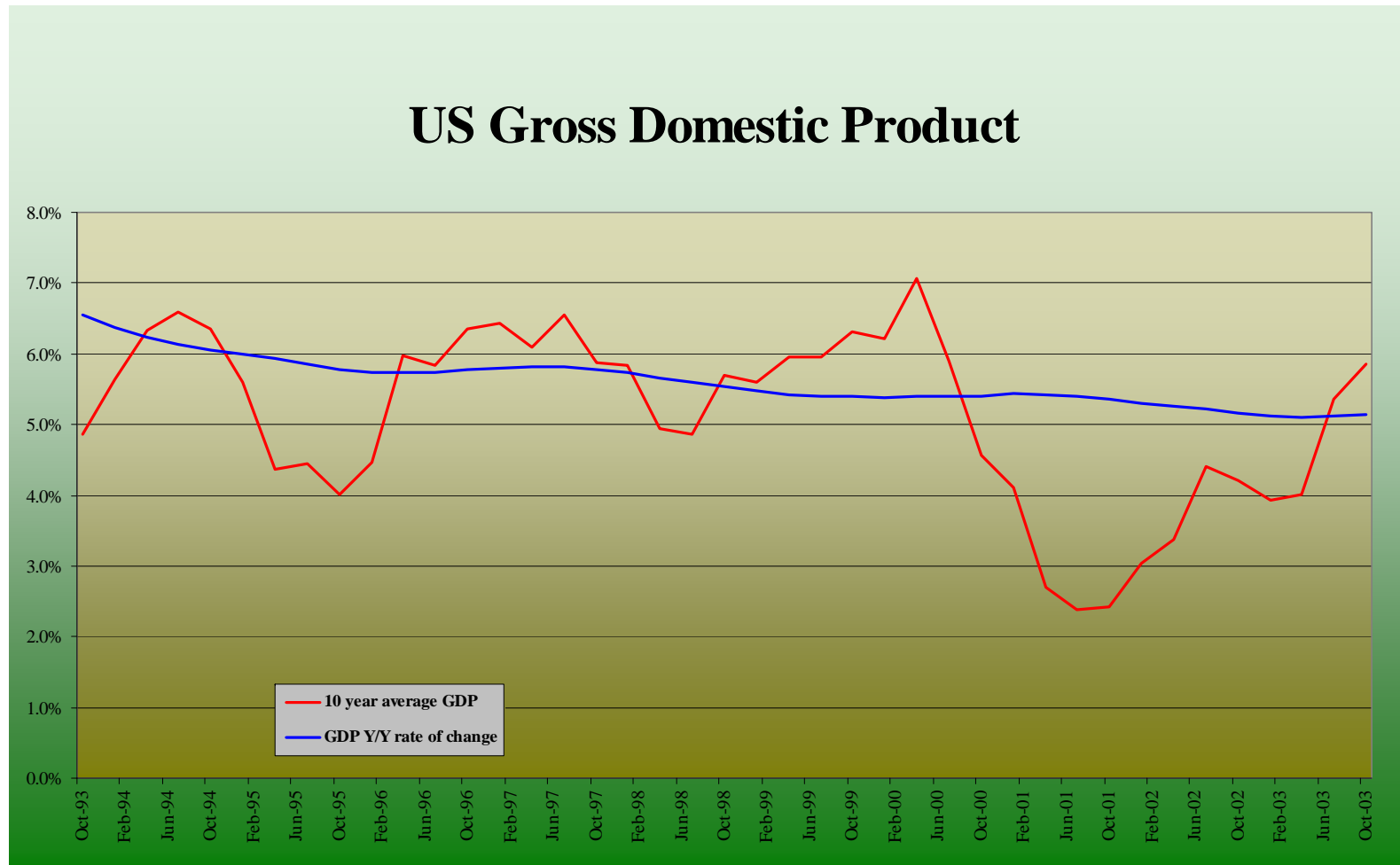
# Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
<b>S&amp;P 500</b>	<b>1131.13</b>	<b>Trading range</b>	↔	<b>1050-1200</b>	<b>10-12 Months</b>
<b>Ten Year Treasury</b>	<b>4.13%</b>	<b>Bottomed June 2003</b>	↑	<b>4.00%-4.625%</b>	<b>10-12 Months</b>
<b>Inflation (all Urban)</b>	<b>1.87%</b>	<b>2.25%</b>	↑	<b>1.75%-2.25%</b>	<b>10-12 months</b>
<b>Fed Funds</b>	<b>1.00%</b>	<b>1.00%-1.50%</b>	↑	<b>1.00%-1.75%</b>	<b>6-10 months</b>
<b>S&amp;P 500 Earnings</b>	<b>\$38.17</b>	<b>\$42</b>	↑	<b>\$38-48</b>	<b>1q2004</b>
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

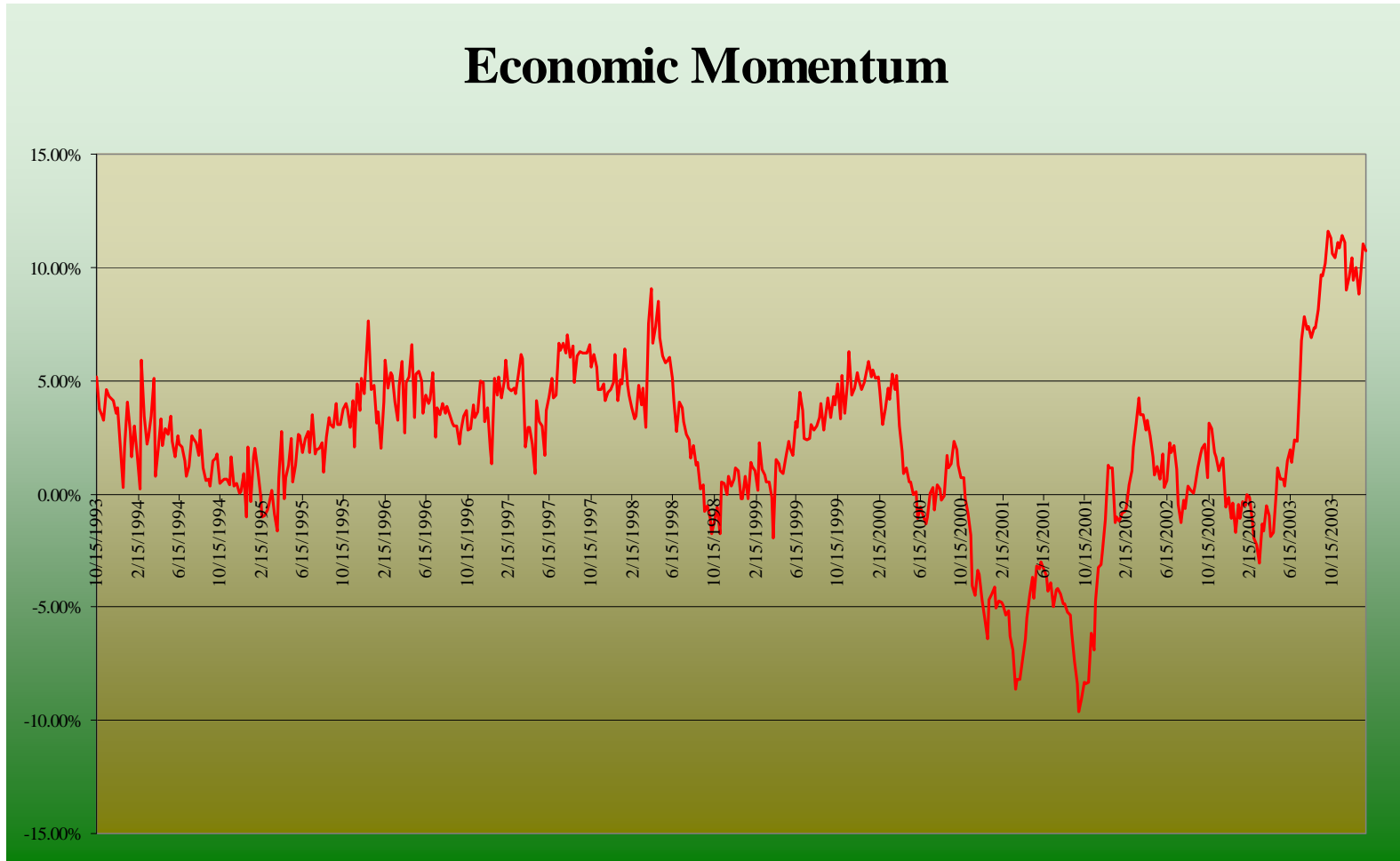
# Macro-economic Research



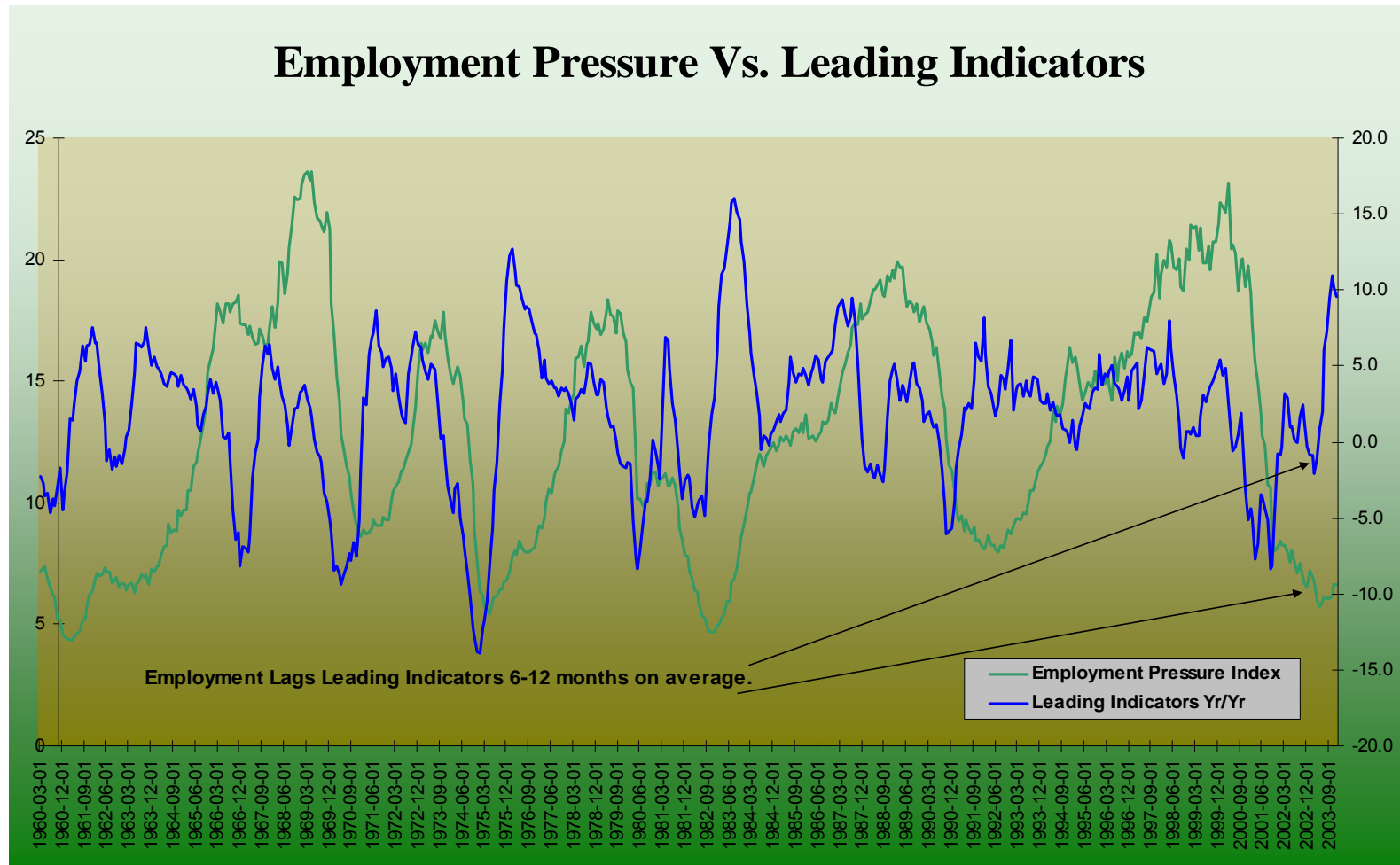
S&P 500 daily -- moved higher quickly after the first of the year.



GDP growth is now back above the 10 year average.



Weekly Leading Economic Indicators are showing signs of growth not seen in the last ten years.



Employment pressure has found a bottom and should follow the Leading Indicators higher in 2004.

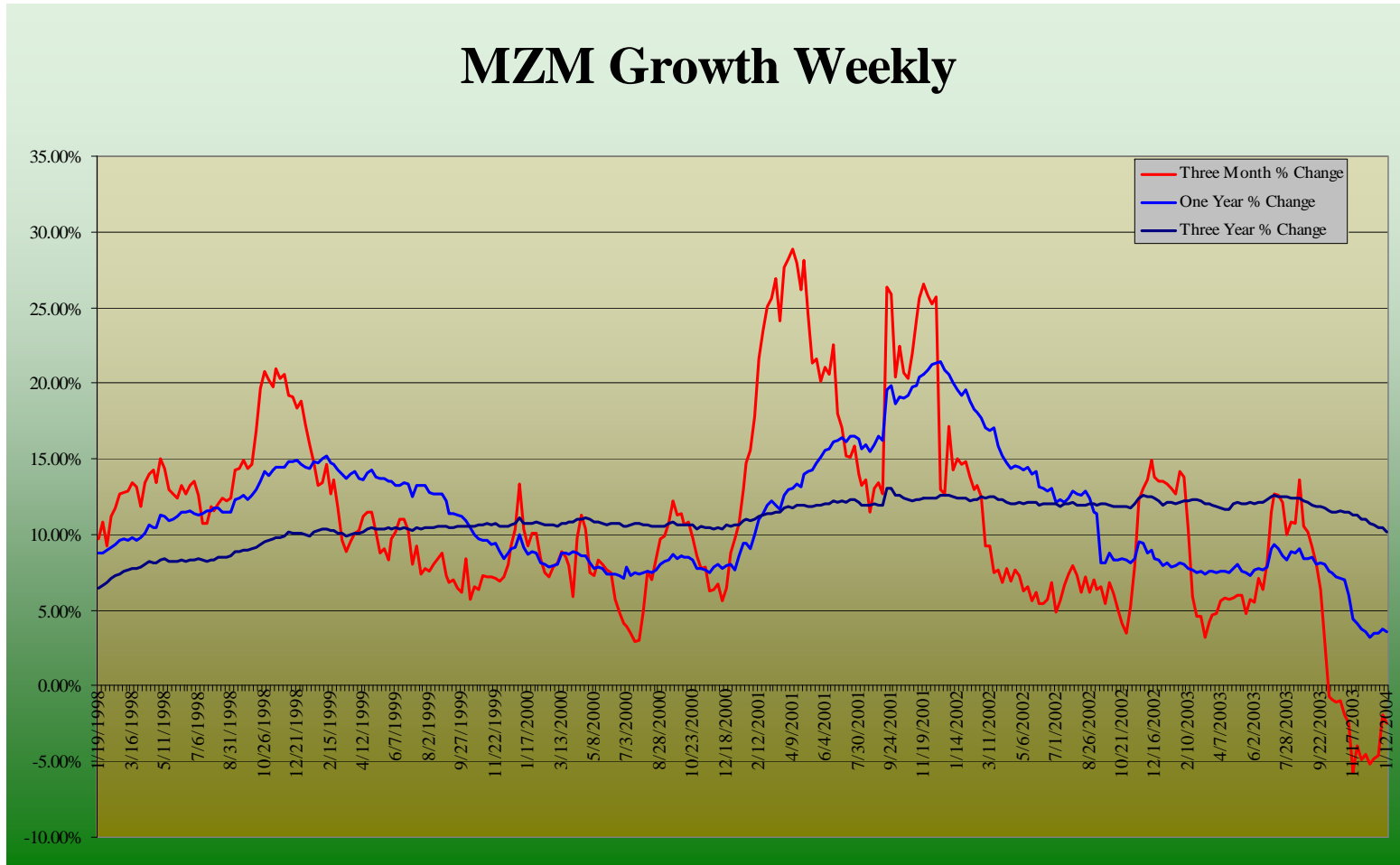
# Federal Reserve Watch

- Overall, monetary policy is still accommodative, but look out for marginal tightening going forward.
- We cannot and should not expect the Fed to keep real short term interest rates negative for years and years on end.
- Rates can rise in absence of the Fed... for example, we are captive to Asia's large purchases of our debt in order to keep rates low.

- **Jan 28, 2004 Federal Reserve Press Release**

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent. The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the inter-meeting period confirms that output is expanding briskly. Although new hiring remains subdued, other indicators suggest an improvement in the labor market. Increases in core consumer prices are muted and expected to remain low. The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. ***With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation. (emphasis added)***

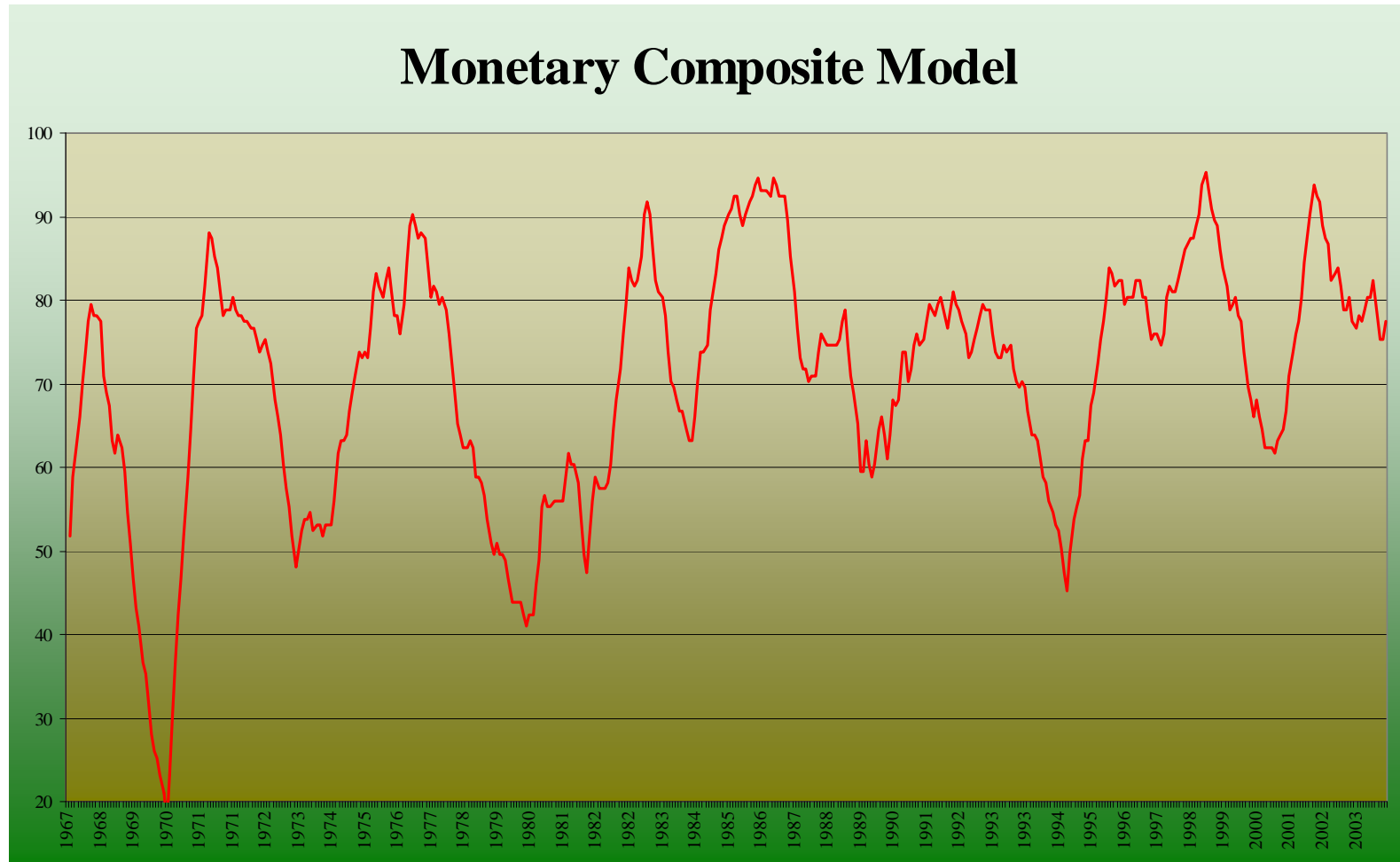
*Federal Reserve Watch*



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

The 3 month growth rate of money supply has improved considerably over the last three weeks.

## Federal Reserve Watch

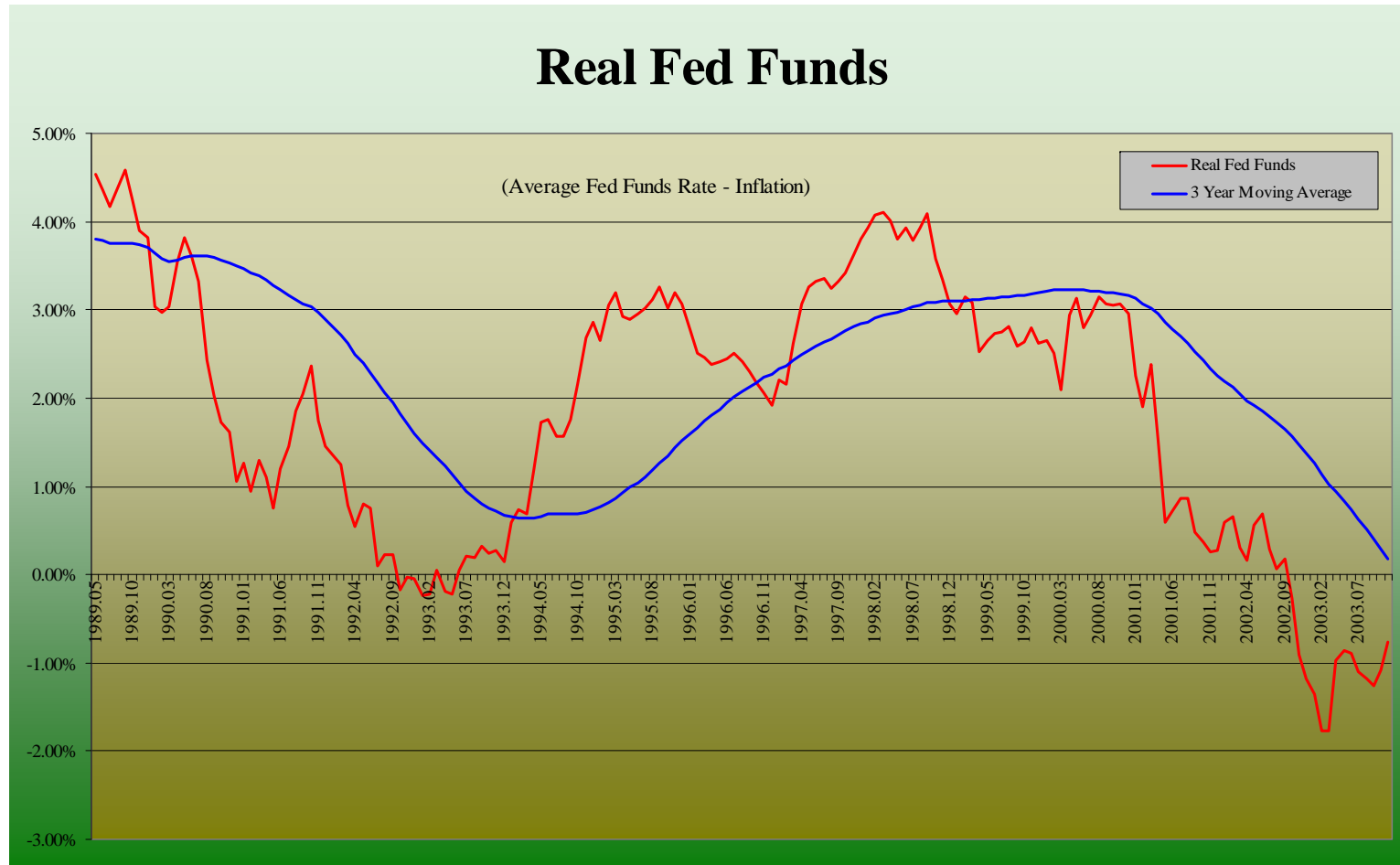


The direction of trend in this series is as important as the level.

A score above 50 indicates the Fed's monetary policy is accommodative.

Money supply growth is increasing, slightly.

## Federal Reserve Watch

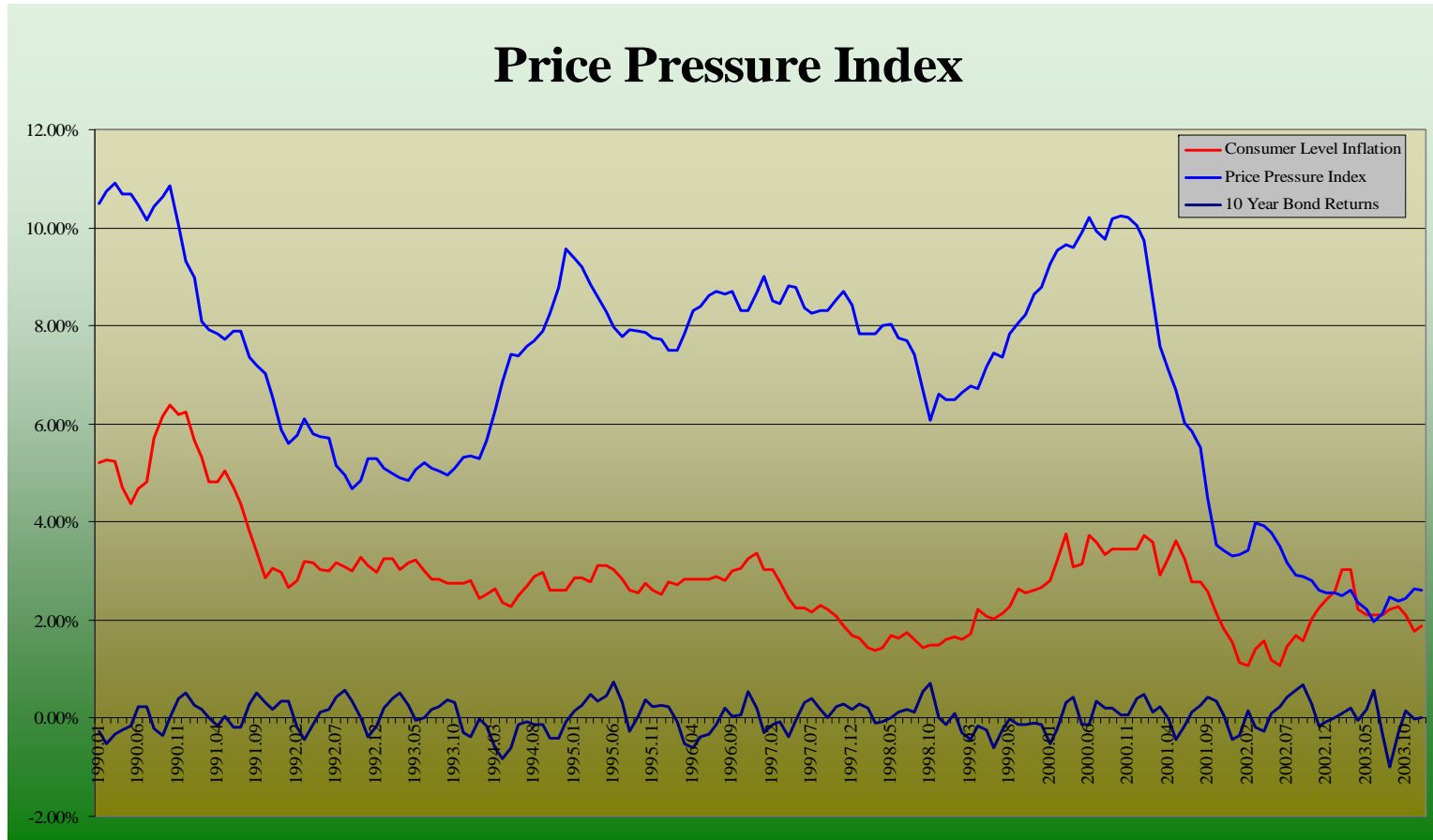


The negative Fed Funds Rate explains why Bank & Money Market Yields are so low.  
We believe the Fed will have few reasons to keep real interest rates negative much longer.

# Inflation expectations

- Price pressure index bottomed June of 2003.
- Leading the way is the price for raw materials due to:
  - Global recovery.
  - China – as this country gets its manufacturing engine going, there is increased demand for most raw materials.
- The market anticipates higher inflation (2.5% expected versus 1.87% current) over the next cycle, as indicated by its pricing of inflation-protected Treasuries.

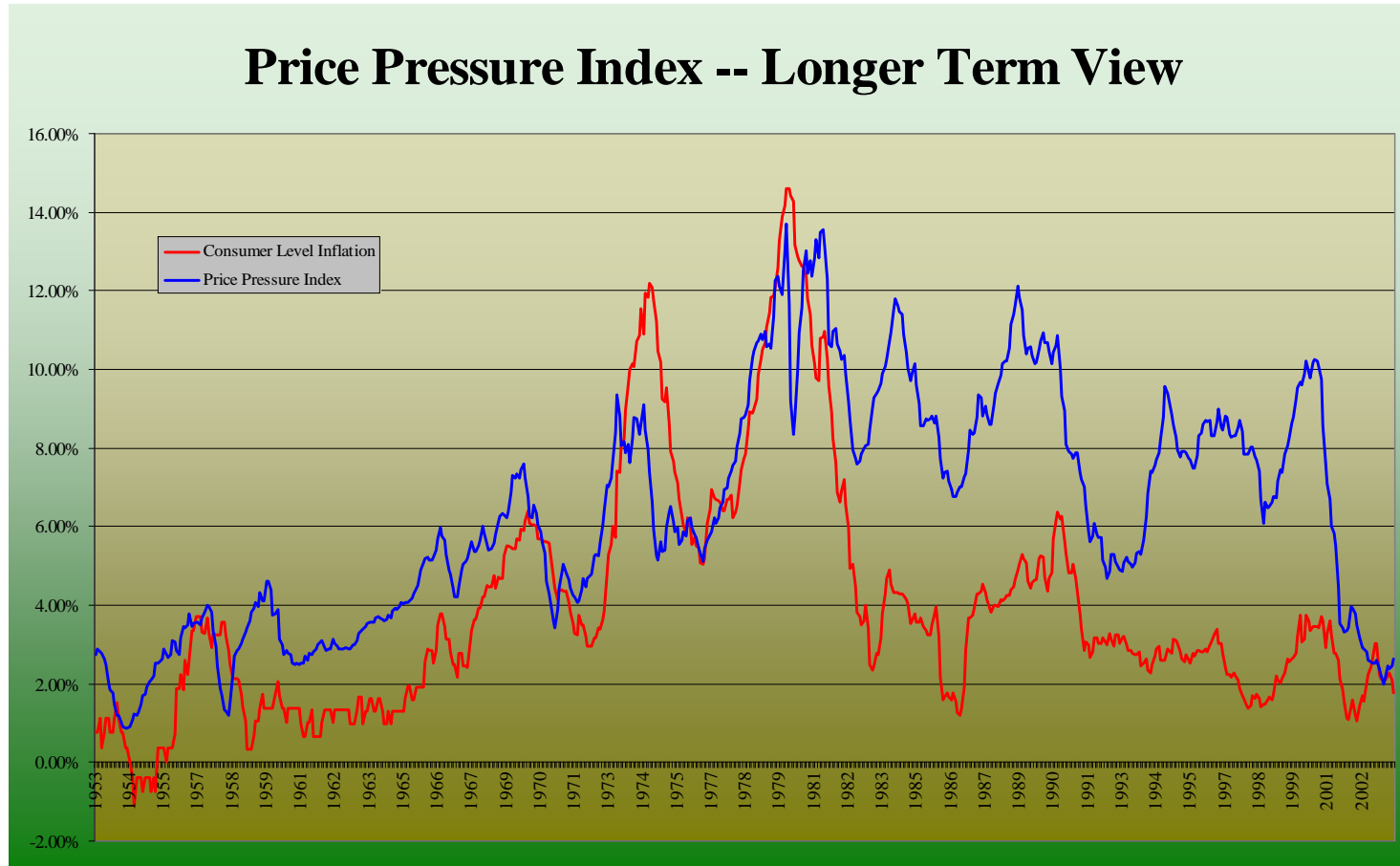
## *Inflation expectations*



A declining index value indicates receding inflationary pressure within the economy, and a rising index value foretells higher consumer prices.

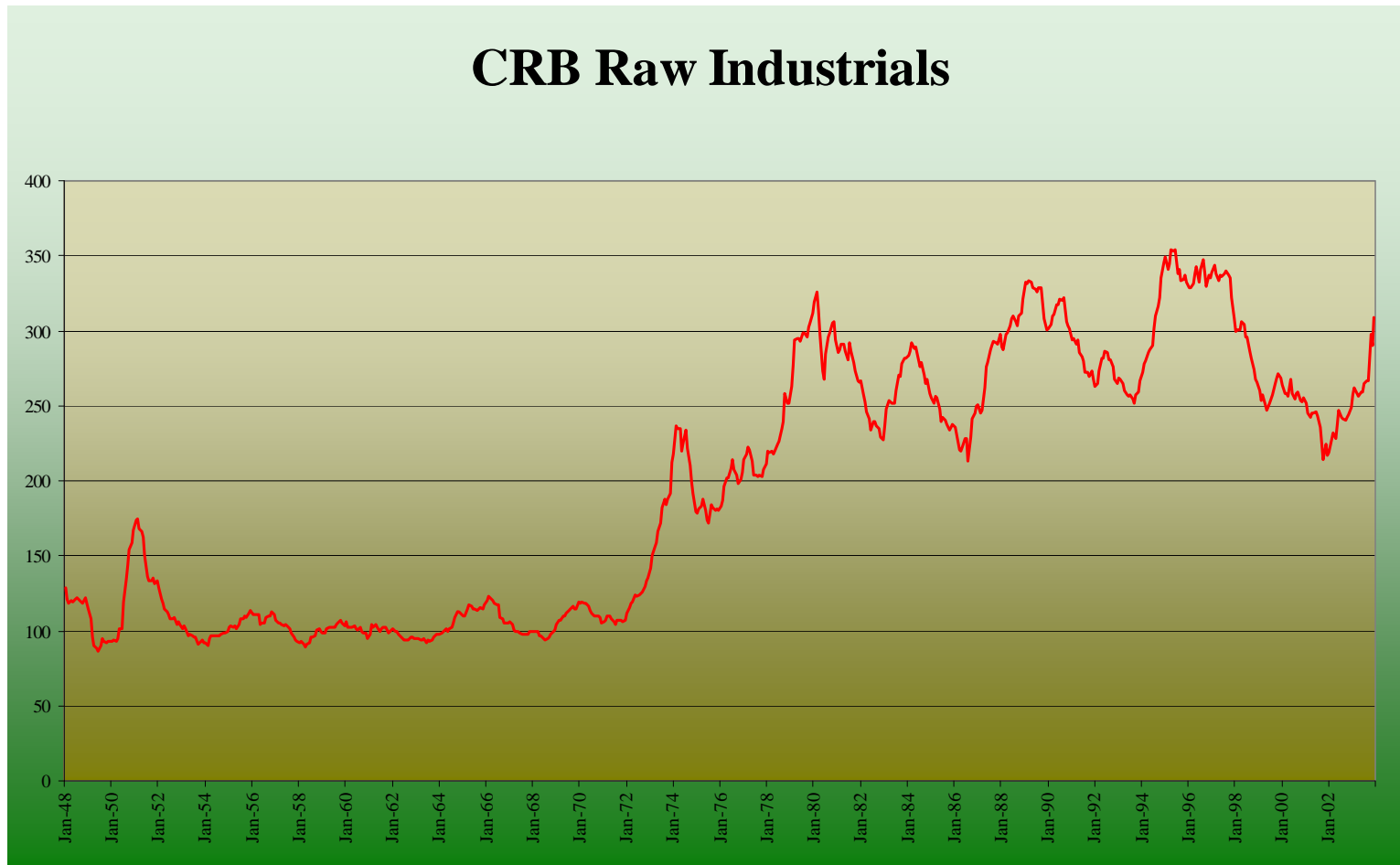
The Price Pressure Index bottomed June 2003.

*Inflation expectations*



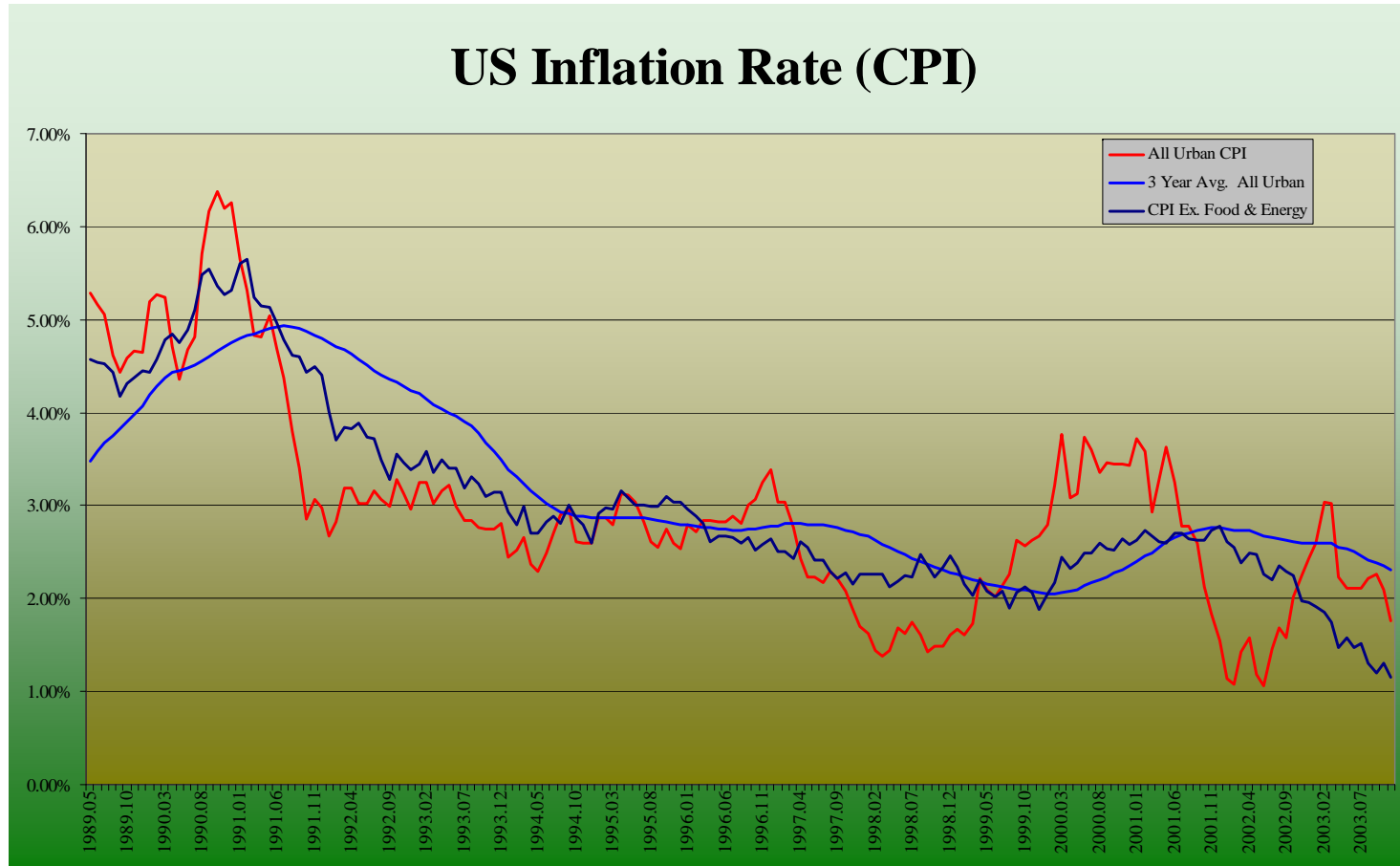
The Price Pressure Index is at its lowest levels since the mid-1950's.

## *Inflation Expectations*



Raw materials prices bottomed in 2001 at almost the same time that China joined the World Trade Organization (WTO).

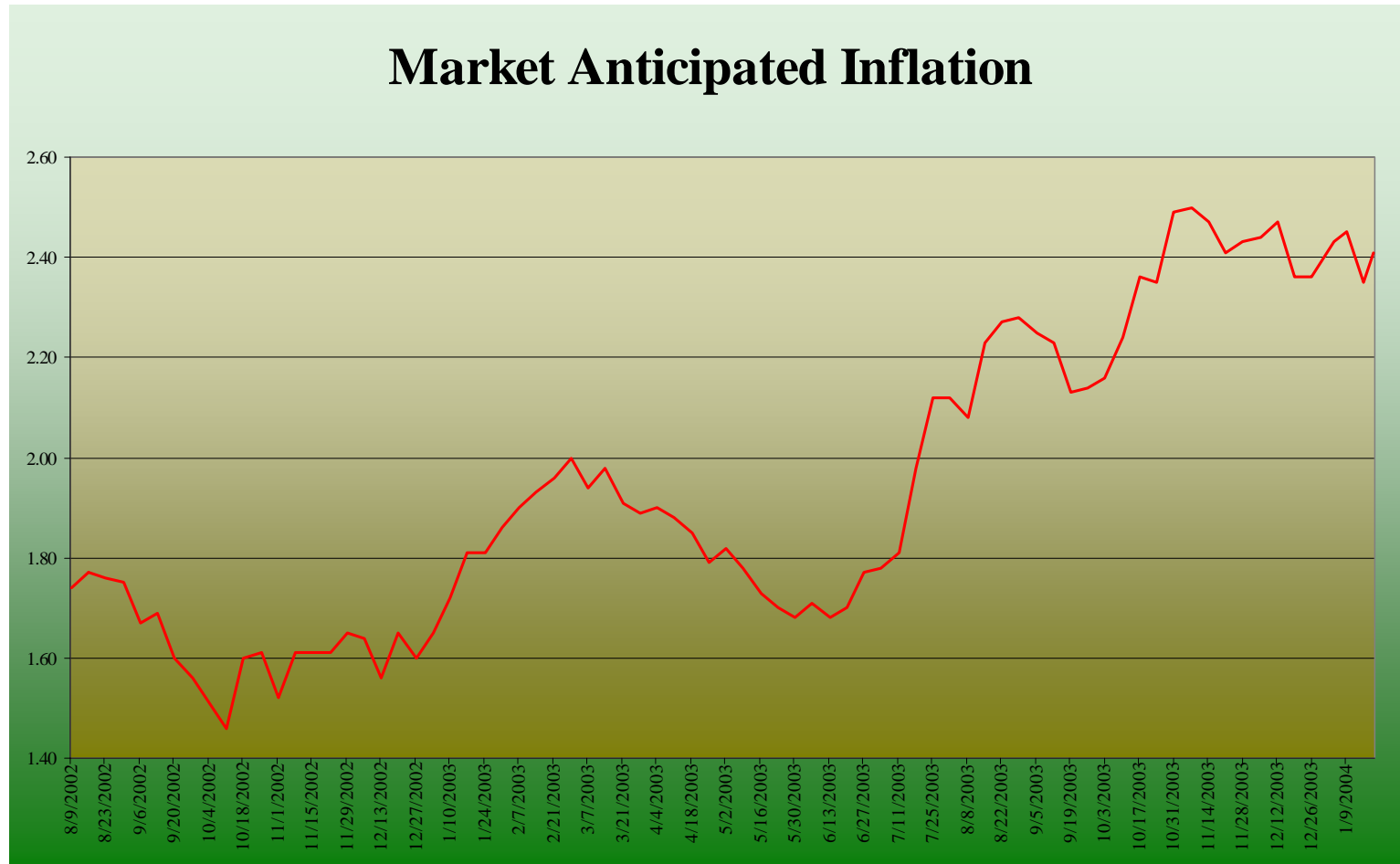
## *Inflation Expectations*



Inflation remains low at the consumer level even though there has been an increase in the cost of raw materials.

Currently, because these materials are being processed by a lower-cost producer (China), there has not been a significant increase in the cost of goods. Soon, these costs may be passed further throughout the supply chain.

## *Inflation Expectations*

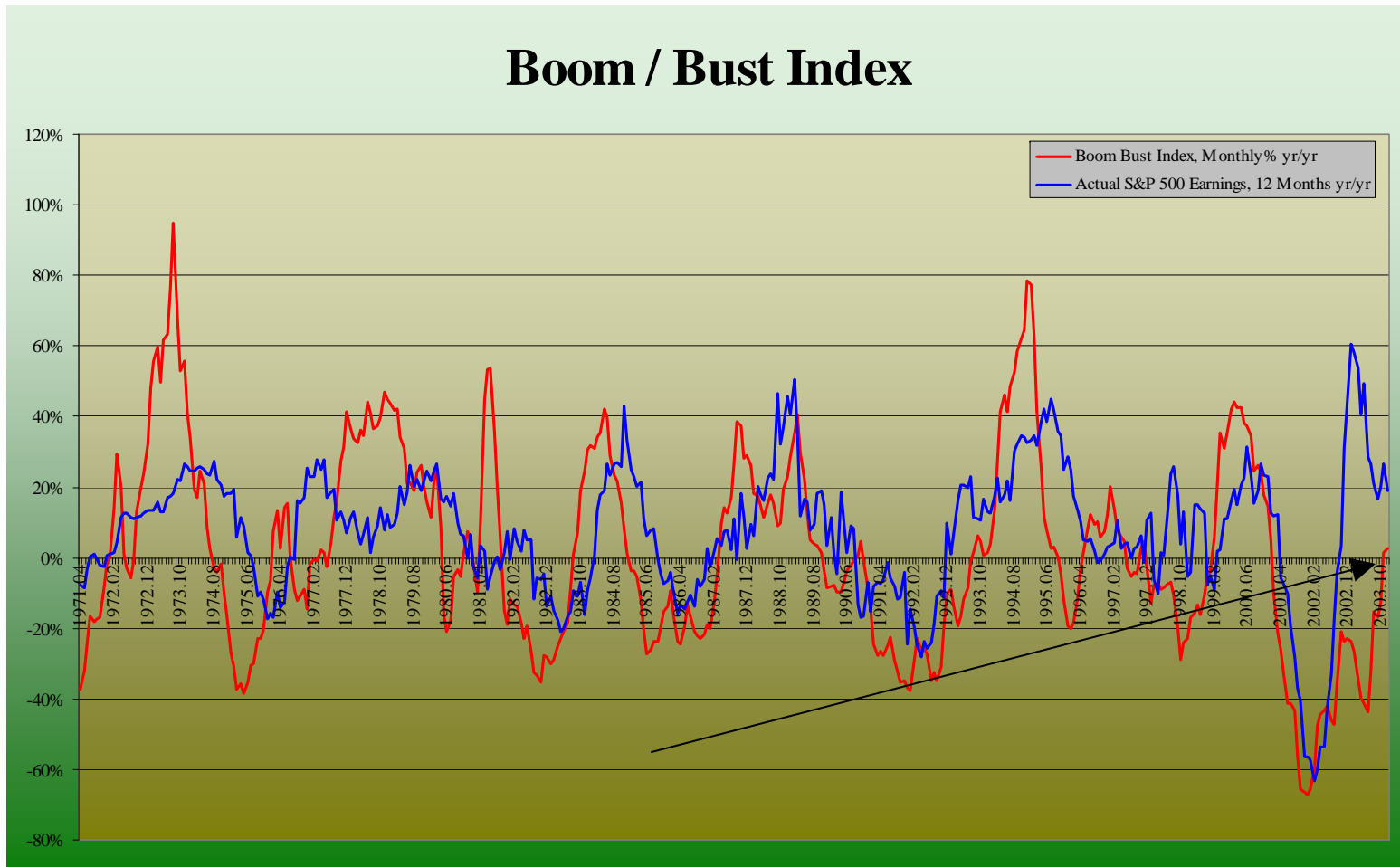


The market anticipates inflation (based on TIPS) to remain just below the 2.5% level over the next ten years.  
Deflation? What Deflation?

# Outlook & Forecast

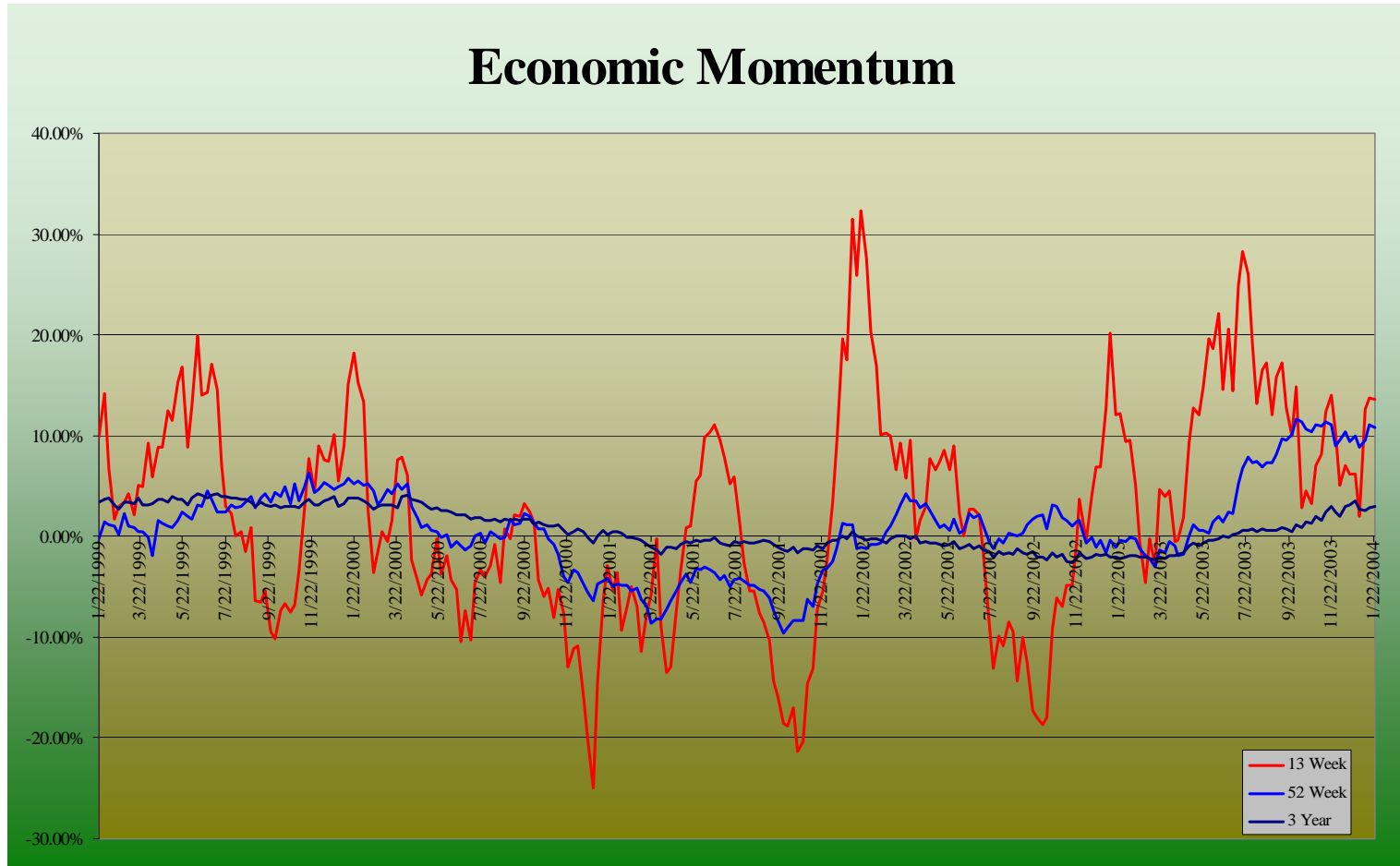
- Cornerstone is still cautiously optimistic:
  - The economy will continue to experience overall growth.
  - Earnings will continue to increase as the recovery broadens.
  - The days of easy comparables for earnings are over.
  - The US economy will continue to create jobs, which bodes well for the current administration.
  - But, much of the upside is already priced into equities.
- That said, the markets have potential to provide returns that should approximate their long-term averages, between 8 and 10% annually.
- Potential wildcards
  - The Fed raises interest rates – highly likely.
  - Exogenous shock (terror attack, other major calamity) – a significant event is not extremely likely but always a possibility.
  - What happens in Iraq if Bush loses?

## Outlook & Forecast



The Boom/Bust Index tracks several key variables within the economy that correlate with earnings. The solid black line is predicted S&P 500 earnings direction, indicating positive movement continuing for earnings and is positive for the first time since February 2001--time for real growth.

## Outlook & Forecast



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

Momentum has turned positive since last month's chart book.