Monthly Chartbook

March 2005

CORNERSTONE
Investment Management and Consulting

3/31/2005

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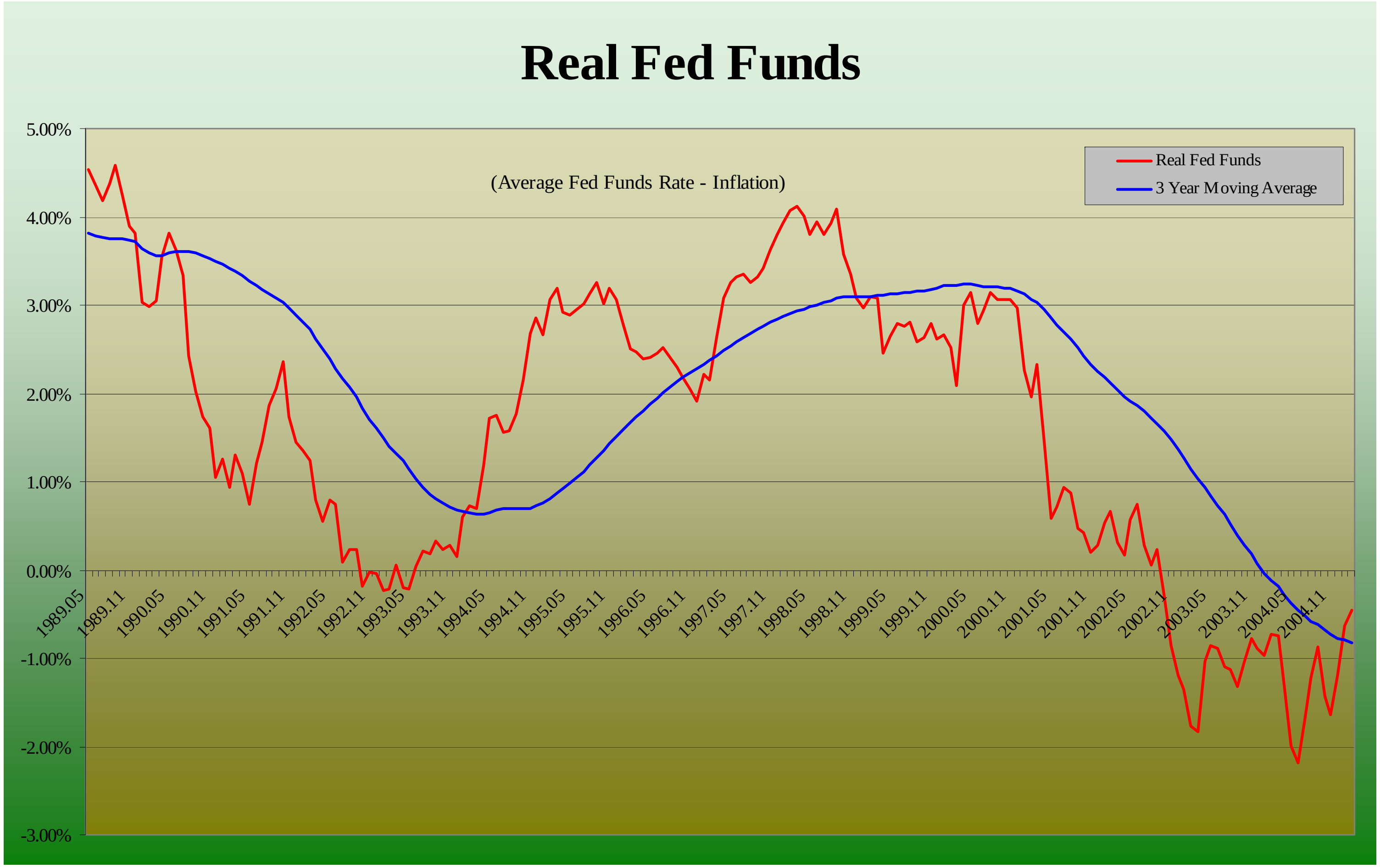
Steady as she goes, or caught in a trap?

Equities look attractive relative to bonds and money market, but there is little evidence of a significant equity risk premium available to buyers.

- Energy prices matter and mask other price increases within the economy.
- Real Fed Funds rate will be critical in coming months.
- Broad market cannot sustain gains if energy retains leadership.
- At current interest rates the stock market is marginally undervalued, as we have stressed in past chartbooks; if rates were trading at a normal spread to inflation, stocks would be overvalued.

Macro-economic Research



The stimulus of Real Fed Funds being negative is quickly dissipating. Just how quickly rates move higher once "neutral" will be key to how the next leg of the recovery unfolds.

U.S. sector stock funds 1Q performance	
Natural Resources	8.8%
Utilities	0.6%
Health/Biotechnology	-6.6%
Telecommunications	-8.7%
Science & Technology	-10.5%

DATA: LIPPER (AS OF 3/29)

Source: cbs.marketwatch.com

Technology has been negatively correlated to Oil and the CRB over this cycle.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	**1180.59**	**Trading range**	↔	**1140-1290**	**Next 6 months**
Ten Year Treasury	**4.496%**	**4.65%**	↓	**4.5%-5.50%**	**6 months**
Inflation (all Urban)	**2.95%**	**3.15%**	↔	**2.75%-3.375%**	**6 months**
Fed Funds	**2.75%**	**2.75 – 3.25%**	↑	**3.00 – 3.50%**	**3 months**
S&P 500 Earnings	**$61.19**	**$63.15**	↑	**$62 - $65**	**June 2005**
	Legend:	↑ "Good"	↓"Bad"	↔"Indifferent"	

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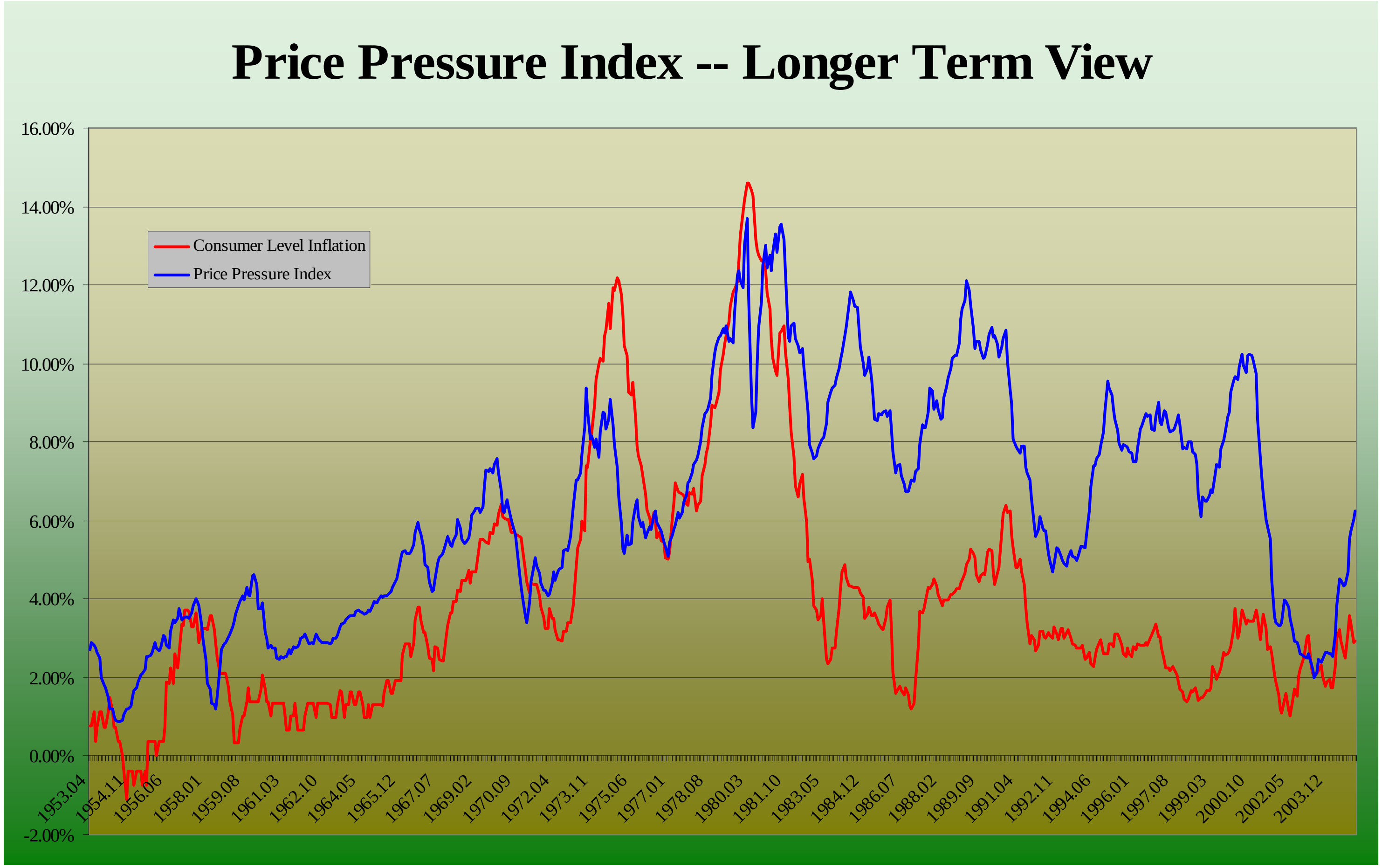
Inflation expectations

The moderate cyclical upturn in inflation has something for both the bulls and bears to cheer.

While energy and a weak dollar have contributed to this trend, it's the relative weakness of the US Labor recovery that has kept a lid on inflation and rates.

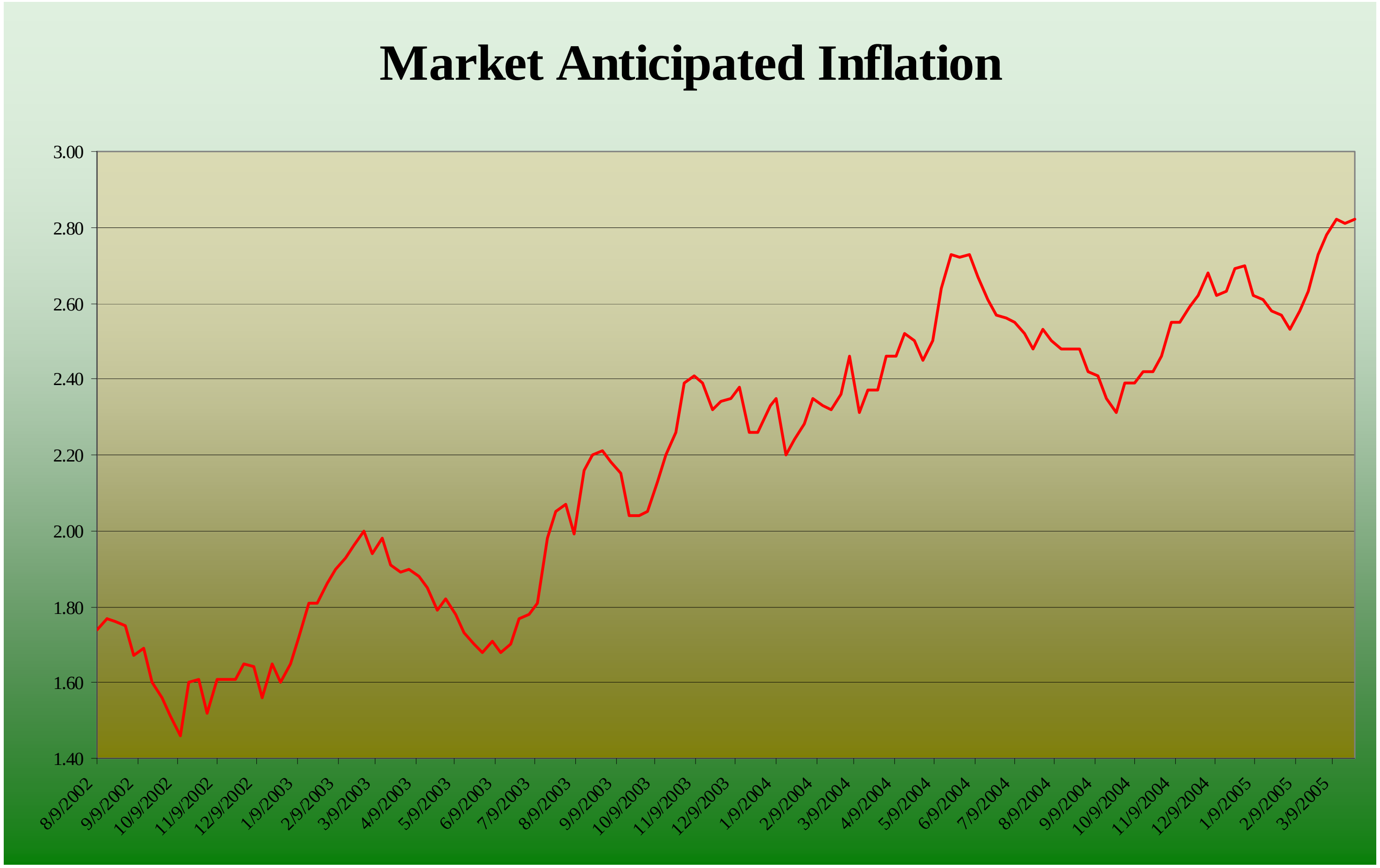
We continue to believe that inflation remains a risk, and it is important that future inflation remain within expectations. The price pressure index is exhibiting a sharp, cyclical rise in pricing power which can be bullish for stocks but is often bearish for bonds.

Inflation expectations



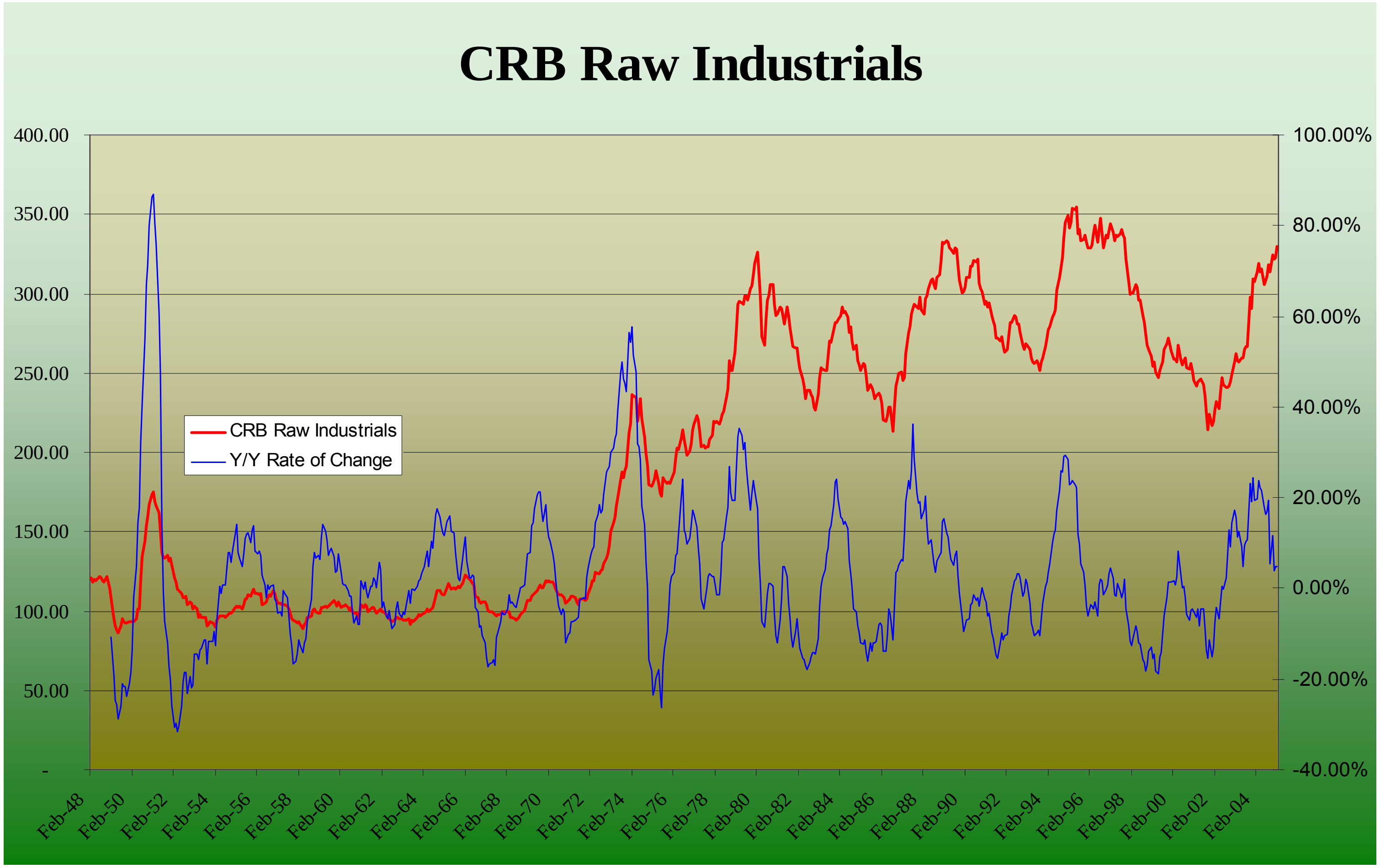
Price pressure index continues to exhibit a strong, cyclical upturn. Based on this measure, higher levels of inflation remain a risk and we are avoiding long dated bonds.

Inflation expectations



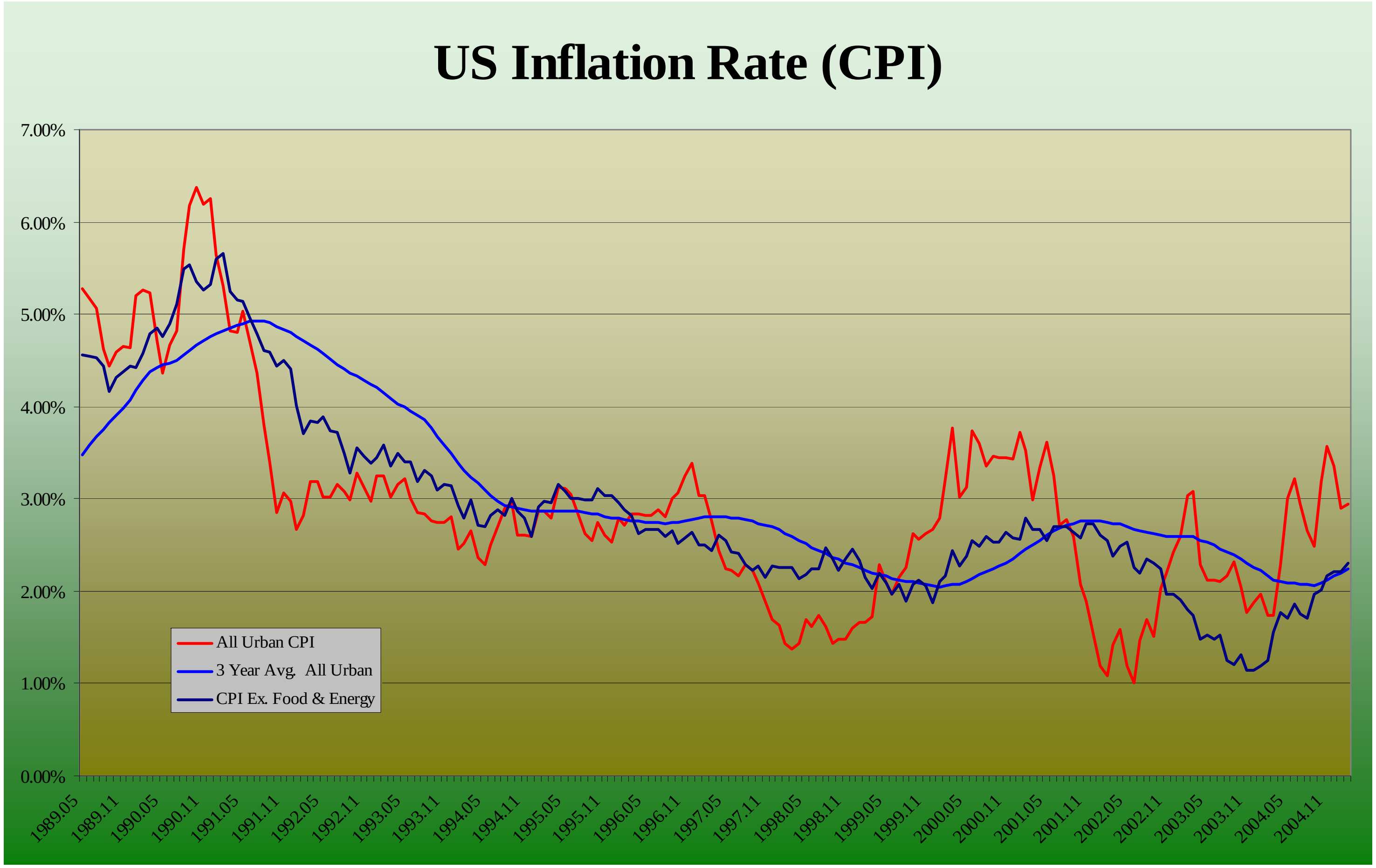
Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting higher but moderating inflation, with an implicit forecast of 2.8%. In our opinion, stable and expected inflation levels are as important as the aggregate level.

Inflation expectations



The Y/Y percentage increase in commodity prices continues to moderate, but the trend level remains higher. The sustained rise in industrial 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. As you can see the All Urban rate of inflation leads the core rate, not the reverse. Food & Energy prices matter.

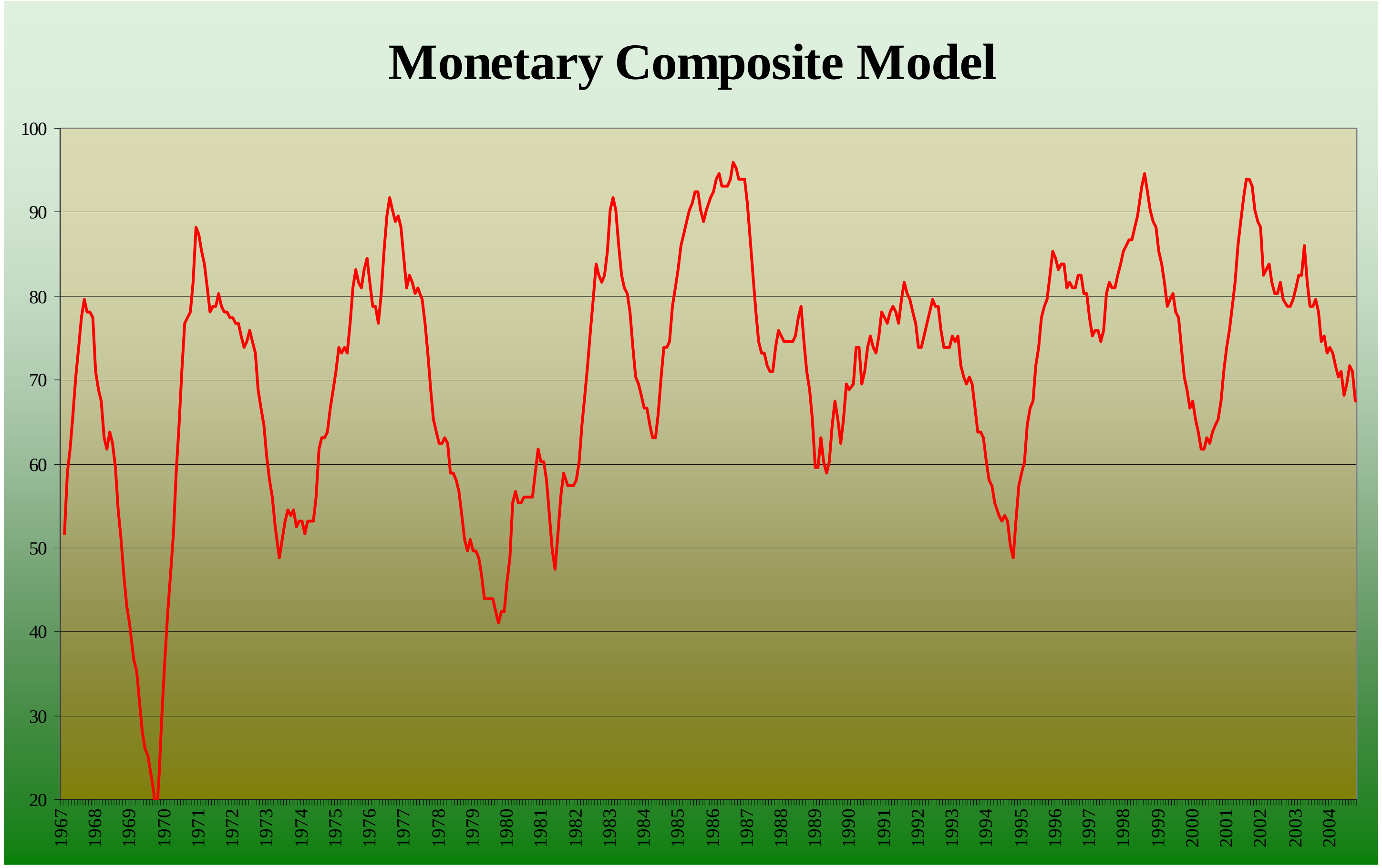
Federal Reserve Watch

The Fed has gotten what they have tried to engineer -- a recovery in pricing power. Real Fed Funds has been negative for 29 months, the second longest period of time we have recorded.

The most telling thing in the coming months will be how aggressively the Fed moves the Fed Funds rate higher once Real Fed Funds are no longer negative. For the last couple of months the Fed has be watering down the punch bowl, future moves of ¼ point or a meeting with no rate move will indicate that they are not taking the punch bowl away.

If the Fed moved Fed Funds ½ a point at the next meeting, look out below.

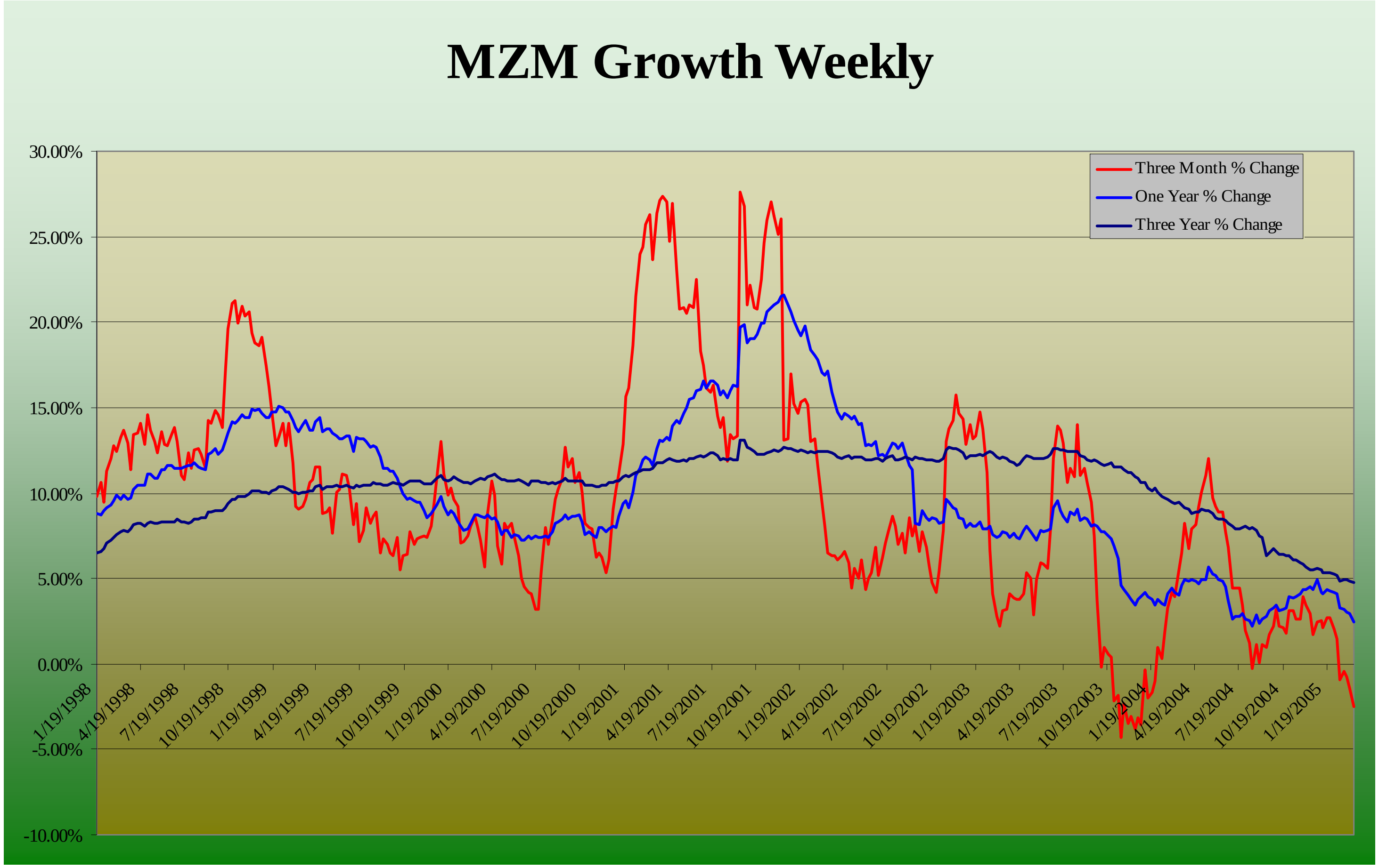
Federal Reserve Watch



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

While monetary conditions are by no means tight, they are relative to the accommodative stance since 9/11. What would normally be neutral conditions feels like traveling at 55mph after screaming down the interstate at 80.

Federal Reserve Watch



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

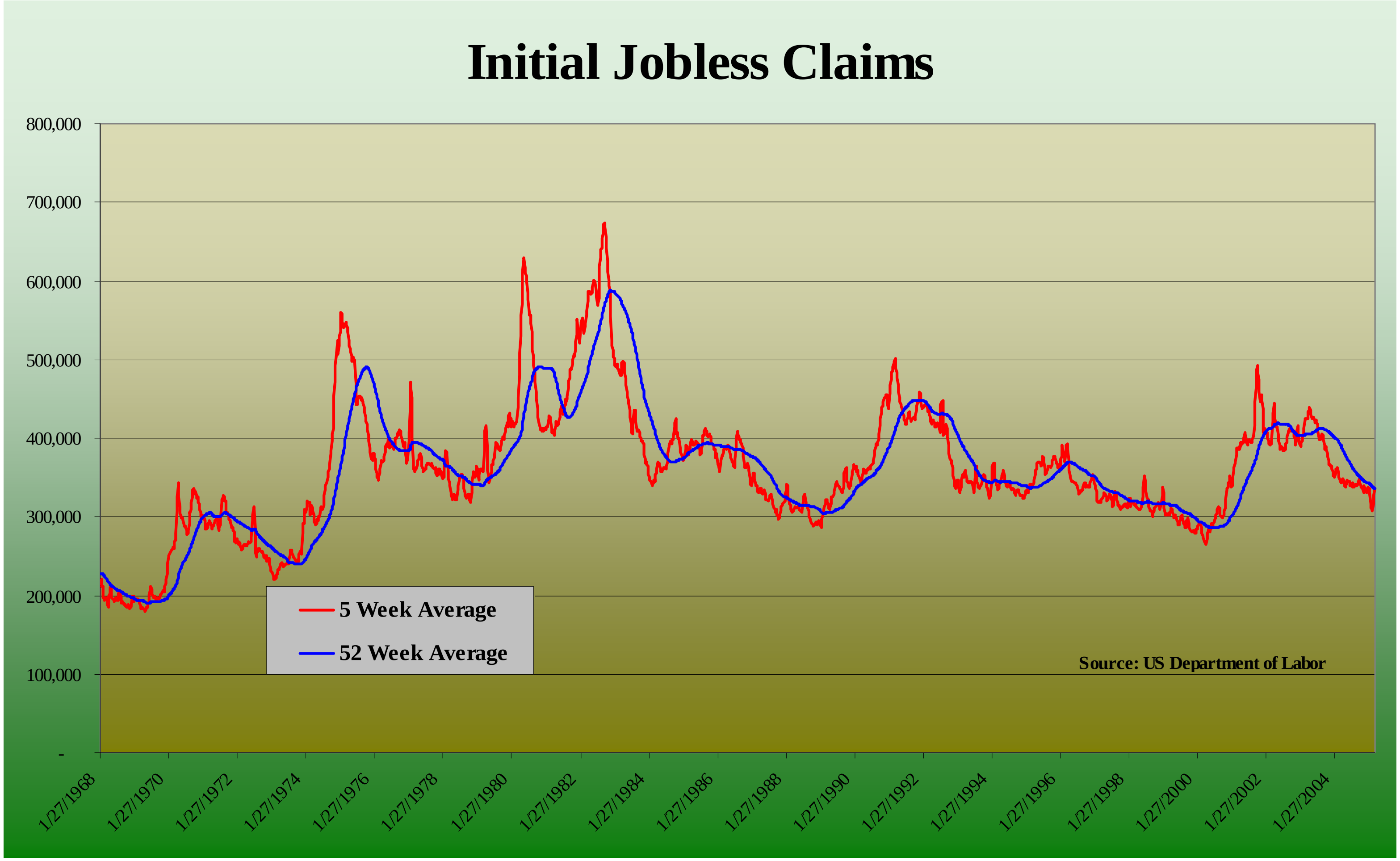
Higher rates are starting to take hold, and excess liquidity is waning.

Outlook

Slowing growth in conjunction with moderate levels of inflation and improving labor markets should sustain the recovery. In past periods when earnings growth moderated, the equity markets did quite well.

While many risks are present, we believe that sustained recovery will support moderate appreciation in the equity markets.

Outlook & Forecast



The slow but steady improvement in labor conditions has masked the typically inflationary pressure of this factor.

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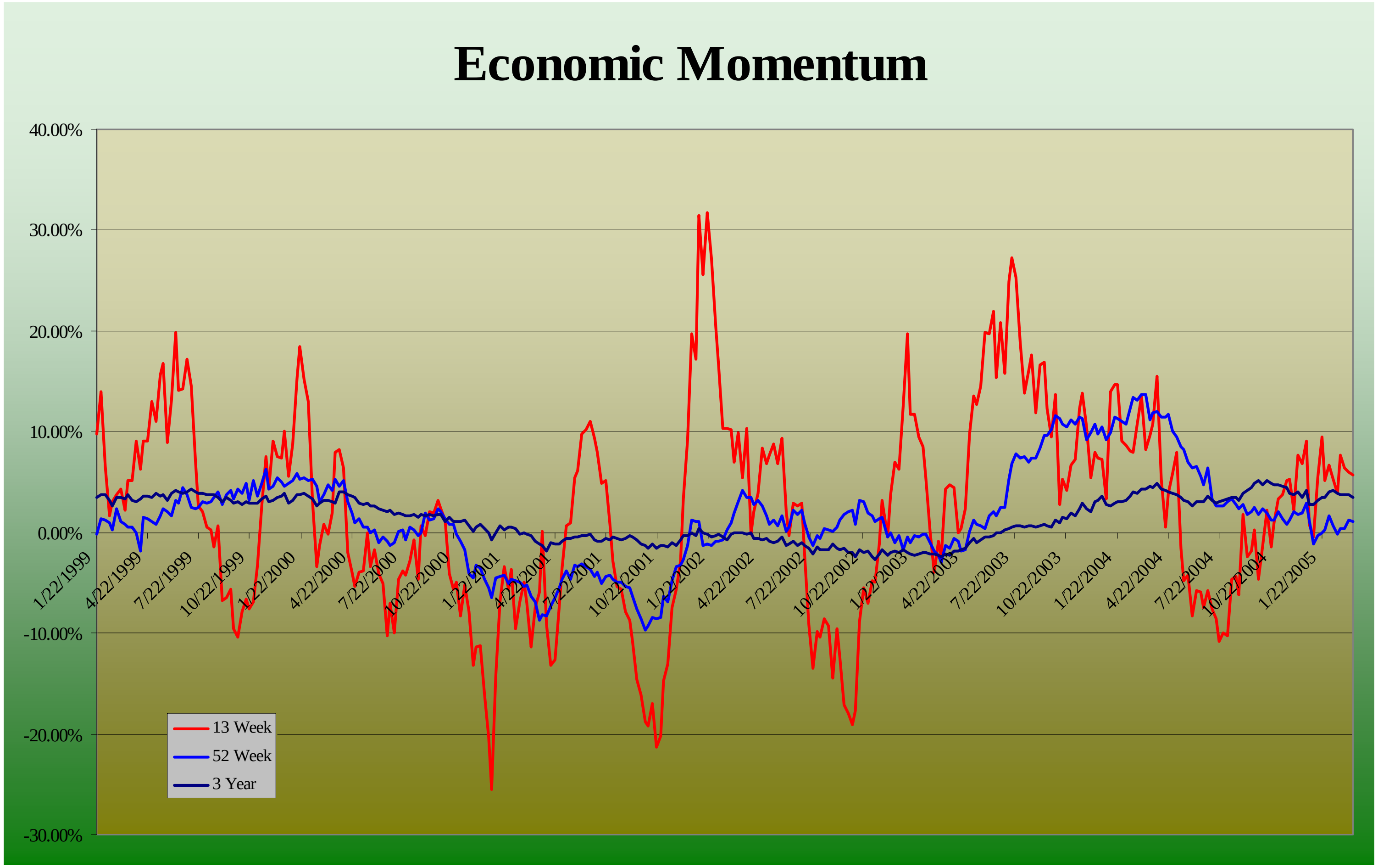
Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com). Moderate growth remains the status quo.