Monthly Chartbook

January 2005

CORNERSTONE
Investment Management and Consulting

www.investwithcornerstone.com

1/31/2005

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Macro-economic Research

The unheralded strength of earnings…

The current valuation of the marketplace is reasonable given that earnings have been growing steadily to underpin equity prices and inflation (although growing) is at historically low levels.

- The market is growing into its PE ratio as year-over-year earnings growth has been above 50% since February of 2004.
- And, with inflation between 3% and 3.5%, the Price / Earnings ratio is well within its target range. Our study this summer indicated that…

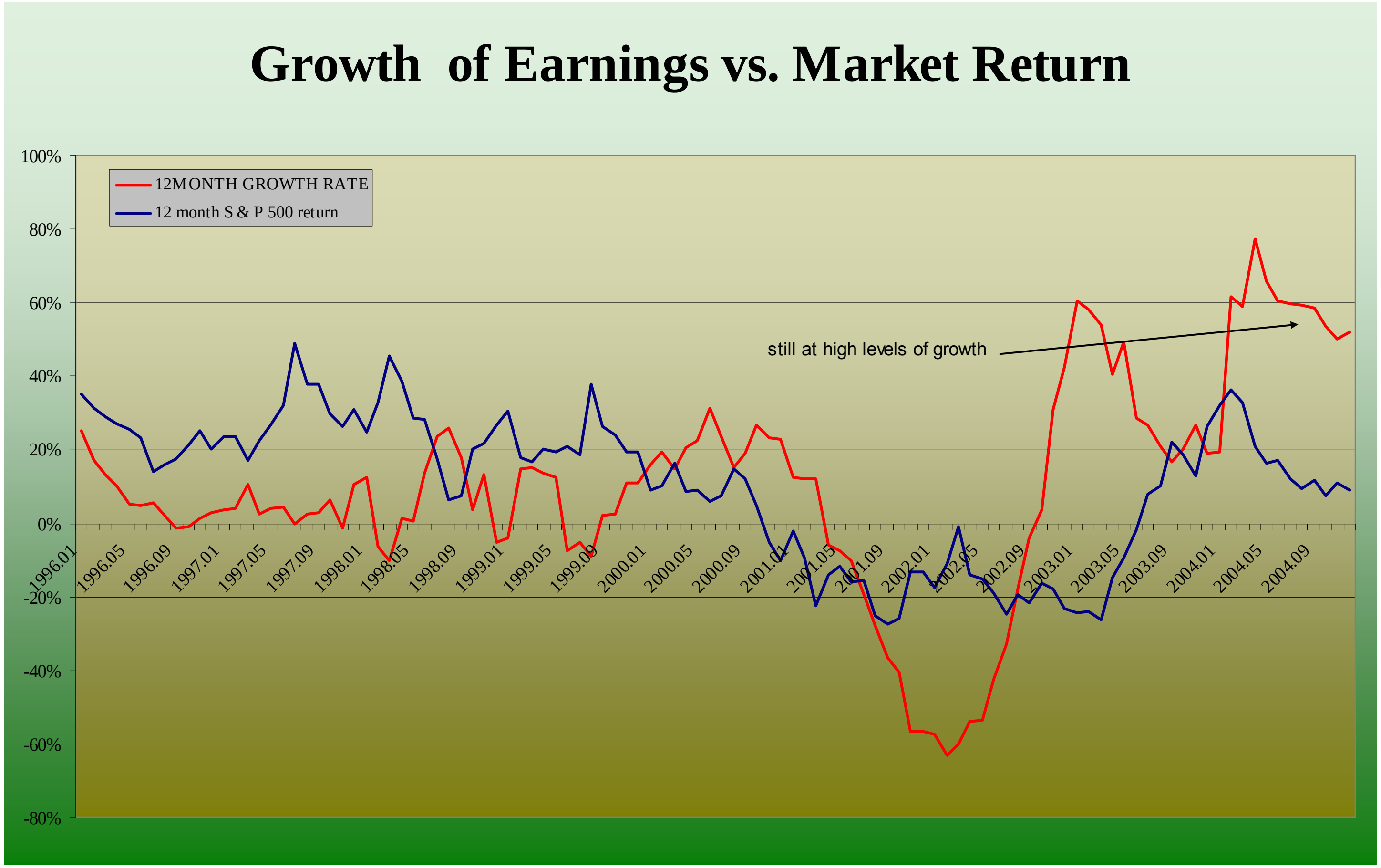
1) if inflation is less than 5%, market PE averages 19.46
2) if inflation is less than 3%, market PE averages 20.82
3) if inflation is greater than 5%, market PE averages 11.82

In spite of this continuous earnings growth, there has not been dramatic market movement as the PE ratio has remained between 19.5 and 23 over this entire period. And, there appears to be no trouble on the horizon:

- In this environment of slowing but steady growth, earnings growth should continue.
- As the increase in prices for commodities slows, inflation should remain in its current range.

The only potential issue is the slowing rate of money supply, which is why we believe equity returns for the next six to eight years will be between 5% and 7% annually. Not very exciting relative to the past fifteen, and somewhat scary if your retirement is predicated on 10% growth for the next decade.

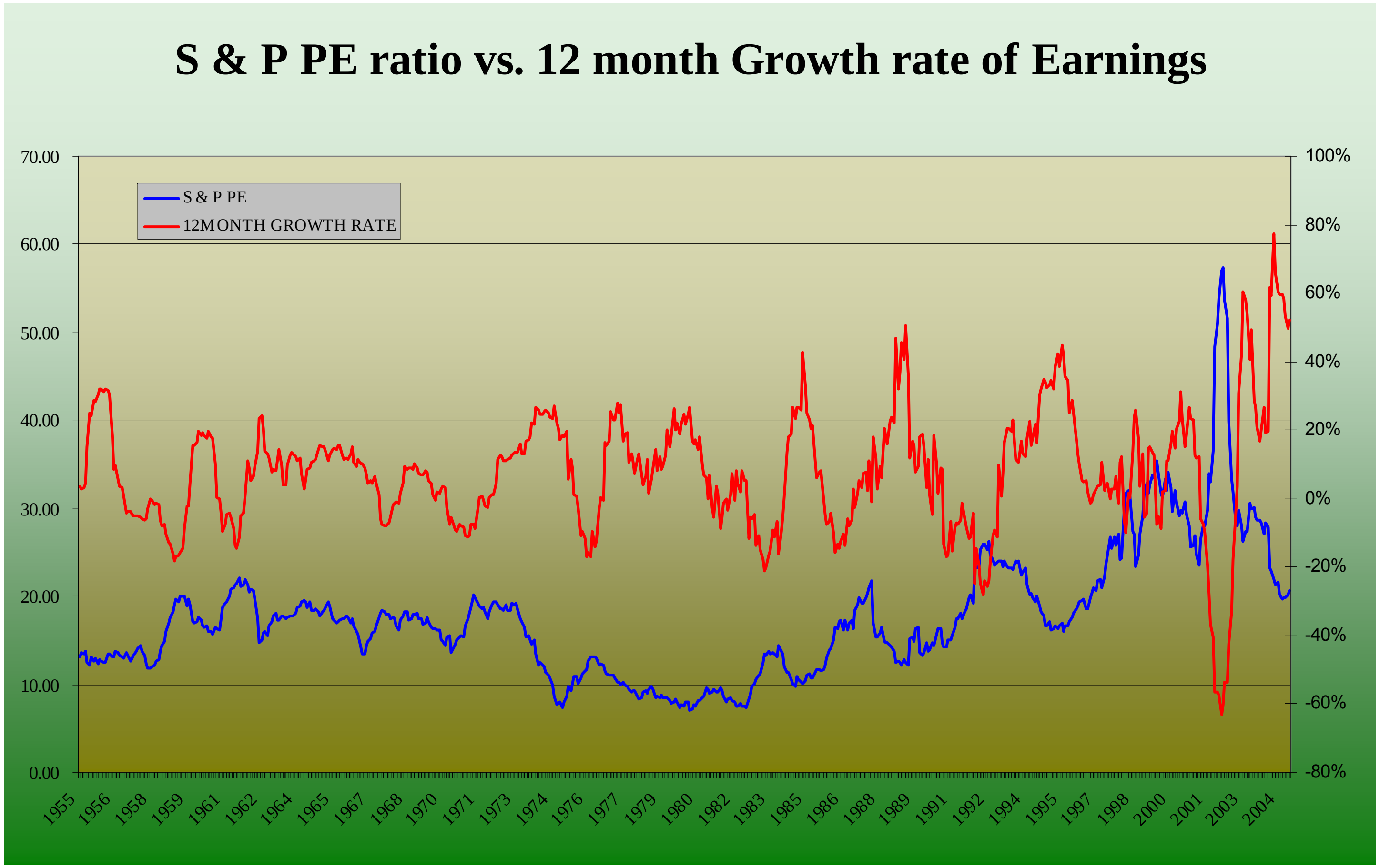
Macro-economic Research



The level of year-over-year earnings growth is as high as it has ever been; of course, we're still coming off of the decline in earnings following the recession and the Sept. 11th attacks.

Even so, the market has not provided the return that might be expected given the earnings growth. It appears the relationship between earnings growth and return is more a function of direction and duration than of magnitude.

Macro-economic Research



Although earnings growth on a year-over-year basis is as strong as it has ever been, the market PE is not at levels that reflect over-valuation.
As would be expected, when earnings growth declines, the PE increases for a period of time until growth in earnings again stabilizes this relationship.
This would indicate the market tends to anticipate earnings.

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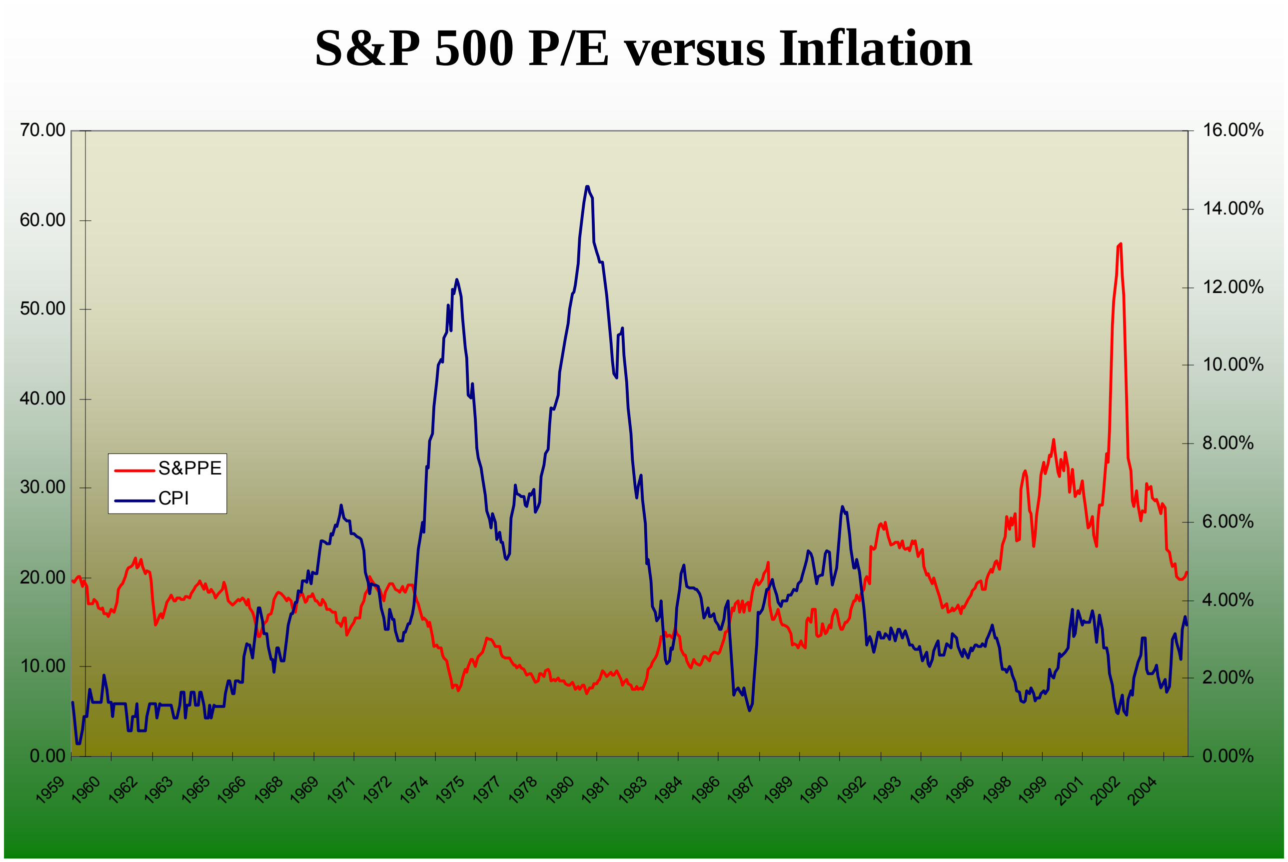

When inflation is high, the market PE tends to contract due to the uncertainty of the marketplace. On the other hand, low inflation often supports higher valuation by the market.

With an inflation rate that is between 3% and 3.5%, the market PE of approximately 20 is well within its normal range.

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Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	**1181.27**	**Trading range**	↔	**1150-1300**	**June 2005**
Ten Year Treasury	**4.13%**	**4.65%**	↓	**4.25%-4.875%**	**6 months**
Inflation (all Urban)	**3.35%**	**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	**$58.04**	**$62.13**	↑	**$60 - $65**	**June 2005**
	Legend:	↑ “Good”	↓”Bad”	↔”Indifferent”	

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Inflation expectations

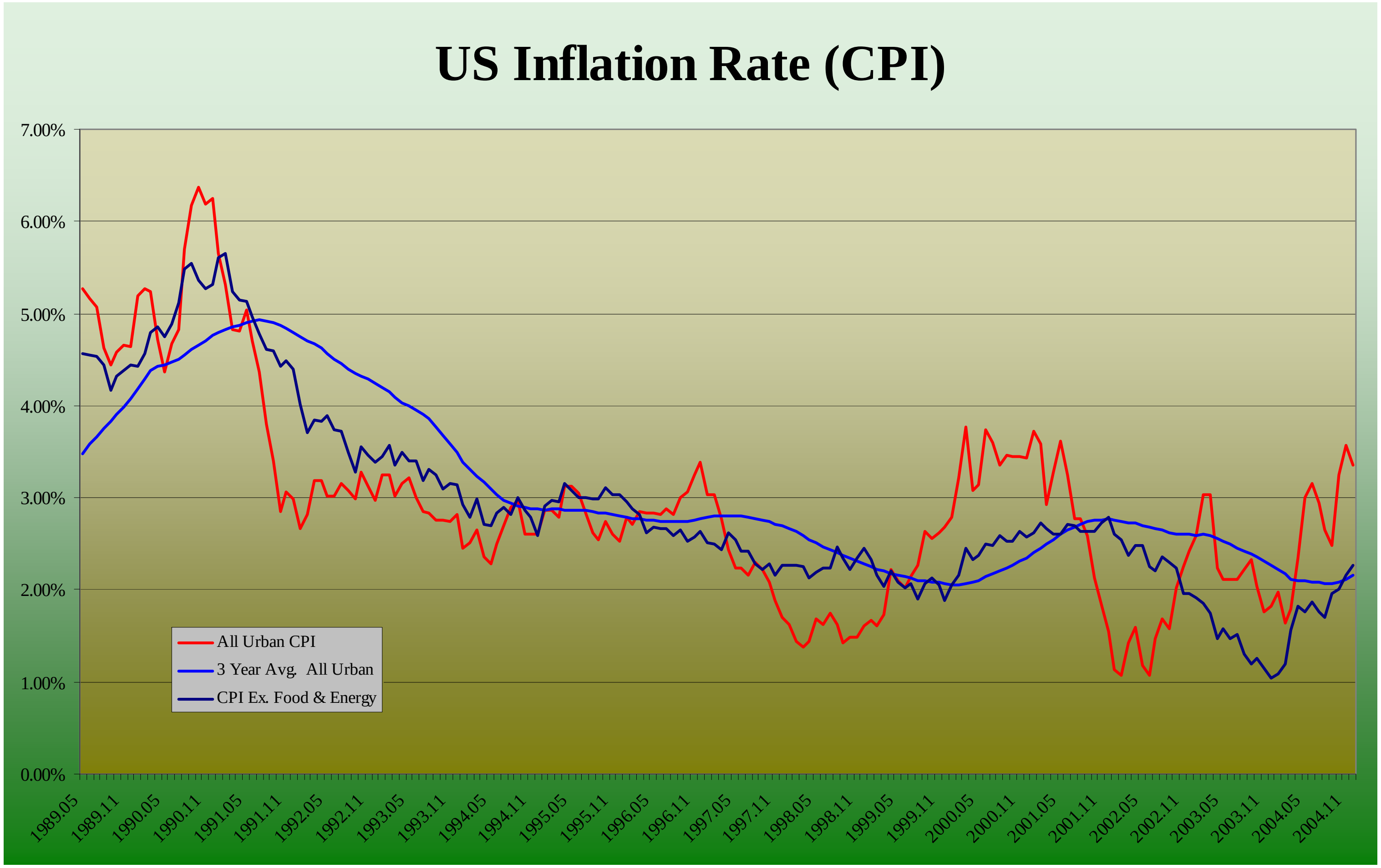
Inflation measures decreased over the month as energy prices declined.

However, the most positive news is that increases in the prices of commodities have slowed to a 4% year-over-year rate. This has been a source of upward pressure in prices since the middle of 2002.

The market has responded accordingly by providing lower estimates for inflation within the ten year TIPS.

We continue to 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 decreased slightly last month due to a fall in energy prices that may be short-lived as a near-term phenomenon but should be part of a long-term trend.

The current rate is 3.35% which is below the most recent fifty year average of 4.02%

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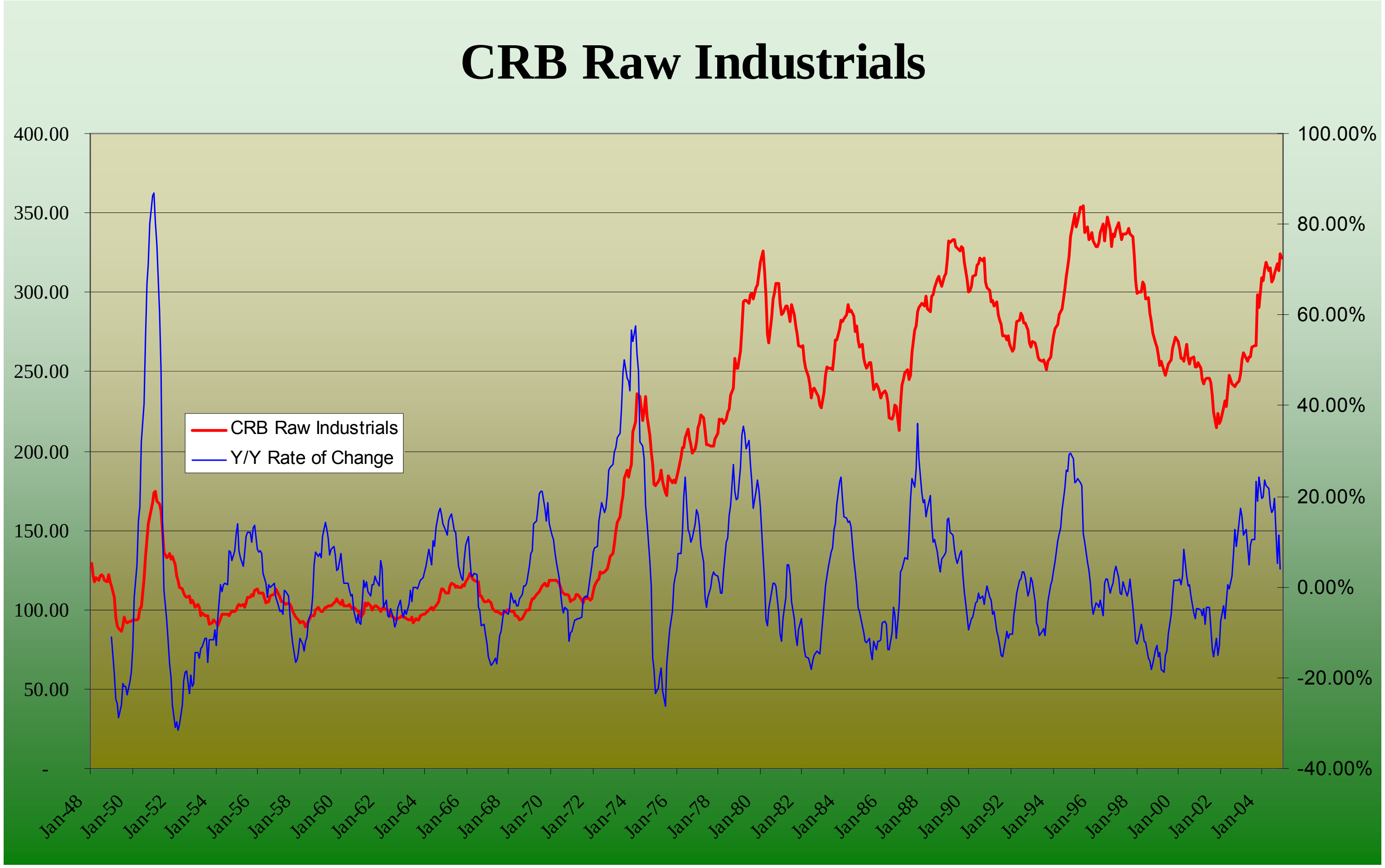
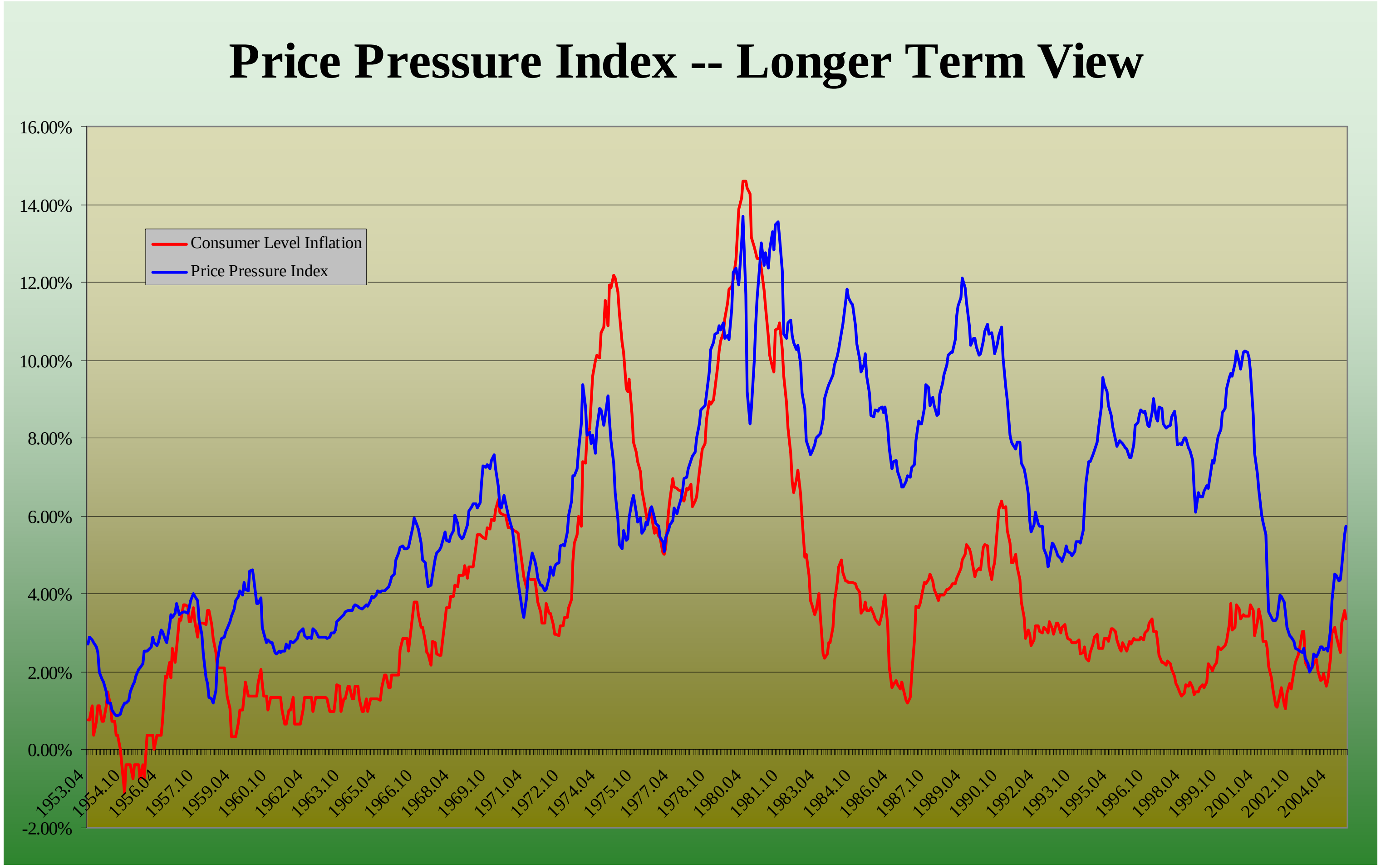
Inflation expectations



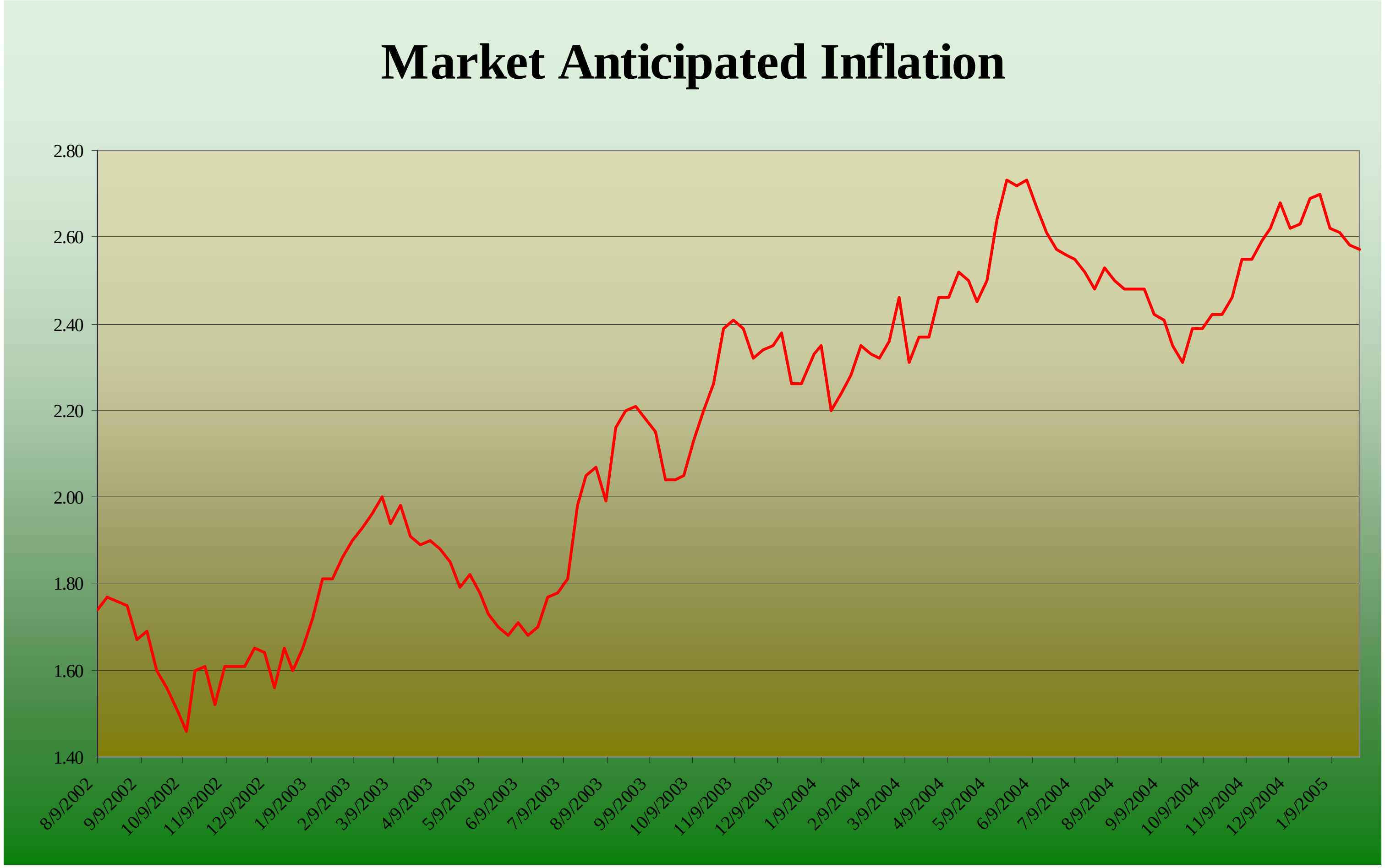
Another positive is the slowing rate of increase in commodity prices; this time last year the annualized rate of growth was 24%, whereas prices are up only 4% during 2004.

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



Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting higher but moderating inflation.

Federal Reserve Watch

We have mentioned in the past that the real rate of interest is negative (and has been for a period of about three years). This is in part because inflation has returned to more normal historical levels but is also due to extraordinarily low interest rates used as monetary stimulus during the past four years.

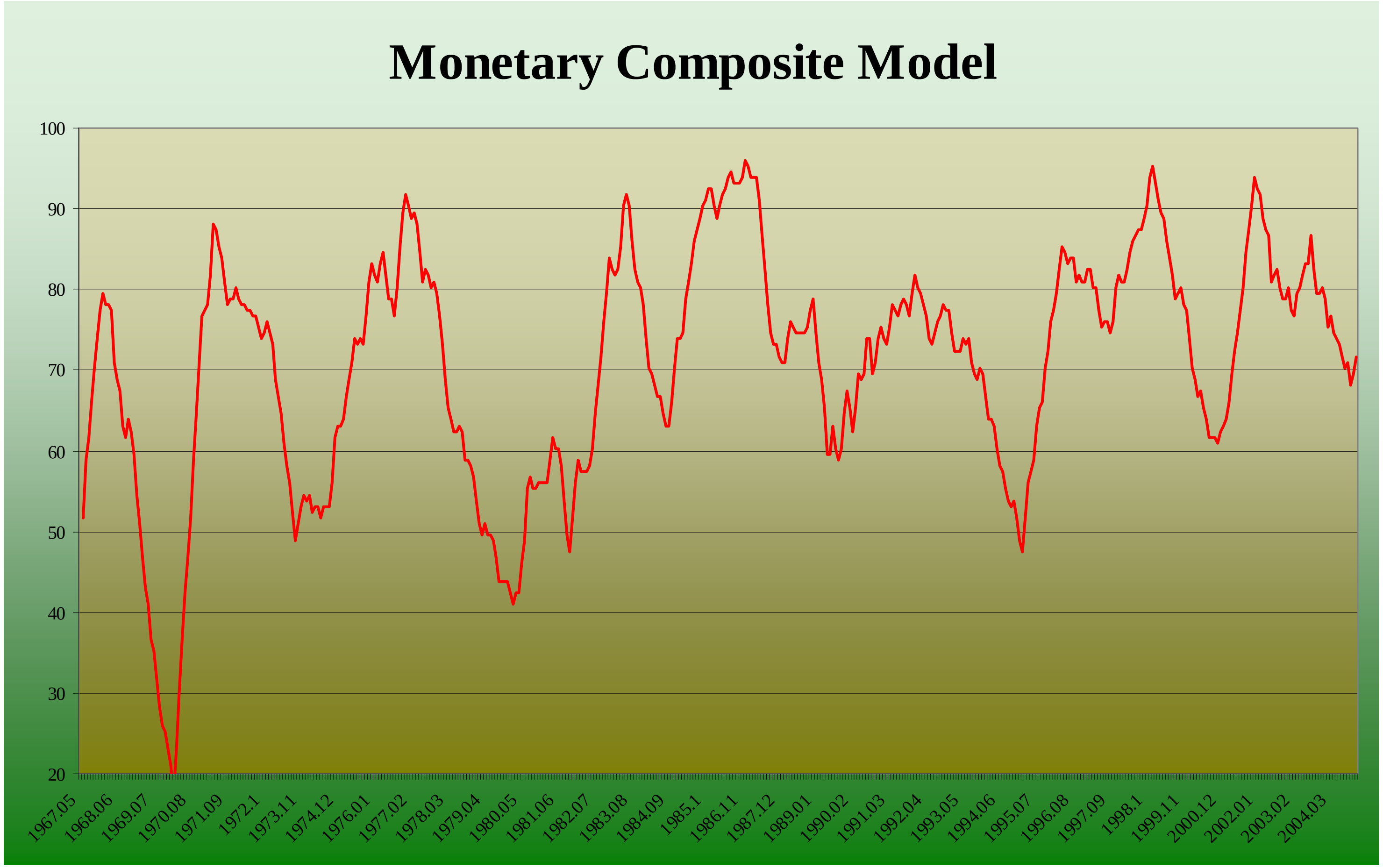
The Fed is working hard to increase these rates, at least in the short term, through raising the Federal funds rate; and, we have been warning investors for quite some time about the impending increases in interest rates.

We anticipate that 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 current goal is to moderate money supply without "killing off" the recovery.

- Money supply had grown significantly in the past 8 ½ years – doubling since March of 1996. During that time, GDP has increased approximately 65%.
- By way of comparison, the money supply last doubled between 1982 and 1996 and was accompanied by a 126% increase in GDP.

Federal Reserve Watch



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

The recent move upwards can be deceiving as it is partially based upon the declining ten year Treasury bond and an ever-flattening yield curve. In our opinion, the growth rate for the monetary supply will be diminished in coming periods.

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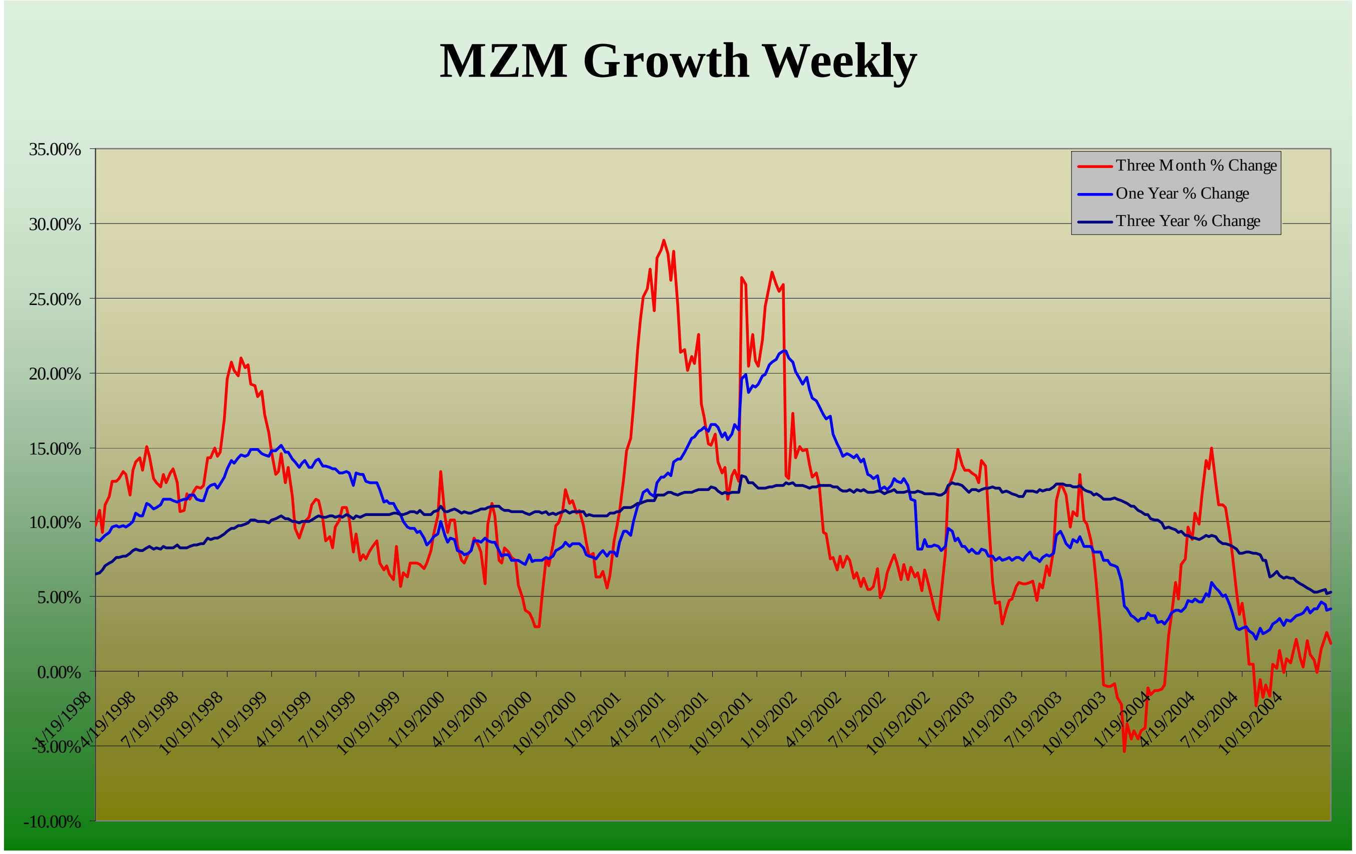
Federal Reserve Watch



The growth rate of money supply will not become negative for a sustained period, but monetary growth over the coming periods will not be the primary means of economic stimulus.

Federal Reserve Watch

As we have documented in previous Chartbooks, 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	Current	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.

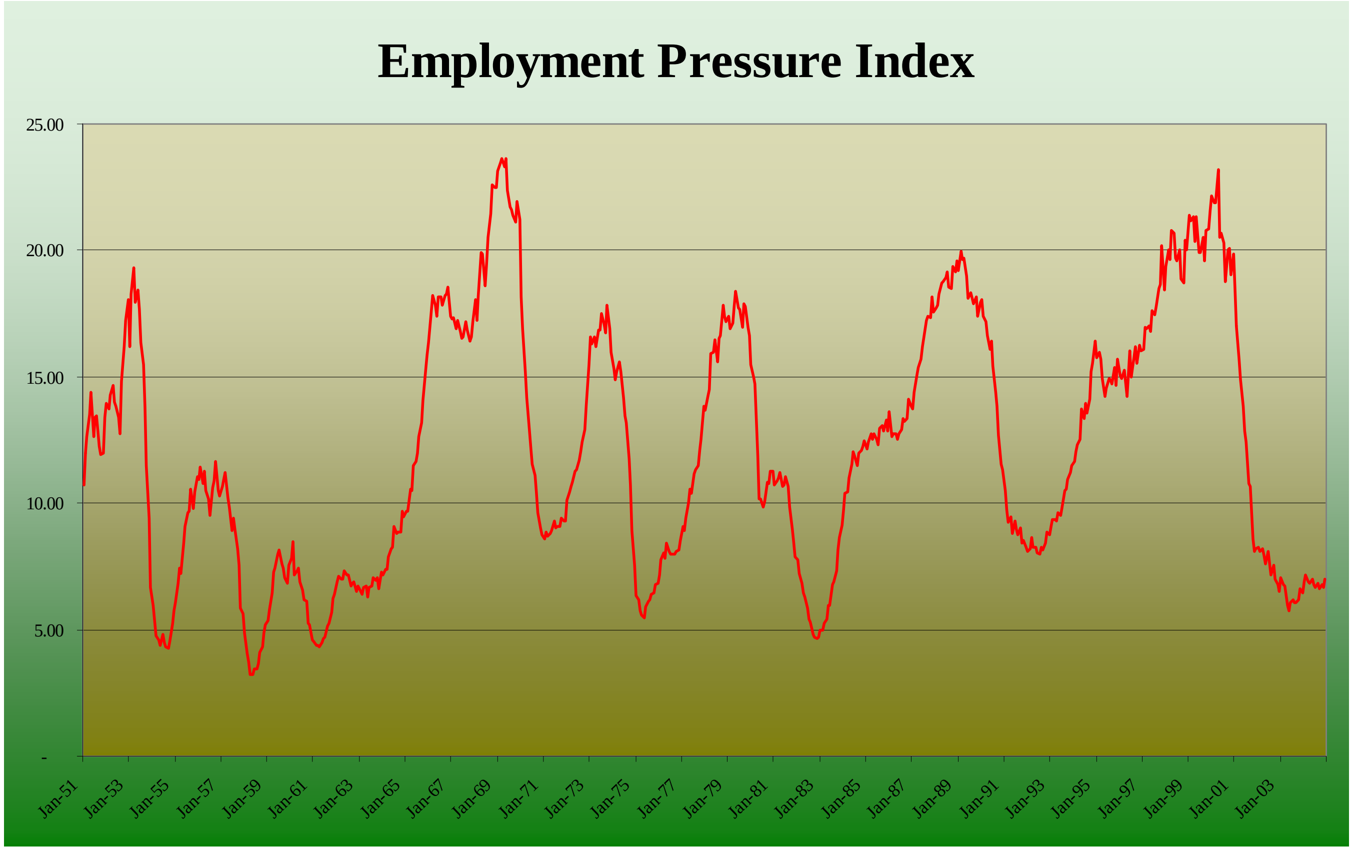
Outlook

Although we feel the marketplace is fairly valued at the present time due to strong earnings and low inflation, we believe there is upside opportunity (just not out-sized).

Growth is present, but it is slowing from the fast pace pulling the United States out of recession.

It is too bad we haven't had the increase in job growth typically associated with this period in the market cycle, but we are holding out hope.

Outlook & Forecast



Although the inputs into this model may be dated due to the advent of internet job searches, we simply do not have enough data to rely on alternate sources of information for our calculations yet. There is a, though, historical lag between employment pressure and the leading economic indicators.

Last month, there was a move upwards in this measure that may allow it to escape the bottom that has been its home for far too long; evidence to back this assertion up is the trend in weekly jobless claims over the past month.

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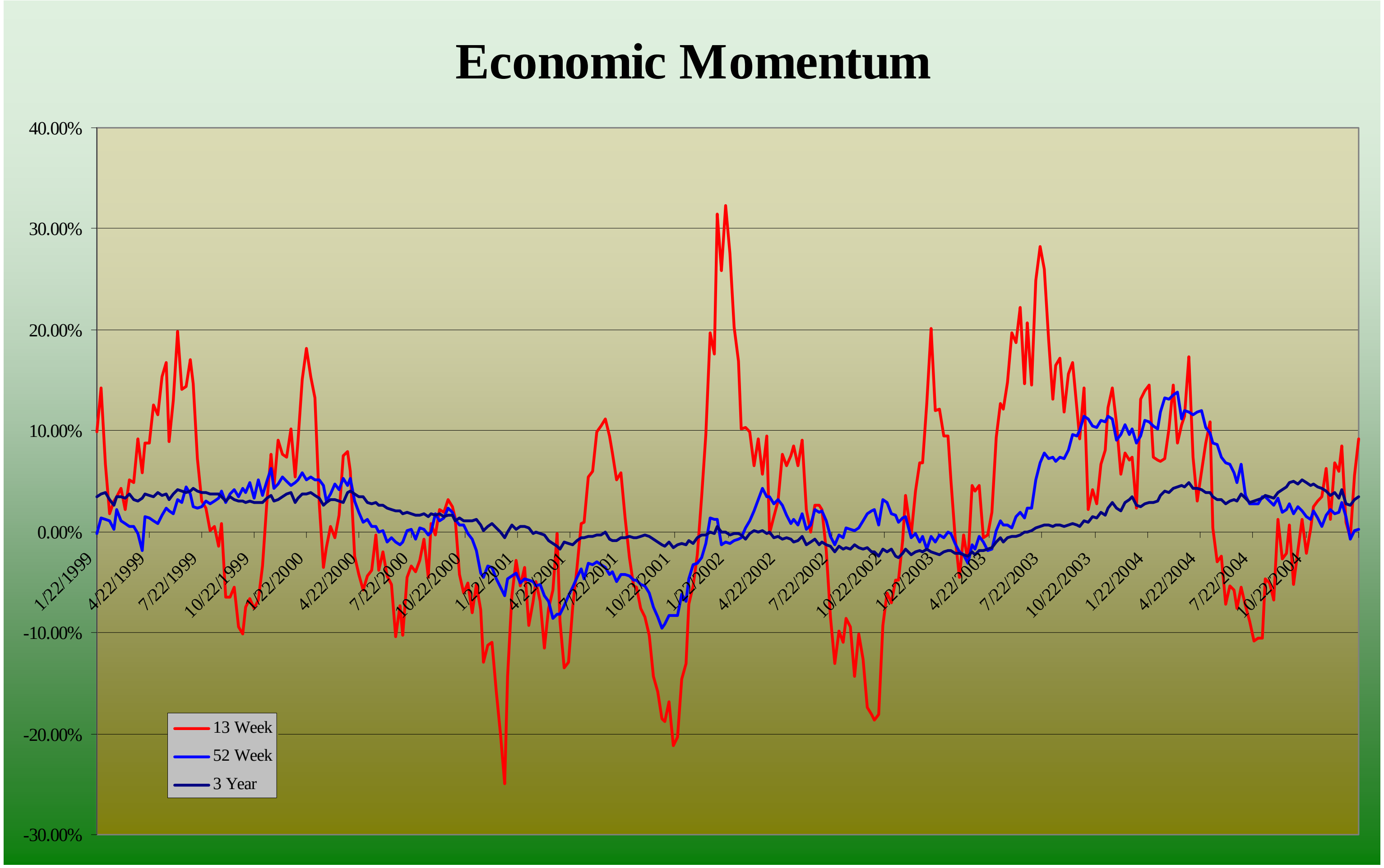
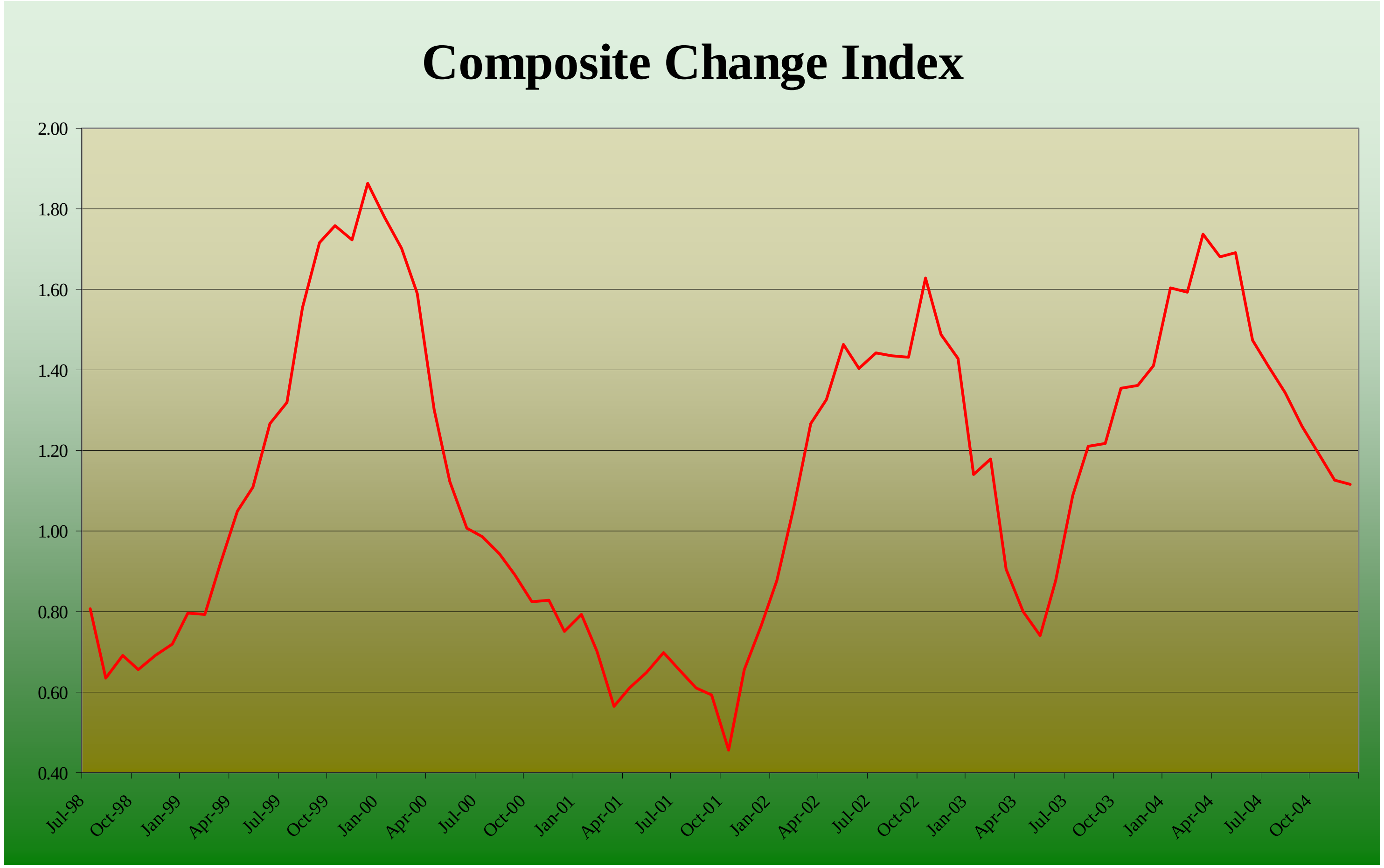


Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).
Economic momentum in the short-term is showing growth, just not at the rates of earlier in the recovery.

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.