Monthly Chartbook

October 2004

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Investment Management and Consulting

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Executive Summary

Goldilocks is smiling… *Not too hot, not too cool.*

The economy, its performance, and persistent "joblessness" have been points of friction in this election campaign. We are now less than 36 hours from the polls opening as we write.

Broad economic activity is satisfactory as an investment environment. Growth continues, pricing power has returned in some sectors and nominal interest rates are low versus history. In terms of the joblessness, we attribute as much to average productivity growth as we do to China and outsourcing. We have some great items posted to our blog which you can find by clicking the highlighted text.

Next month's Chartbook will be full of ex post facto analysis of the election results, assuming the election is over and a victor has been named.

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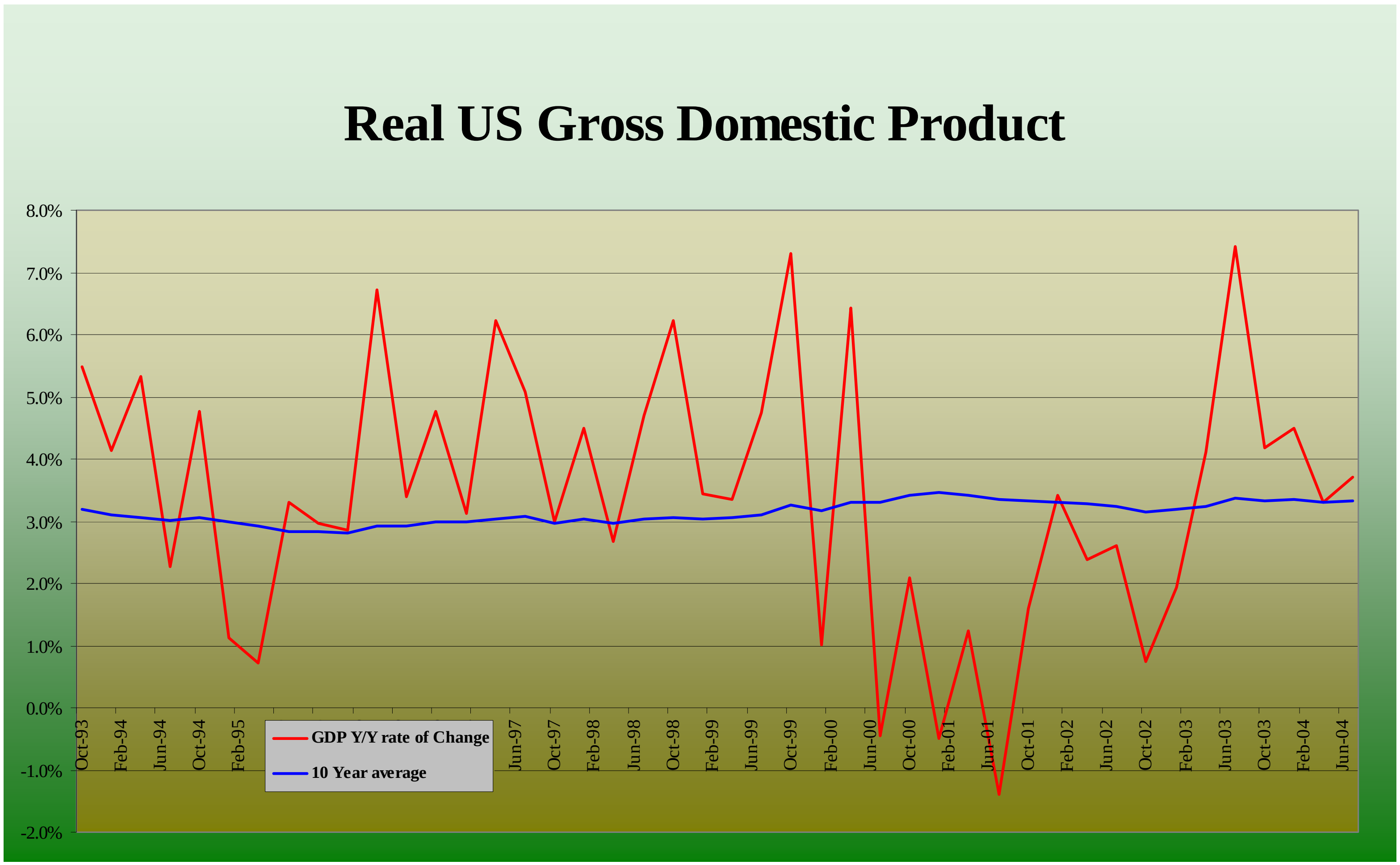

Advance third quarter GDP, though weaker than forecast, is still above trendline.

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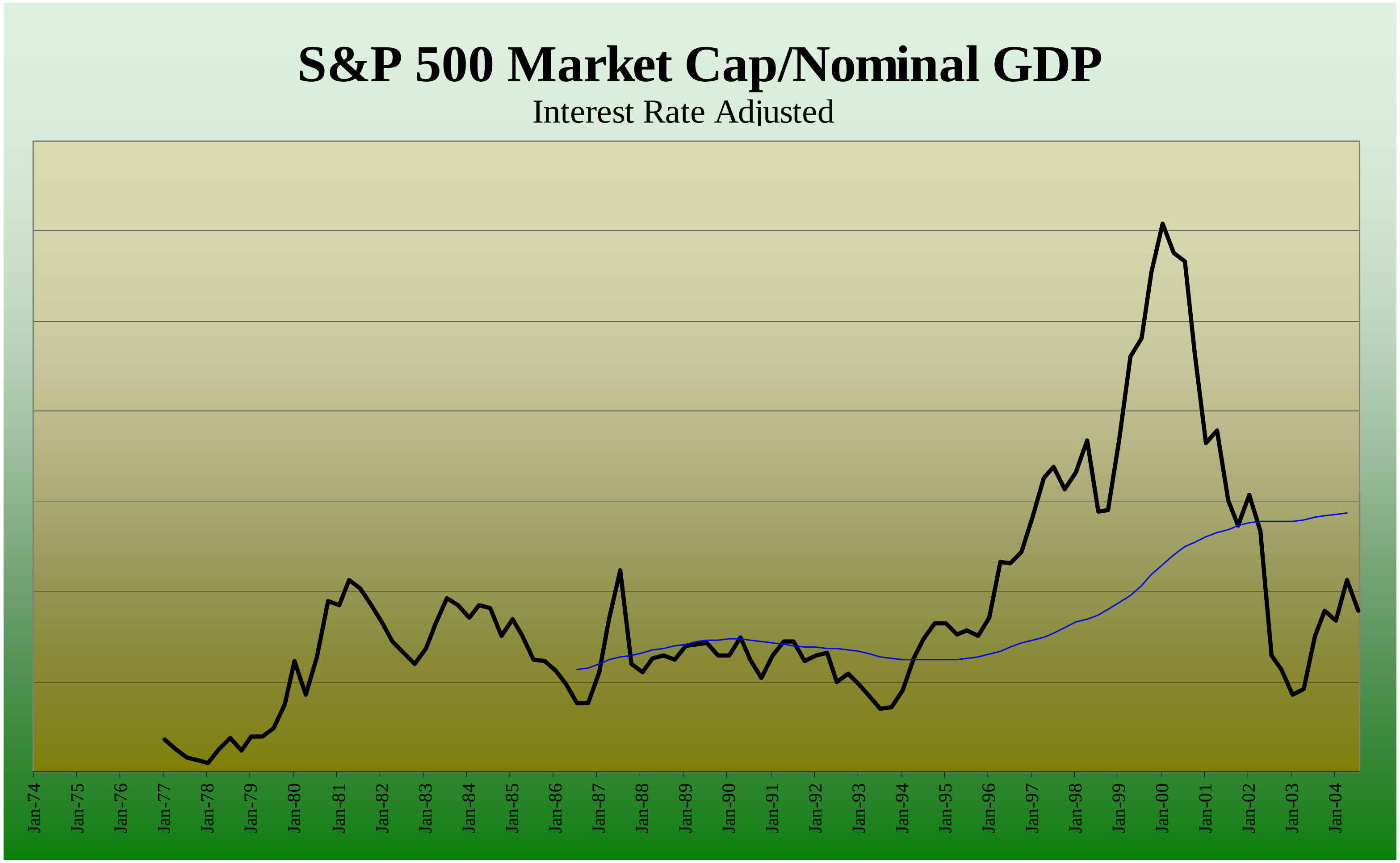
Macro-economic Research



Valuations are well below the peaks of past bubbles and within a normal range versus the last two business cycles.

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Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	**1114.58**	**Trading range**	↑	**980-1180**	**End of 2004**
Ten Year Treasury	**4.12%**	**4.65%**	↔	**4.35%-4.875%**	**9 months**
Inflation (all Urban)	**2.66%**	**2.75%**	↔	**2.50%-3.10%**	**6 months**
Fed Funds	**1.75%**	**1.50%-2.00%**	↑	**1.25%-2.25%**	**6-9 months**
S&P 500 Earnings	**$55.16**	**$58.50**	↑	**$55-59**	**4q2004**
	Legend:	↑ "Good"	↓"Bad"	↔"Indifferent"	

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Inflation expectations

The still-rising core rate of inflation gave the market some concern when reported. Our experience is that when energy prices are on the rise, the core rate follows the board rate of inflation higher with a lag.

Although there is headline risk in the coming months from the rise in energy prices, they have not spiked due to supply shocks but are driven by demand. In broad measures of inflation, the upward momentum is abating.

Still, if above trendline inflation persists to the point that the Fed becomes concerned, we have a problem. Tight money at this point of the cycle will tip us into recession and knock the P/E on the market down. Not a prediction, just something worthy of monitoring.

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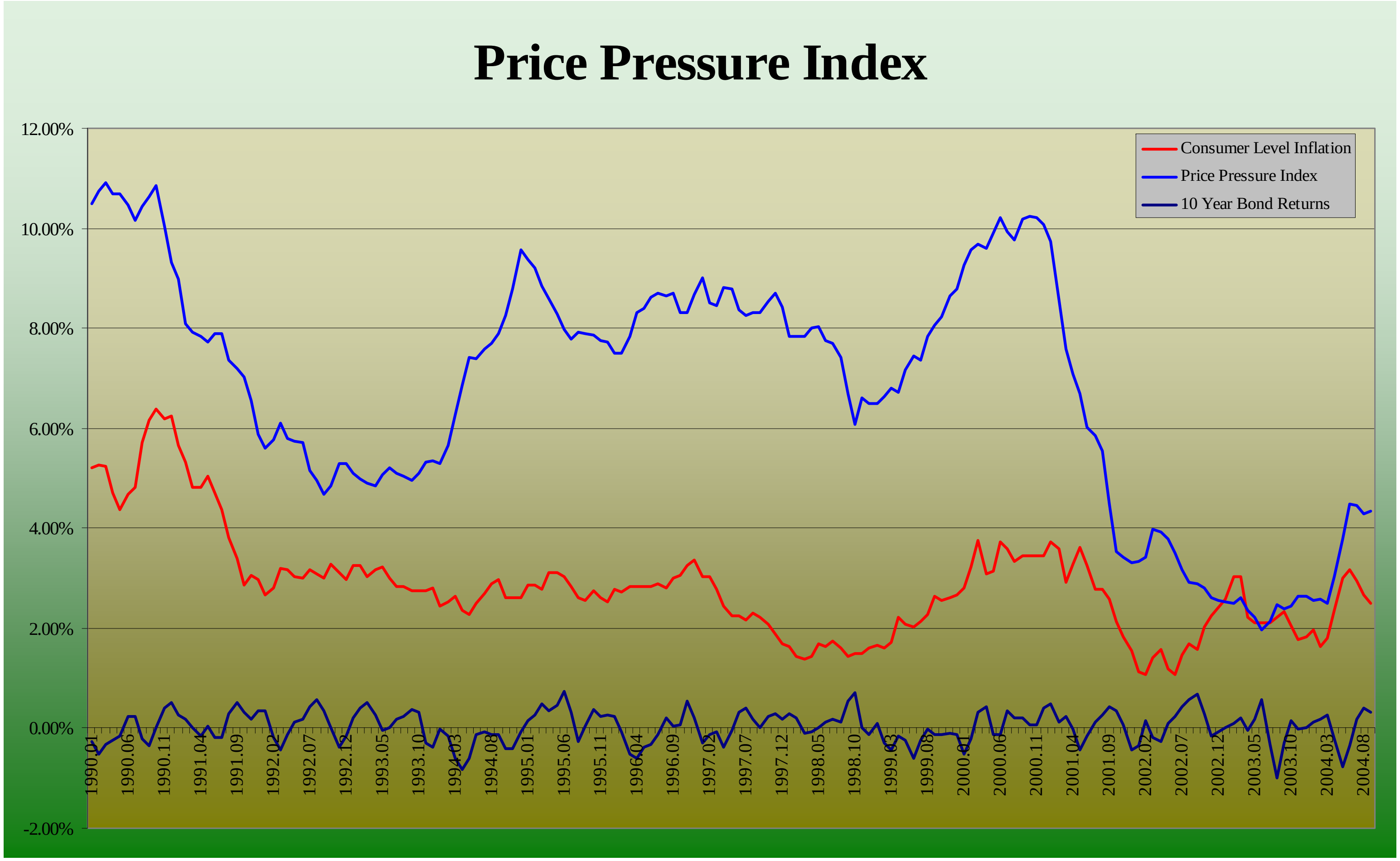
Inflation expectations



Price Pressure Index has moderated significantly over the past three months. As oil has moved higher, broad economic activity has seen a loss of momentum..

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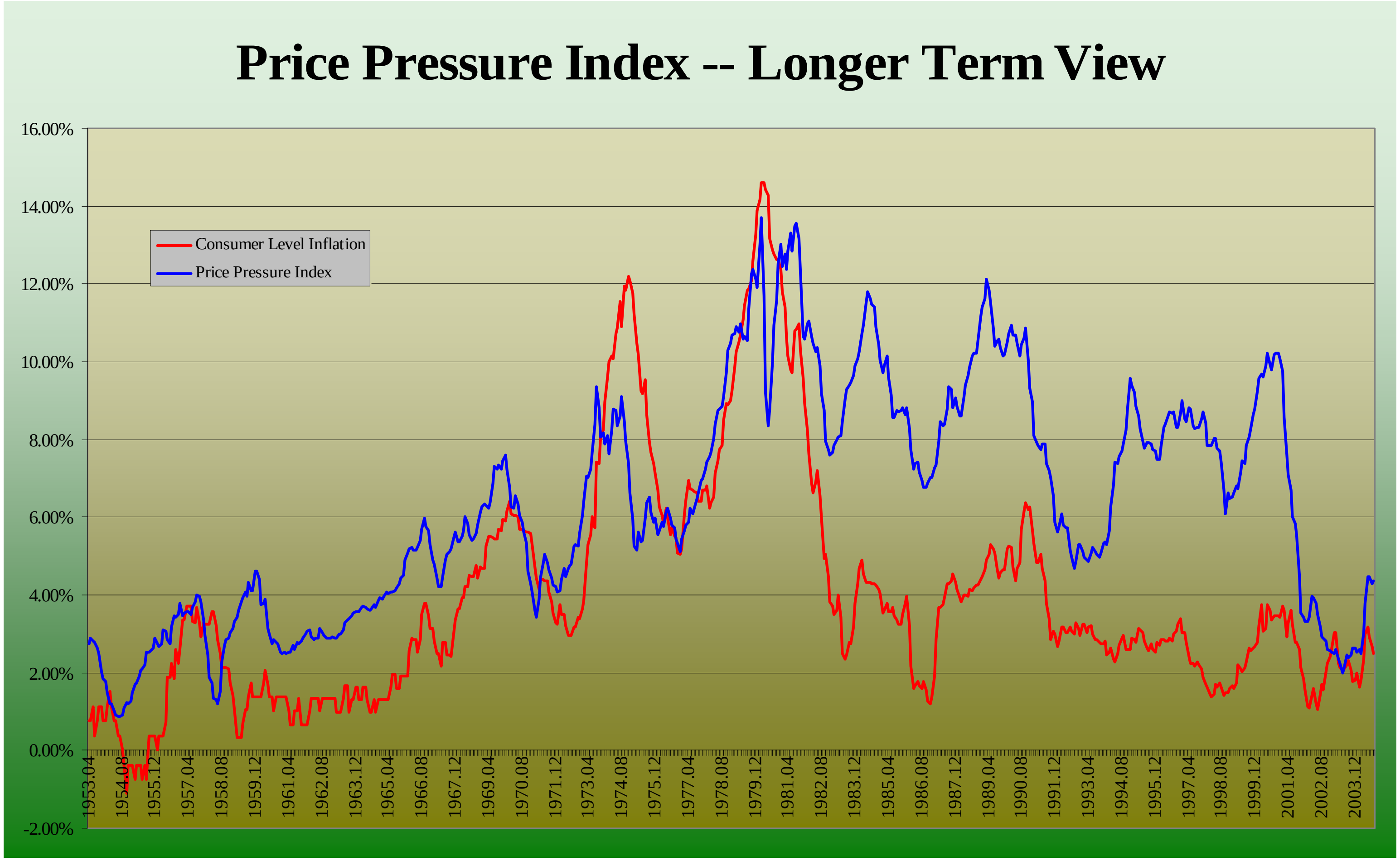
Inflation expectations



Inflation and inflationary pressures remain low relative to past business cycles.

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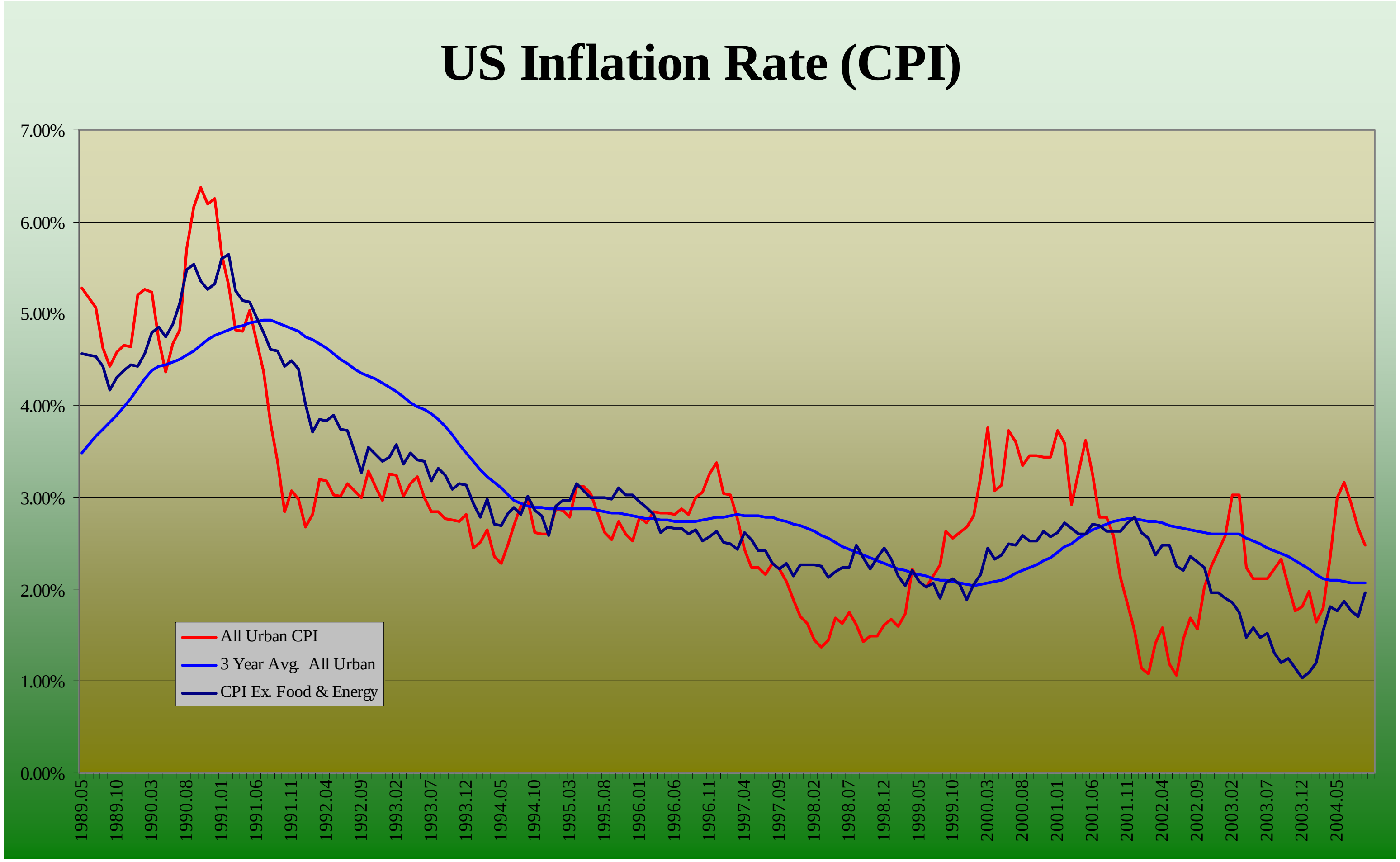
Inflation Expectations



All urban CPI moderating, core rate still climbing.

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Federal Reserve Watch

Weakness in the economy will not hold the Fed back from continuing to move Fed Funds and, hence, Real Fed Funds into a more "normal" range.

Indeed, weakness to them is not the risk; as oil has risen, the yield curve has tightened.

We still look for higher short rates with the Fed continuing to move at a measured pace. One item of concern will be the uncertainty surrounding Dr. Greenspan should John Kerry be declared President.

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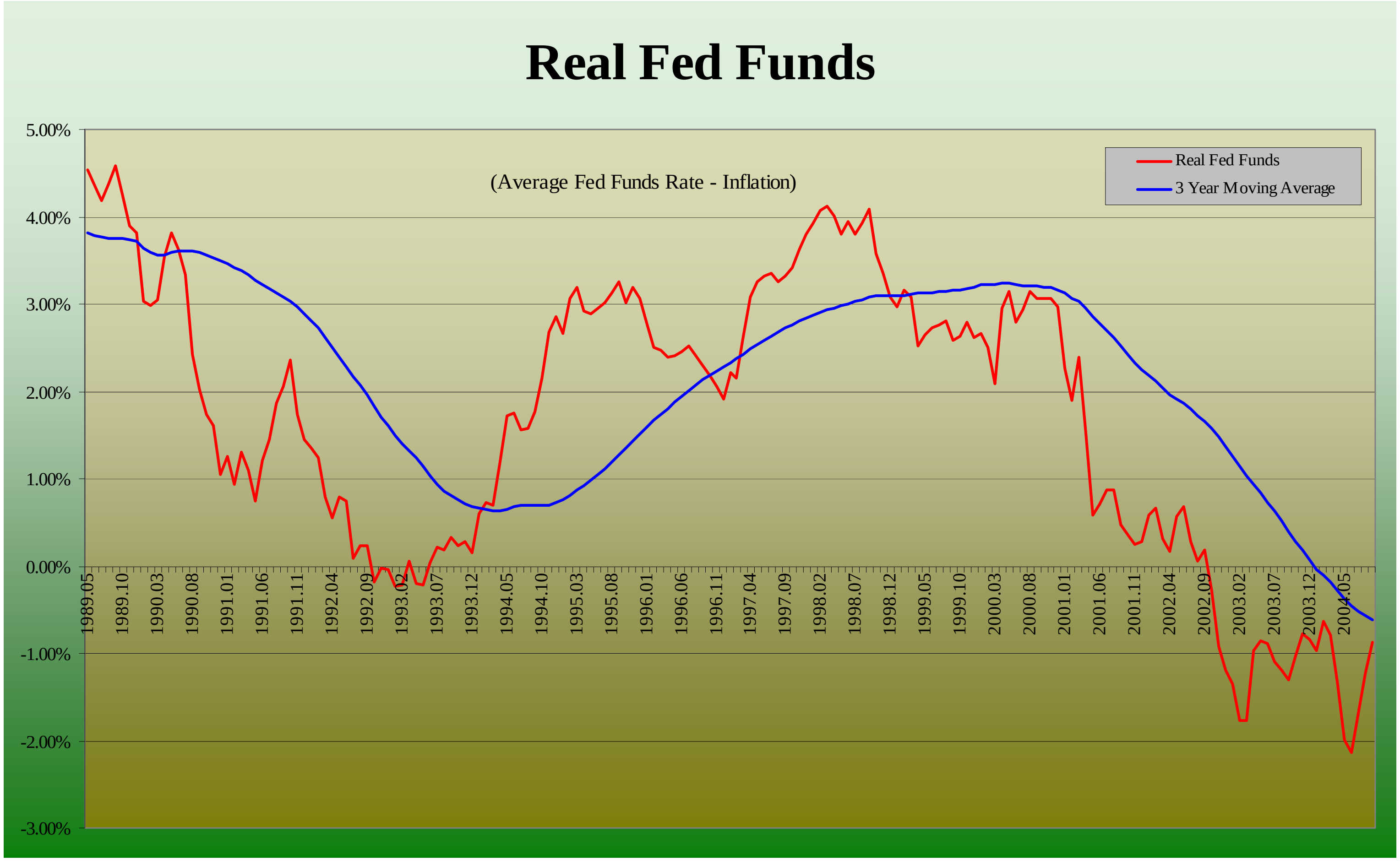
Federal Reserve Watch



The carry trade is alive and well with real rates still negative. We see real rates moving higher, pushed by the Fed. Interest rate sensitive companies addicted to low real rates will have problems on the back end of this cycle.

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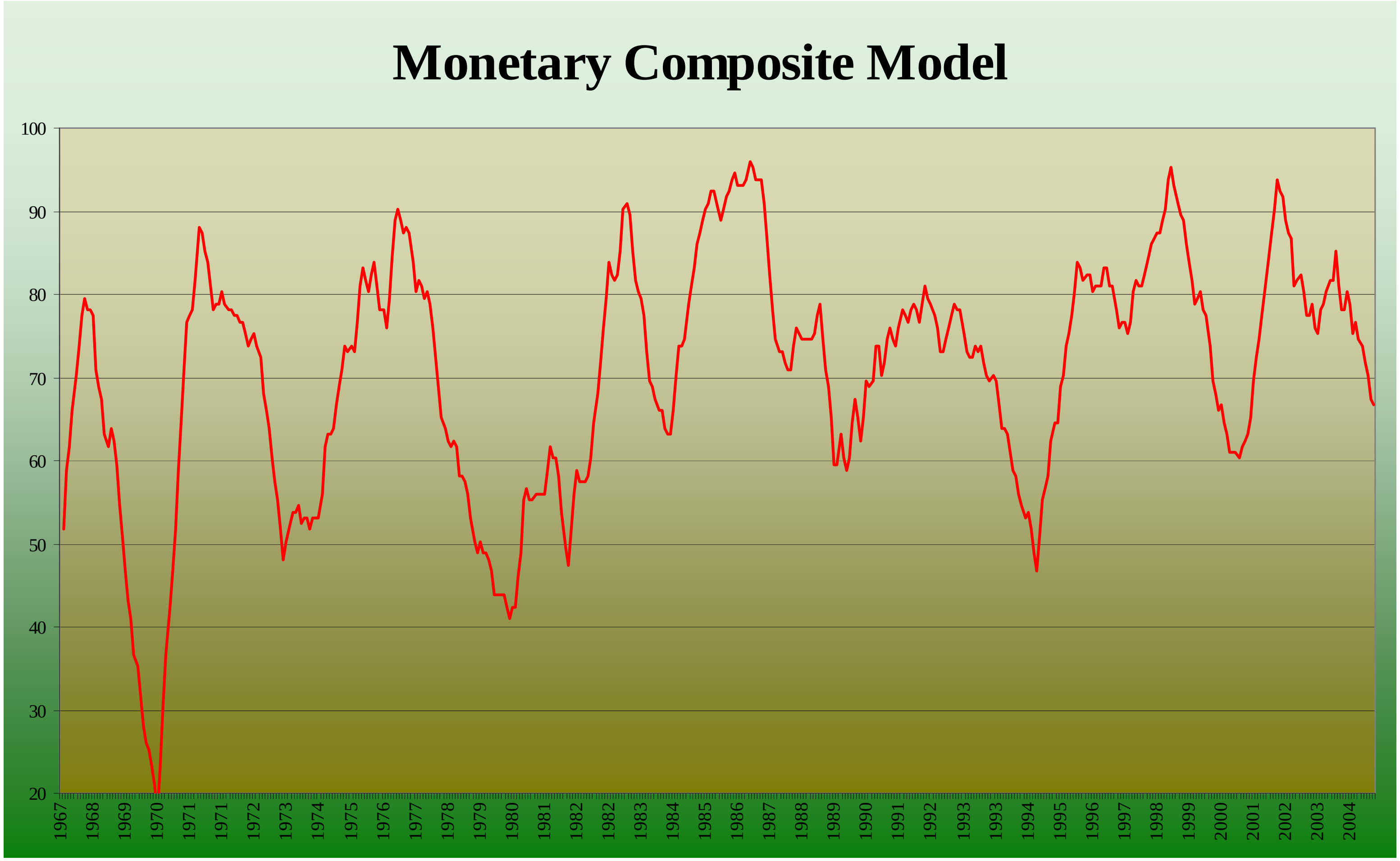
Federal Reserve Watch



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. To be succinct, monetary policy is a headwind for the markets and will be for the foreseeable future.

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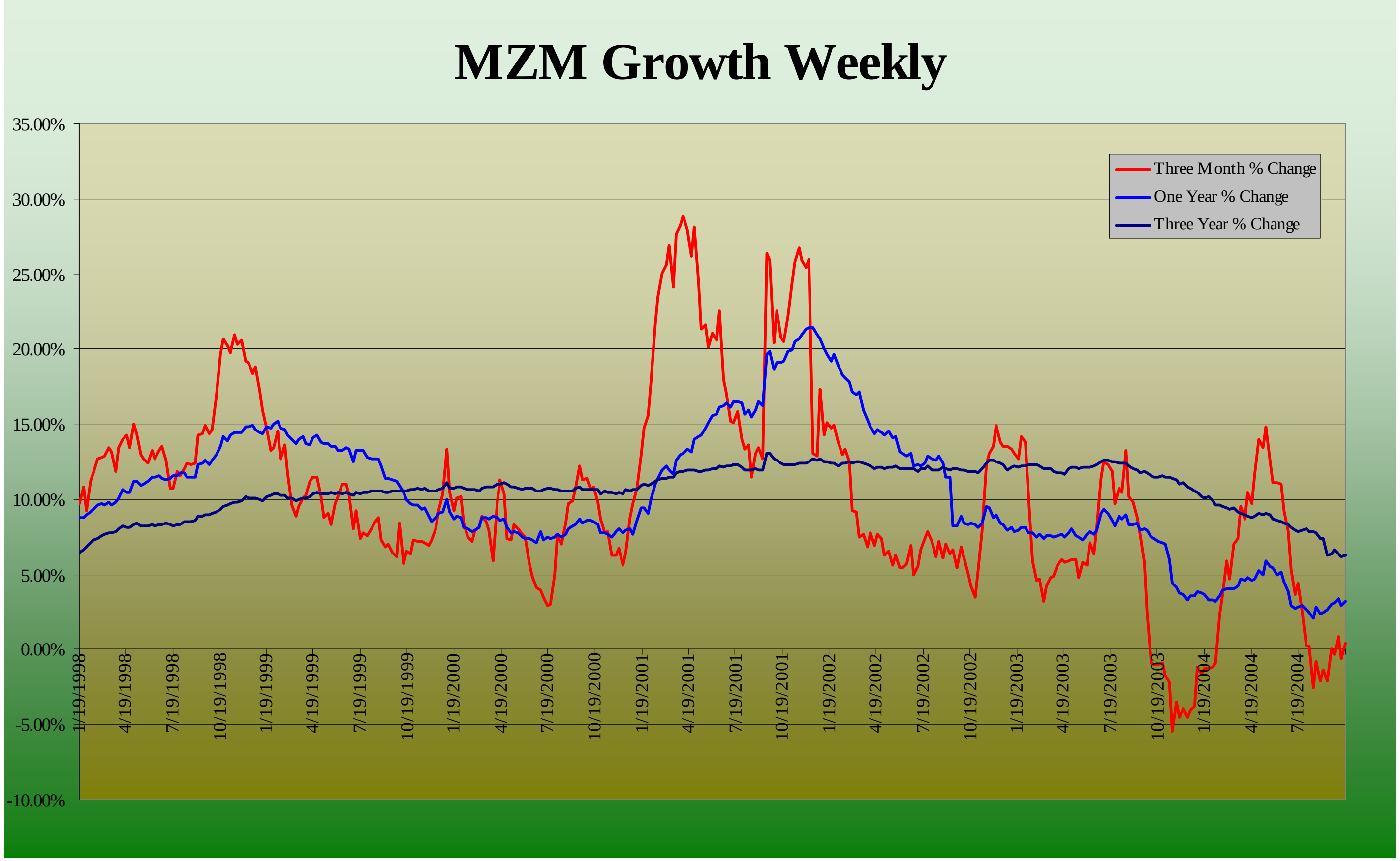
Federal Reserve Watch



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 over the past few weeks but is still very weak.

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Outlook & Forecast

Cautiously Optimistic

As long as the momentum in this earnings cycle has peaked and not absolute growth, we are in good shape. Our expectations for capital market returns over the next 3-5 years are modest. Seeking higher returns with marginal risks is not likely to be a successful strategy in this environment.

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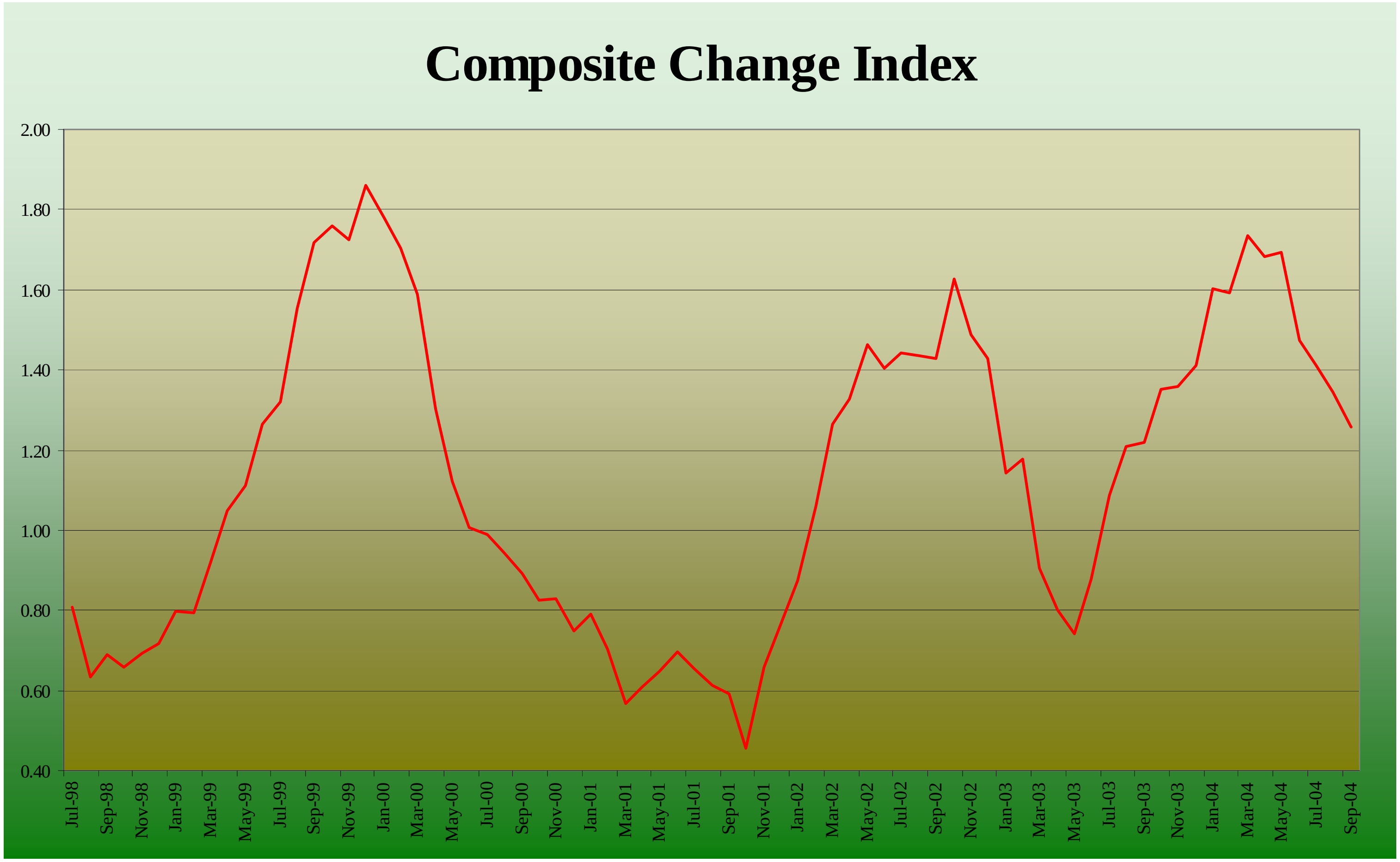
Outlook & Forecast



The composite change tends to lead earnings, and values over 1.00 are considered bullish. Growth for the cycle may have peaked but positive growth continues.

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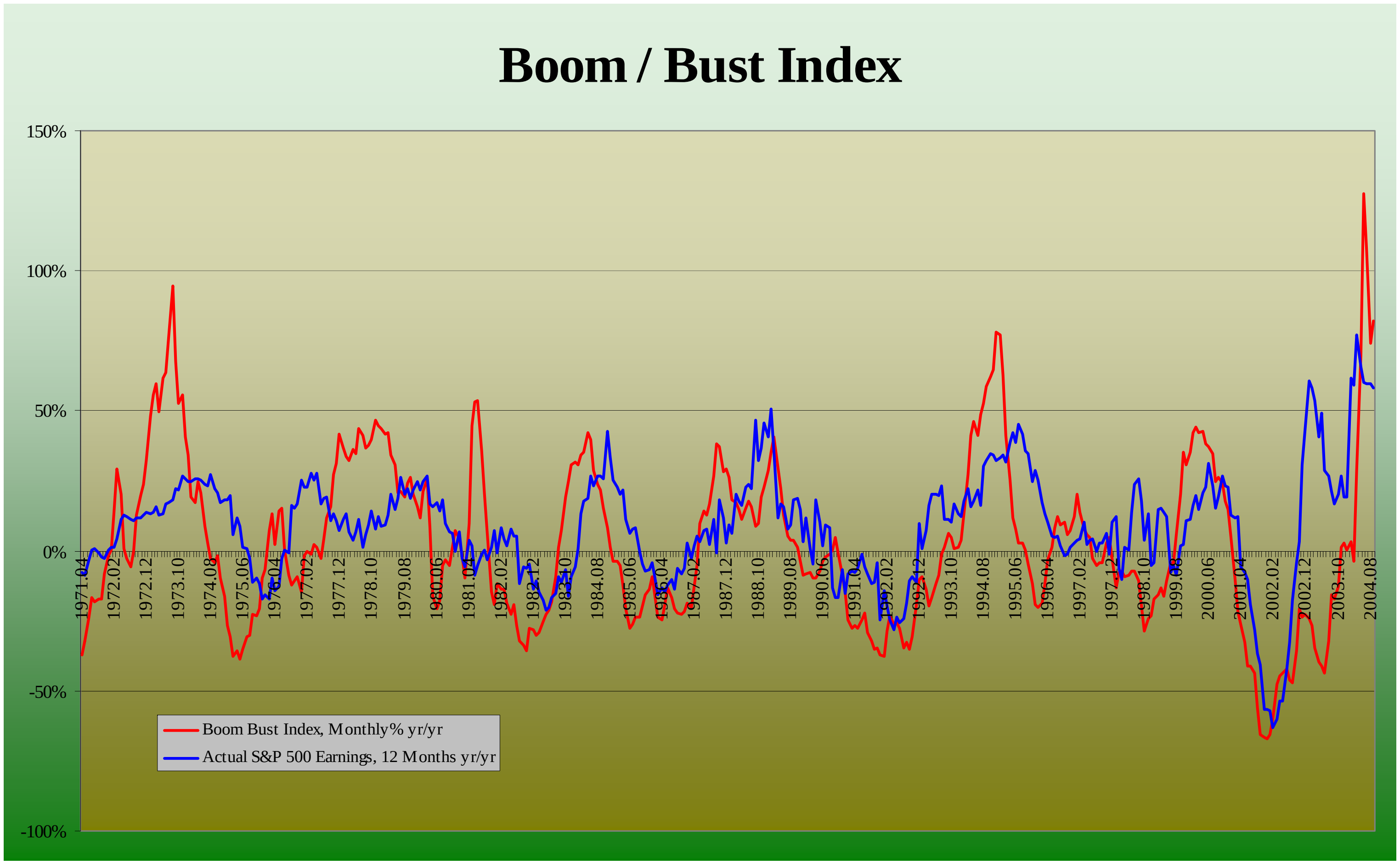
Outlook & Forecast



The Boom/Bust Index tracks key variables within the economy that correlate with earnings. The red line is predicted S&P 500 earnings direction, indicating positive movement continuing. The return of some pricing power has the boom/bust index at almost ridiculous levels.

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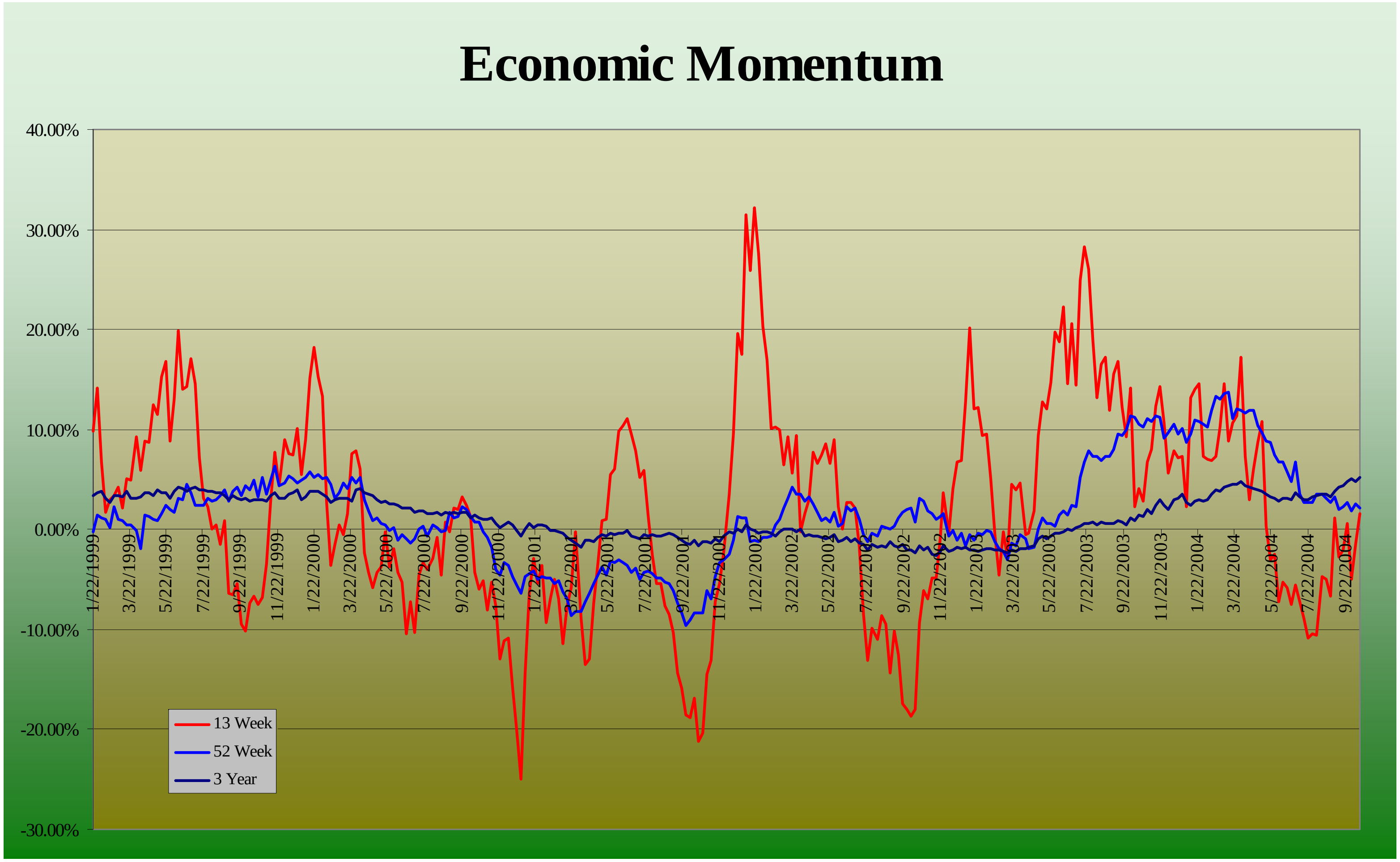

Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).

The trend in the 52 week rate of change is still above long run averages, indicating to us that moderate growth continues which is a bullish environment for stocks and bonds.

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Final Thought

Unless the absolute level of earnings is poised to fall, broad valuation measures are attractive.

Our expectations are modest, but above levels that can be achieved in risk-free asset classes.

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