Monthly Chartbook

September 2004

Table of contents

Executive Summary

Watching and waiting…

As we write, there are just 33 days that remain until the Presidential Election. Economic policy and investment thesis depend heavily on the outcome of the election.

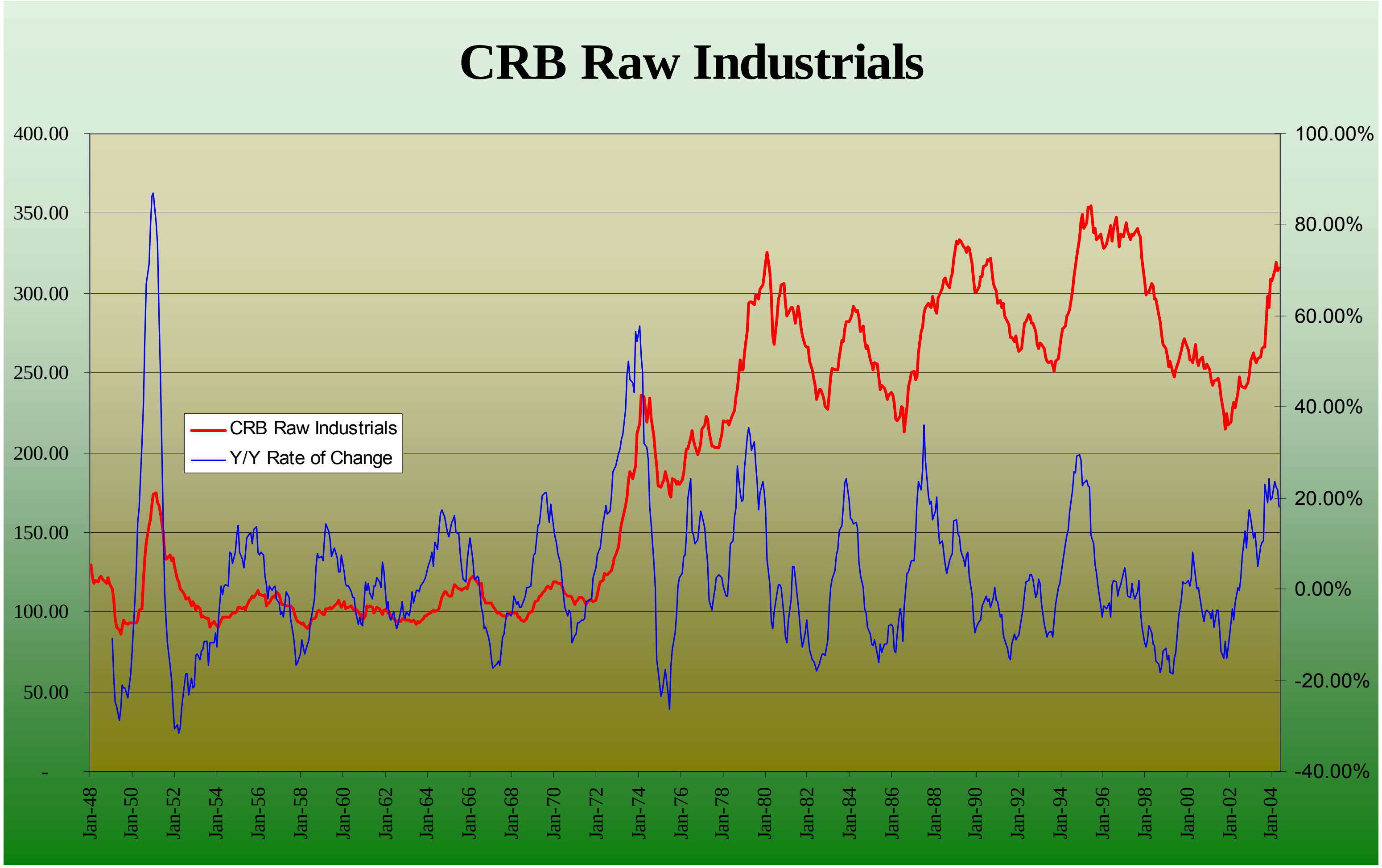
A Bush administration might bring more of the same. Politics aside, tax cuts without additional entitlement reform and spending reform could lead to run-away deficits and a dollar crisis. Our role in the world is as a leader and we cannot lead purchasing every additional thing we need on credit. While we do have a crushing deficit a simple solution would be to freeze spending for a year and reimpliment the paygo rules, but nothing in Washington is ever simple.

A Kerry administration could lead to a dramatic departure from the last eight years. Along with populist items that might hurt pharmaceuticals, tax policy becomes uncertain, and **Alan Blinder** might be the future Chair of the Fed, which in our opinion would be a *nightmare*. Dr. Blinder's ideology was so in conflict with the Fed that he was asked to leave.

Dr. Copper

Dr. Copper (copper prices) is the best economist we have ever worked with. The doldrums of the summer have been followed by a clear advance.

Macro-economic Research



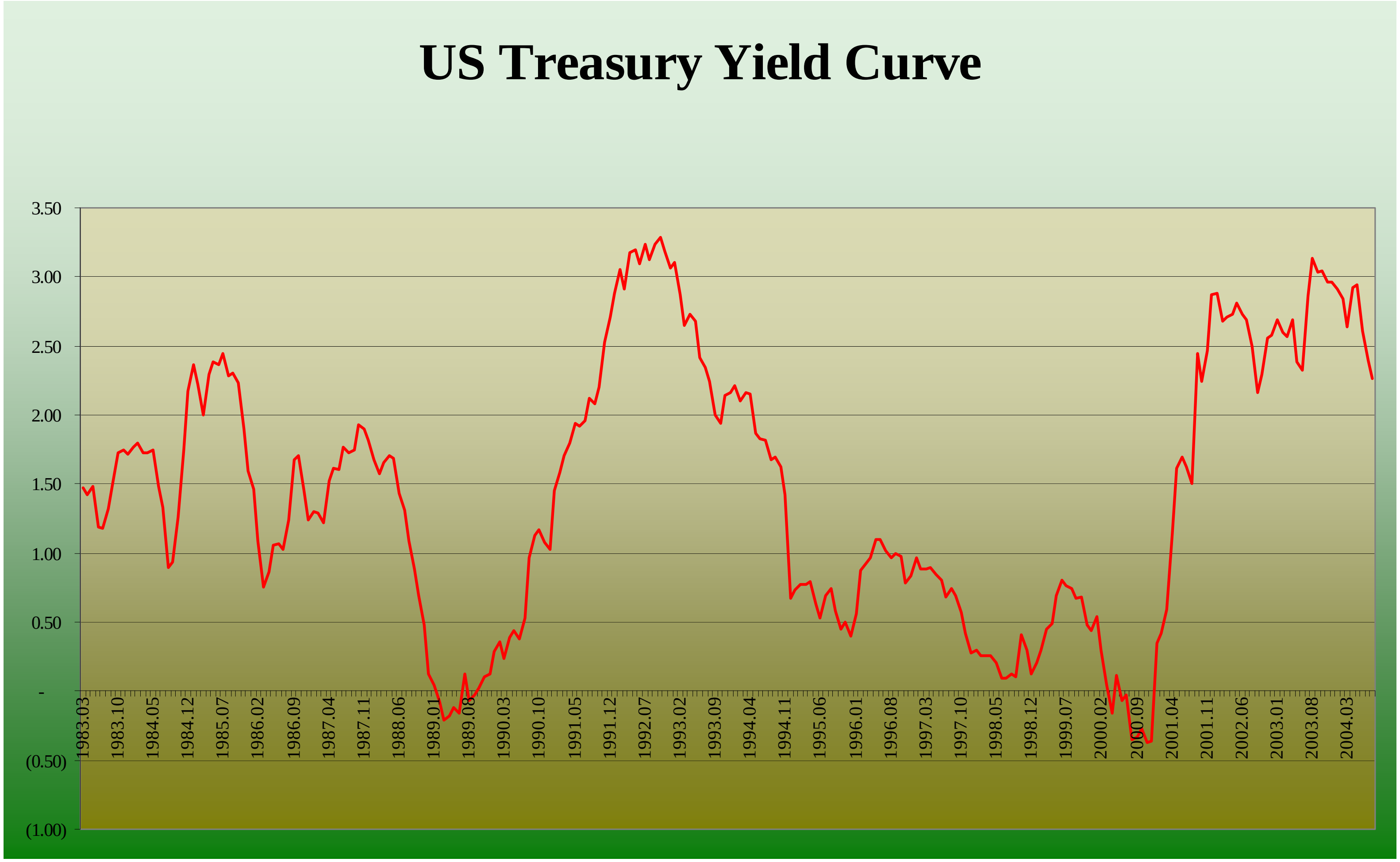
If we were on a desert island and could get one number to base investment decisions on, this would be it. After a February 2004 pause it is again climbing.

CORNERSTONE
Investment Management and Consulting

www.investwithcornerstone.com

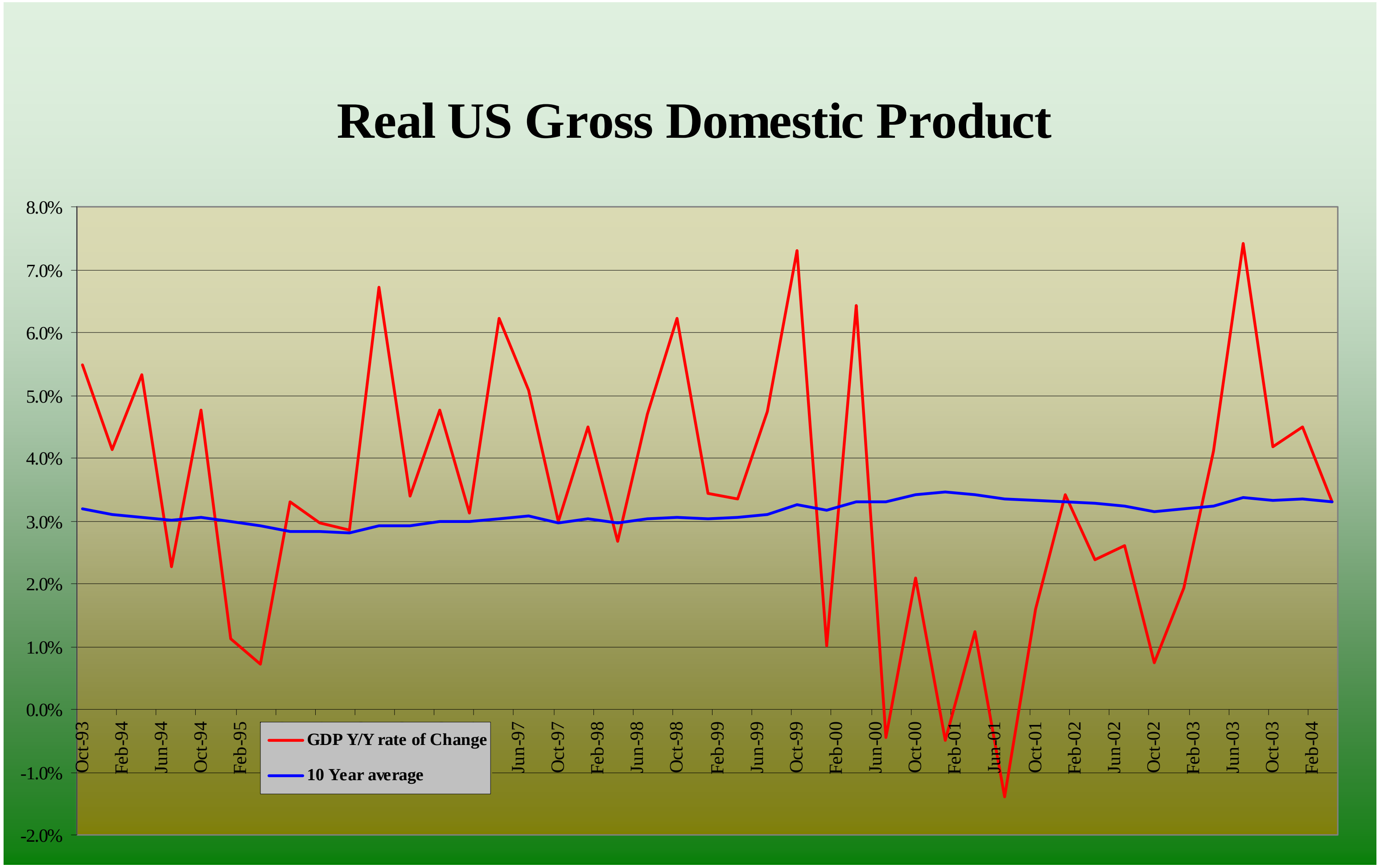
9/30/2004

Macro-economic Research



While the yield curve continues to contract in the last month measured, it is still well above the historic average and is no where near forecasting recession.

CORNERSTONE
Investment Management and Consulting



Real GDP growth finished the quarter right on top of the ten year trend line. Slowing growth is not negative growth.

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"	

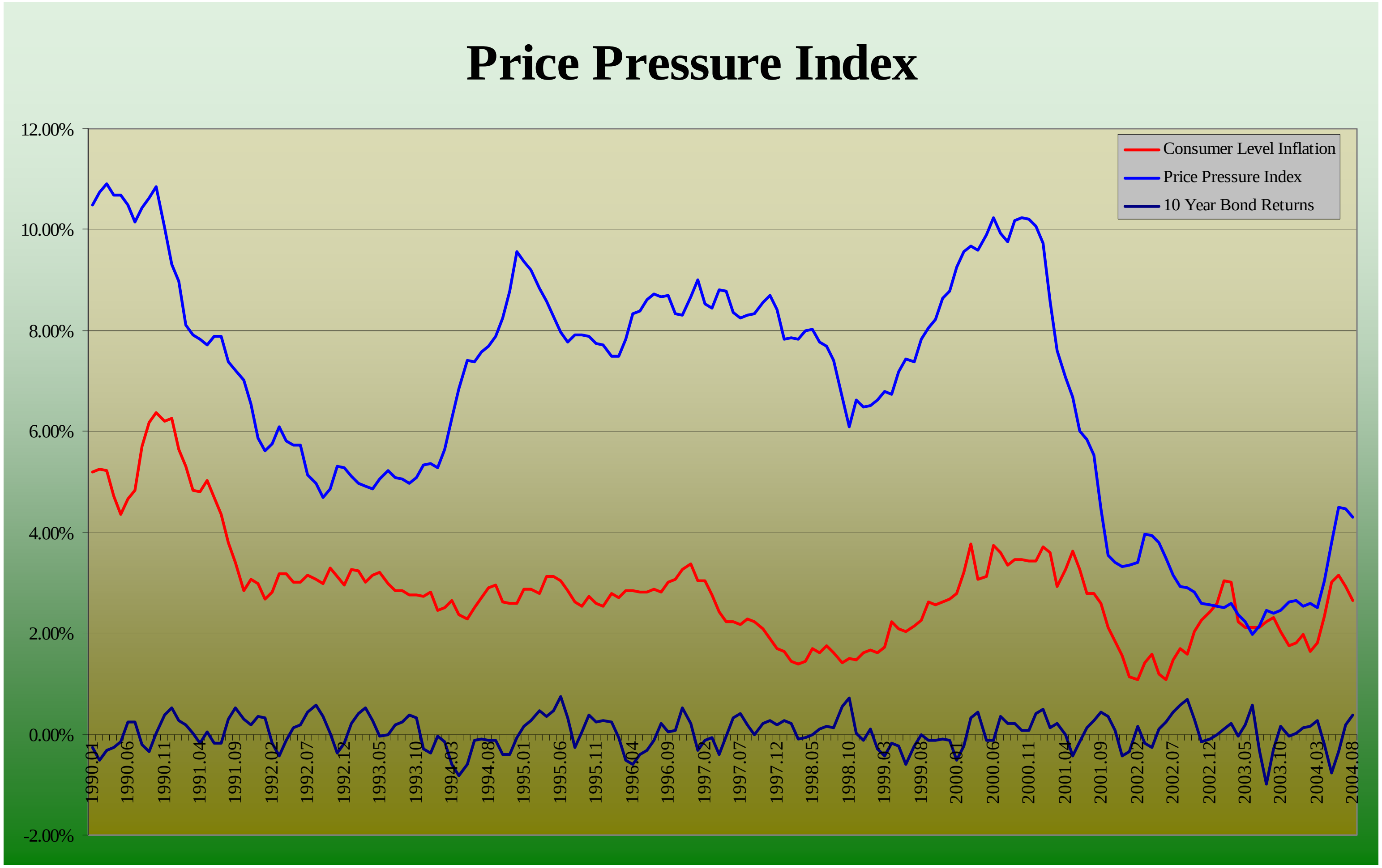
Inflation expectations

The up tick in the overall rate of inflation is a sign for the Federal Reserve "Mission Accomplished". While the return in pricing power is evident, its duration and strength is not.

It appears that the momentum of the rise in inflation is abating. The risk in the near term remains stubbornly high energy prices. It is important that the Fed's measured pace of rate increases be successful in containing the recent rise in inflation.

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 our prediction, just something to think about.

Inflation expectations

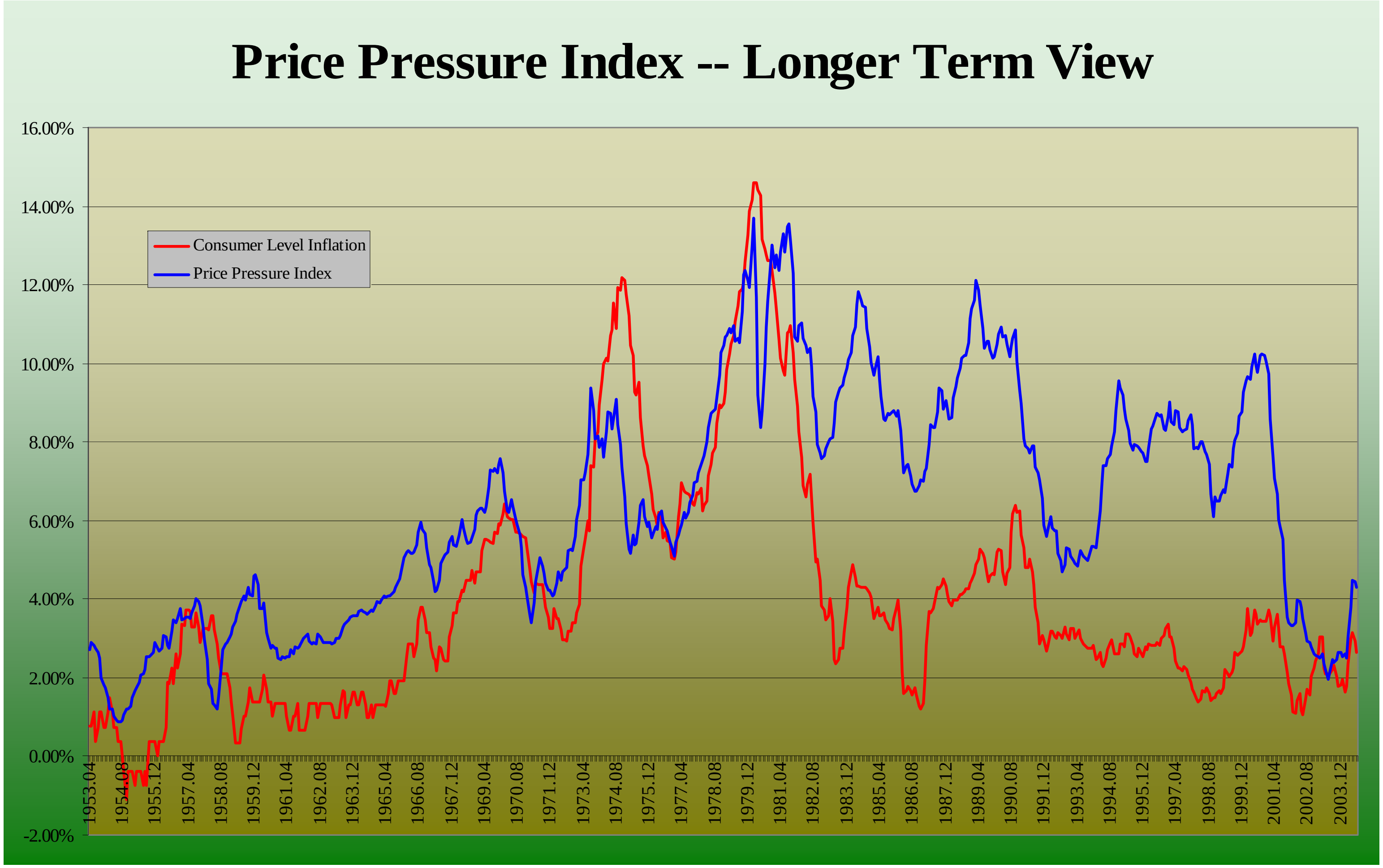


Price Pressure Index remains higher but is moderating some. Good news for pricing power, bad news for rates. This causes us to maintain a bearish outlook on bonds.

CORNERSTONE
Investment Management and Consulting

9/30/2004

Inflation expectations

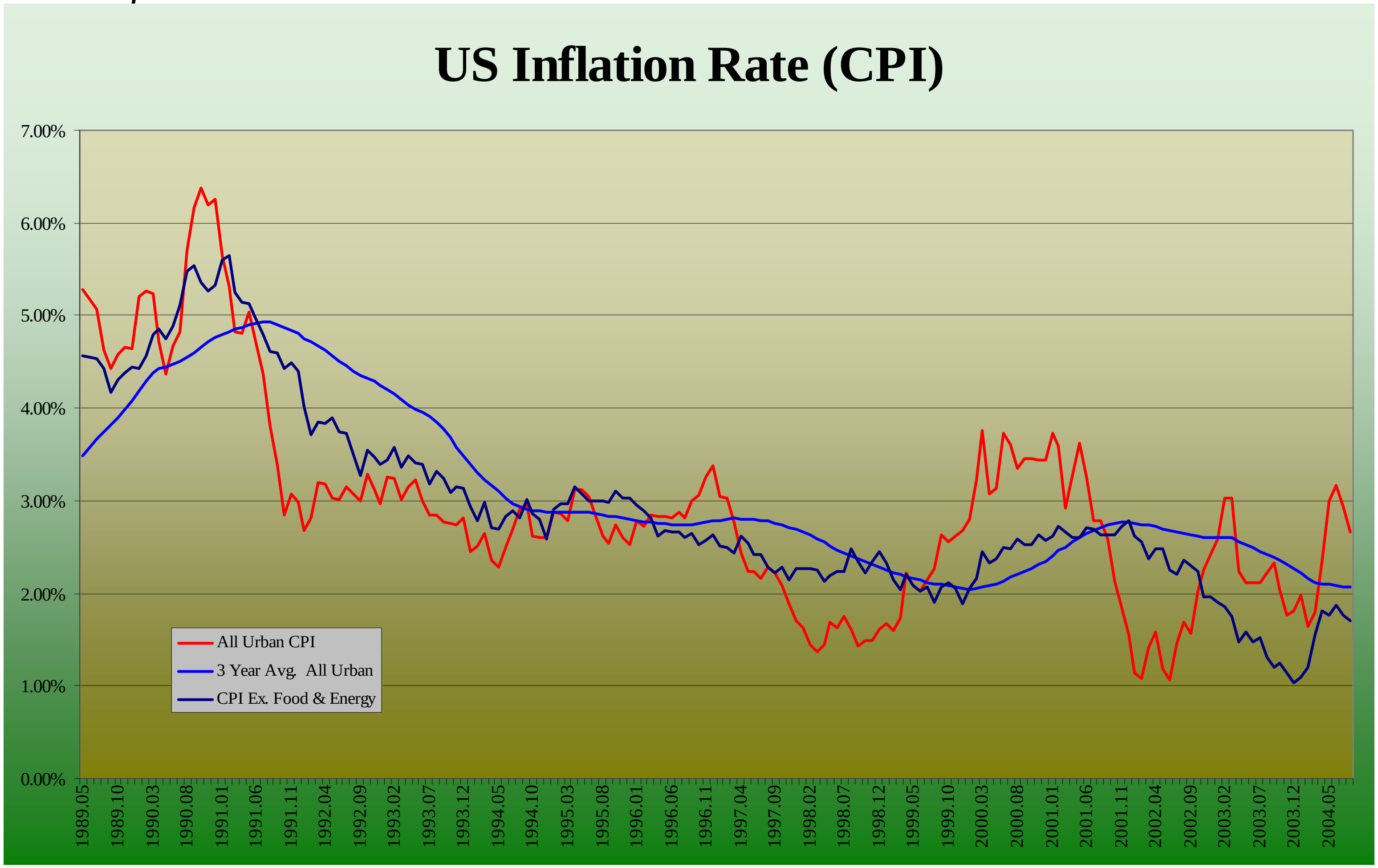


Although it moved off its low this month, price pressure and consumer level inflation are still well within reasonable levels. The long run average in inflation is 3.10% so recent history has been abnormally low.

CORNERSTONE
Investment Management and Consulting

9/30/2004

Inflation Expectations



To the extent that higher prices are demand driven and not caused by supply shocks, the return of pricing power is bullish for stocks.

CORNERSTONE
Investment Management and Consulting

www.investwithcornerstone.com

9/30/2004

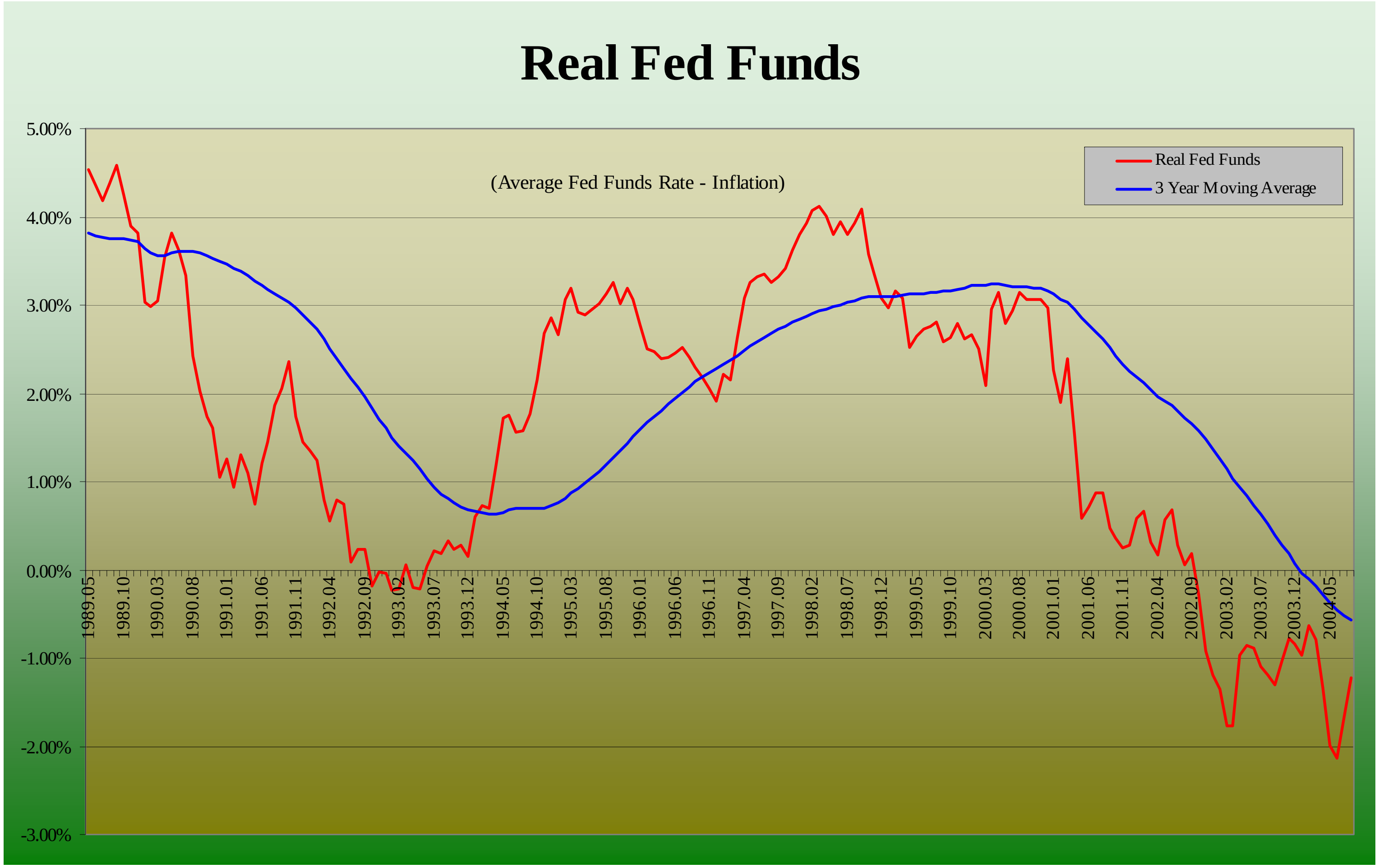
Federal Reserve Watch

At this point in the cycle, monetary policy has nothing left to add.

Margin, speculation and adverse risk-seeking are distinct possibilities with real fed funds where they are. To avoid the creation of another investment bubble, the fed must continue to move rates higher.

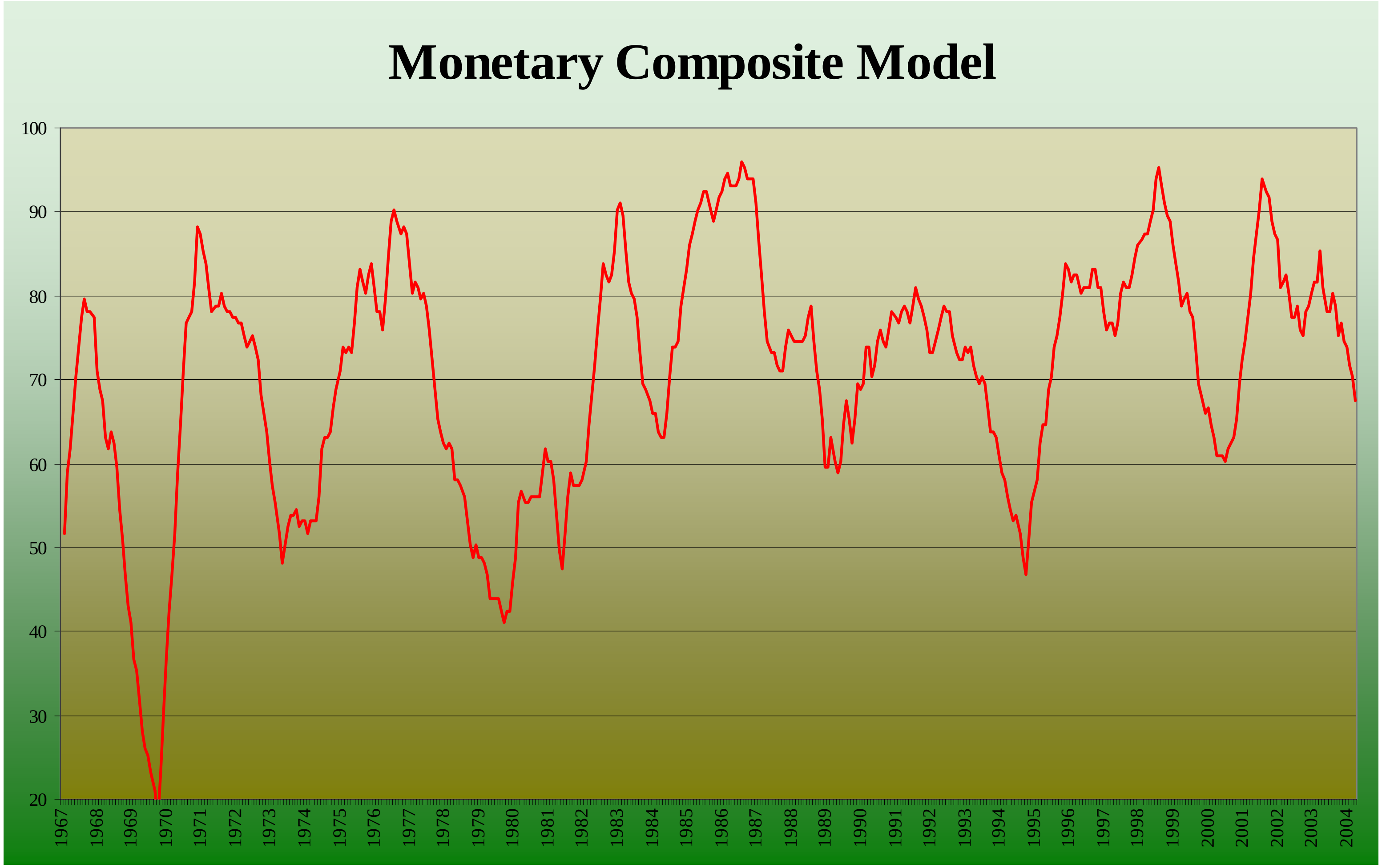
As long as the yield curve remains upwardly sloped and short rates don't rise more than 200 bps a year, the monetary headwind the economy is facing should not be that fierce.

Federal Reserve Watch



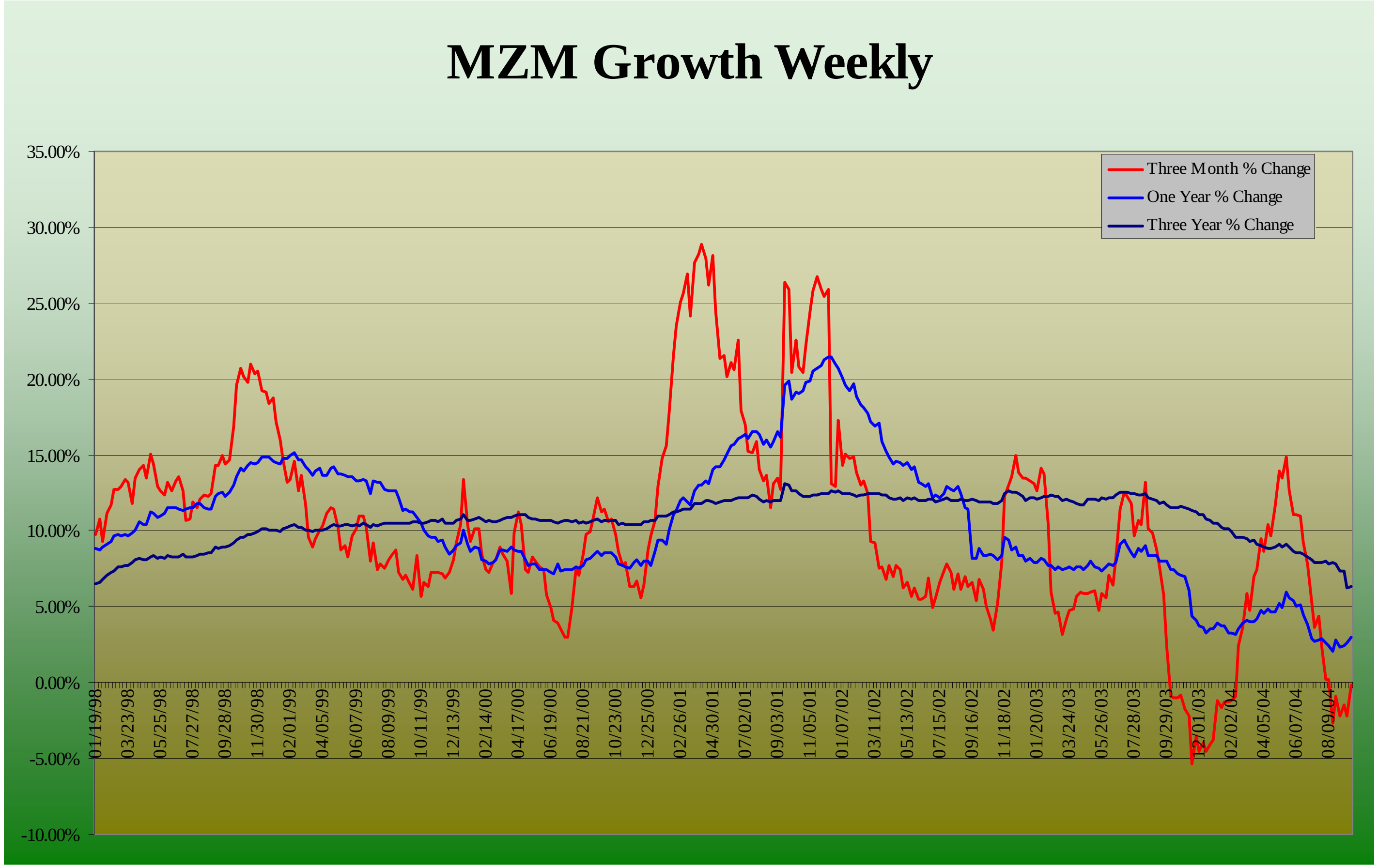
Even with the rate increase, real interest rates are strongly negative as inflation has increased more than rates have.

The year over year changes for inflation will likely moderate while interest rates gradually rise over the remainder of the cycle. The Fed must continue to push short rates higher to normalize this number.



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. Higher interest rates as well as slowing money supply have affected this model and will likely continue to do so as its measure declines. Monetary policy could be a headwind for some time to come.

Federal Reserve Watch



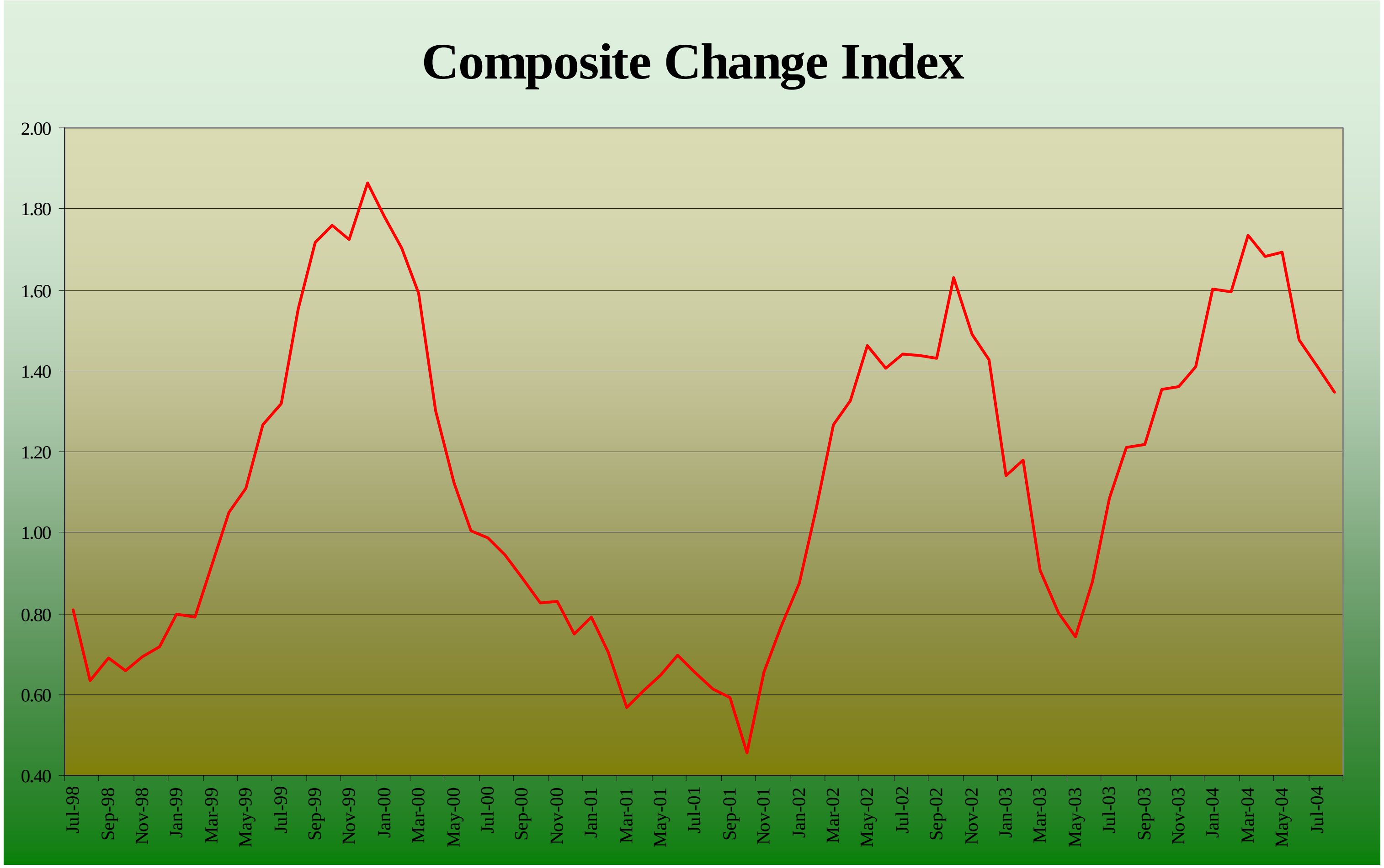
Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices. The 3 month growth rate of money supply has improved over the past few weeks.

Outlook & Forecast

Cautiously Optimistic

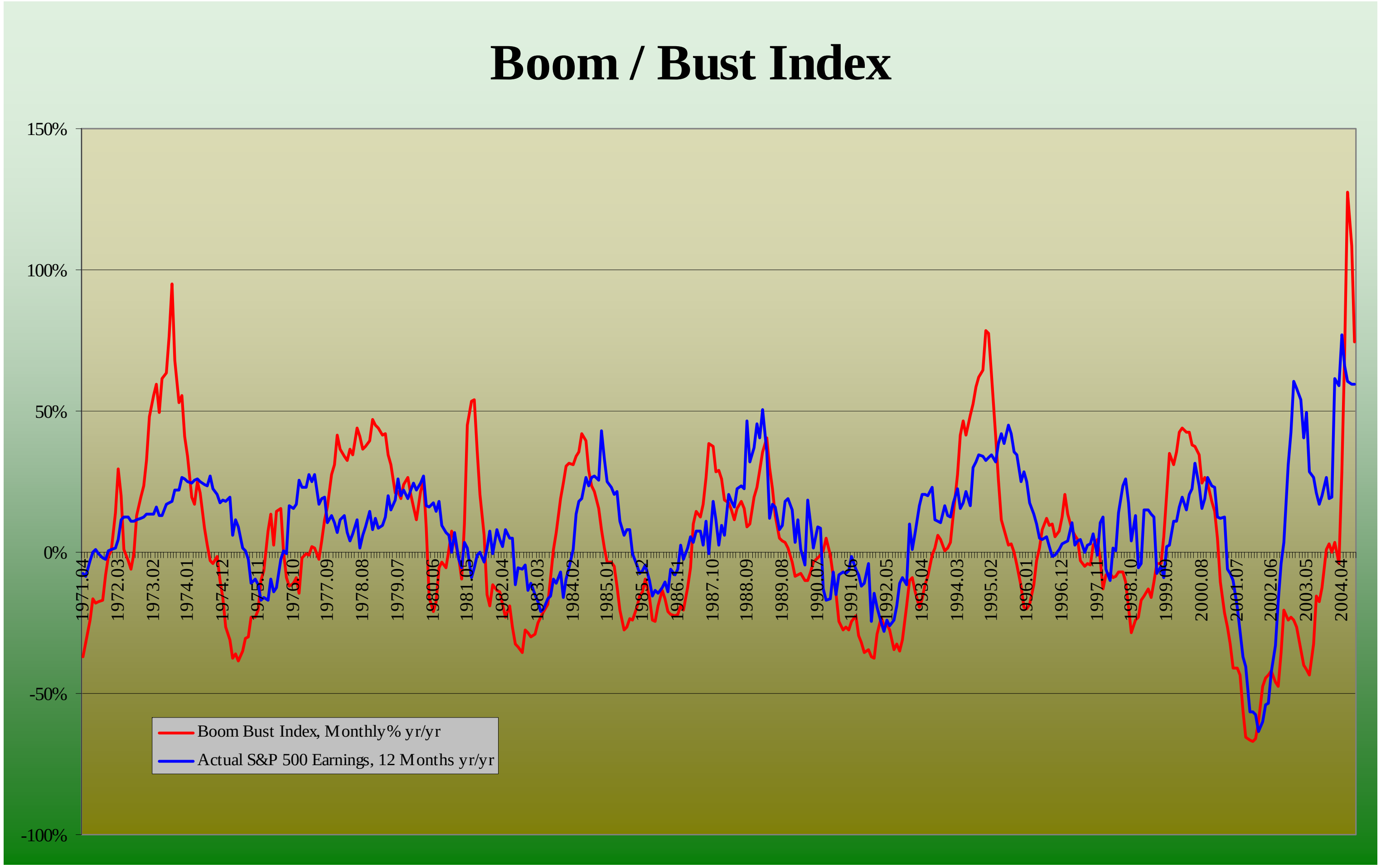
Many negative future events could steer this market lower. We have detailed many of them on these pages over the past few months. To be clear on our opinion, lower than average equity returns are here to stay. Even so, we believe stocks beat bonds and cash on forward looking total return basis for the next five years.

Outlook & Forecast



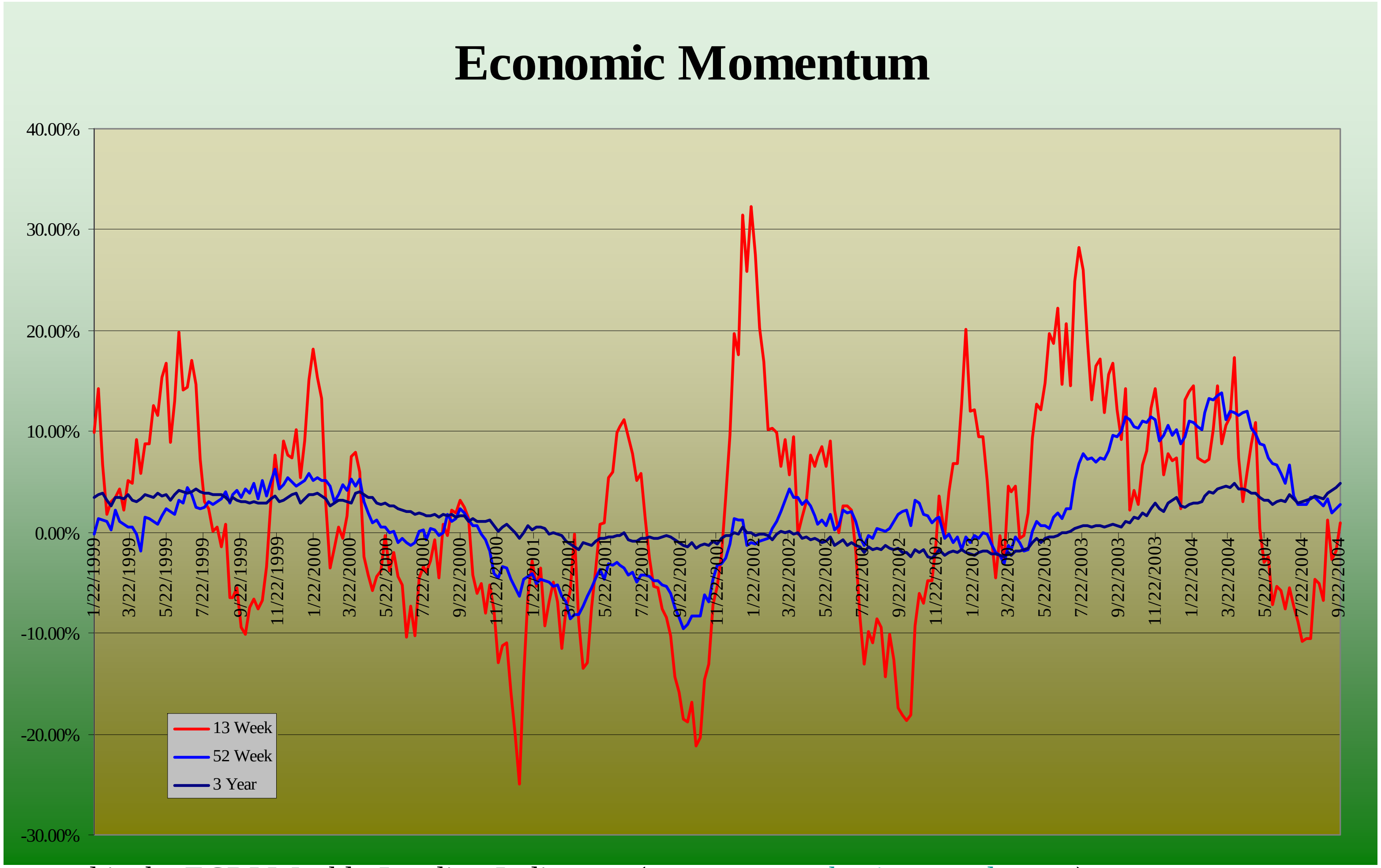
The composite change tends to lead earnings, and values over 1.00 are considered bullish. Growth for the cycle may have peaked but positive growth continues.

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.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).
The Summer slide is over, higher equity prices over the last few weeks will reinforce this stronger trend.

CORNERSTONE
Investment Management and Consulting

9/30/2004

Final Thought

Unless forward growth rates are negative, the valuation of the stock market is quickly becoming attractive.

We have been looking for signs of renewed vigor in growth and finding it.