

Monthly Chartbook

September 2005

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Macro-economic Research

We anticipate 5% - 7% annualized returns in the US through the end of the decade due to the following...

- certain commodity prices (such as gasoline & natural gas), although we believe this to be a short-term impact
- inflation -- until this subsides, the market PE cannot move beyond its present range
- slowing monetary growth
- the competition of other economies (the weaker \$ and US debt tie into this)

However, corporate earnings continue to rise, and that should provide an anchor to limit downside during this period.

Capital Markets Expectations

| Index | Current | Forecast | | Range | Time Frame |
|------------------------------|----------------|----------------------|---------|---------------------|----------------------|
| S&P 500 | 1228.81 | Trading range | ↔ | 1100-1275 | Next 6 months |
| Ten Year Treasury | 4.32% | 4.35% | ↓ | 4.00%-5.00% | 6 months |
| Inflation (all Urban) | 3.59% | 3.15% | ↑ | 2.75%-3.50% | 6 months |
| Fed Funds | 3.75% | 4.00% | ↑ | 3.50 – 4.25% | 6 months |
| S&P 500 Earnings | \$64.03 | \$67.50 | ↑ | \$66 - \$70 | 1Q 2006 |
| | | | | | |
| | Legend: | ↑ Higher | ↓ Lower | ↔ Indifferent | |

Macro-economic research

Impact of Katrina (and Rita)...

We have contended that the talking heads in the financial centers within the US simply don't get the potential impact of these hurricanes on our national economy. It has been marginal demand for energy that has buoyed energy prices on worldwide markets, but these storms have impacted near-term supply. Consider these statistics:

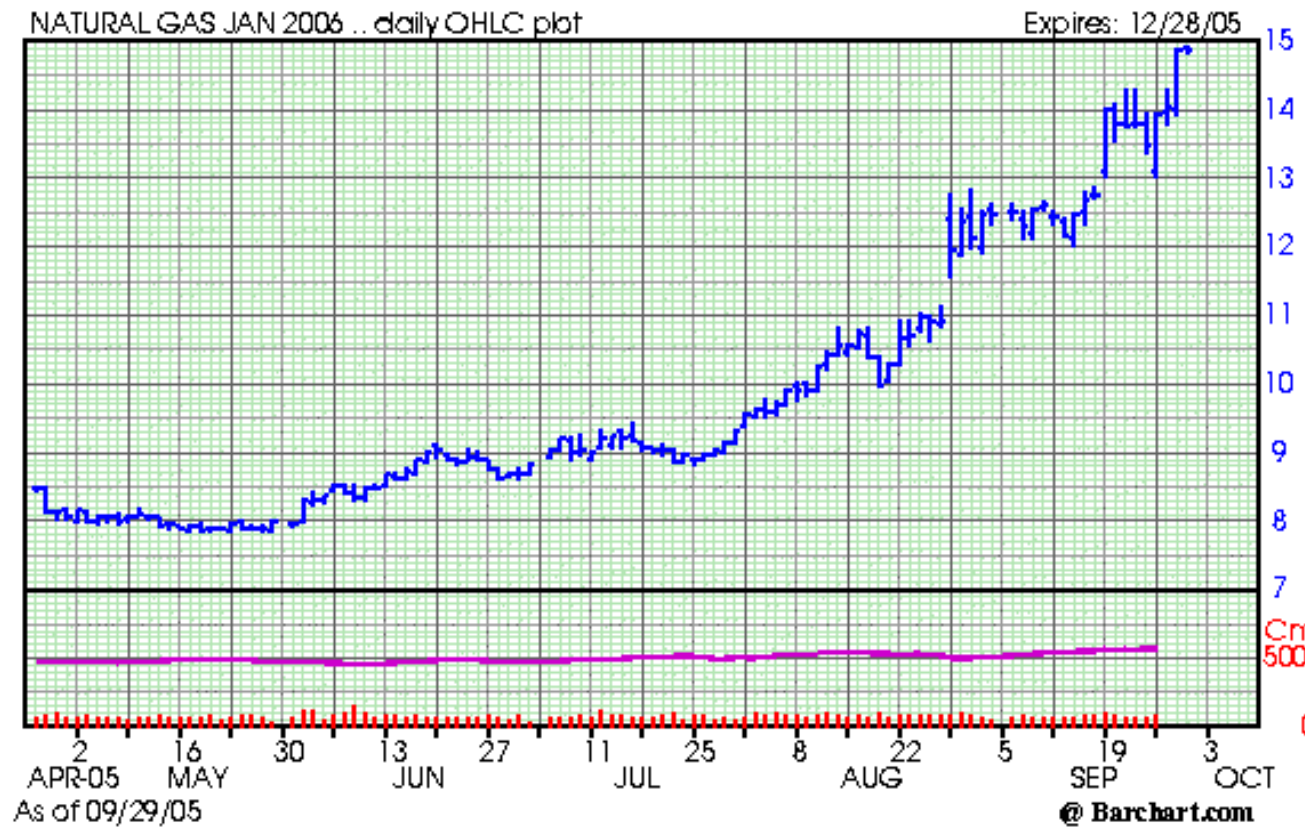
- 50% of the nation's refining capacity is located in the states along the Gulf (MS, LA, TX).
- 25% of US crude production is also based this area.
- over 20% of our country's natural gas is from the Gulf.

Much of this energy infrastructure is still not on-line--some due to storm damage and others as a result of preparation and implementation of disaster policies; others still will not be on-line quickly due to the inability to get their workers back on the job.

The impact of the storms is not necessarily about oil; it's about gasoline and natural gas and their marginal price increases in the short-term.

And, ultimately, the choices consumers are forced to make because of those marginal price increases.

Commodity prices – natural gas



Natural gas accounts for 25% of US energy consumption, and the Henry Hub in Louisiana is the nexus of 16 pipelines that serve much of the US – including the East Coast, the Midwest and the Gulf Coast. If your utility is not properly hedged, you could be paying substantially higher bills to heat your home this winter.

Commodity prices – heating oil



Many homes in the Northeast use heating oil as a source of energy during the winter months which accounts for about 25% of the yield of a barrel of oil.

When people who work in Wall St. have friends paying high prices to heat their homes (or are unable to do so due to supply constraints), then you will hear more about this issue on CNBC.

Commodity prices – gasoline



Our primary contention all along has been that refining *capacity* is the issue – not necessarily oil supply itself. Because we are operating at marginal capacity with respect to refining, taking any capacity off-line will result in lower supply and higher prices.

These marginal price increases for energy will affect consumer decisions in the short-term.

Inflation expectations

Our expectations for inflation have been increased as a result of the continued rise in the prices of energy-related commodities.

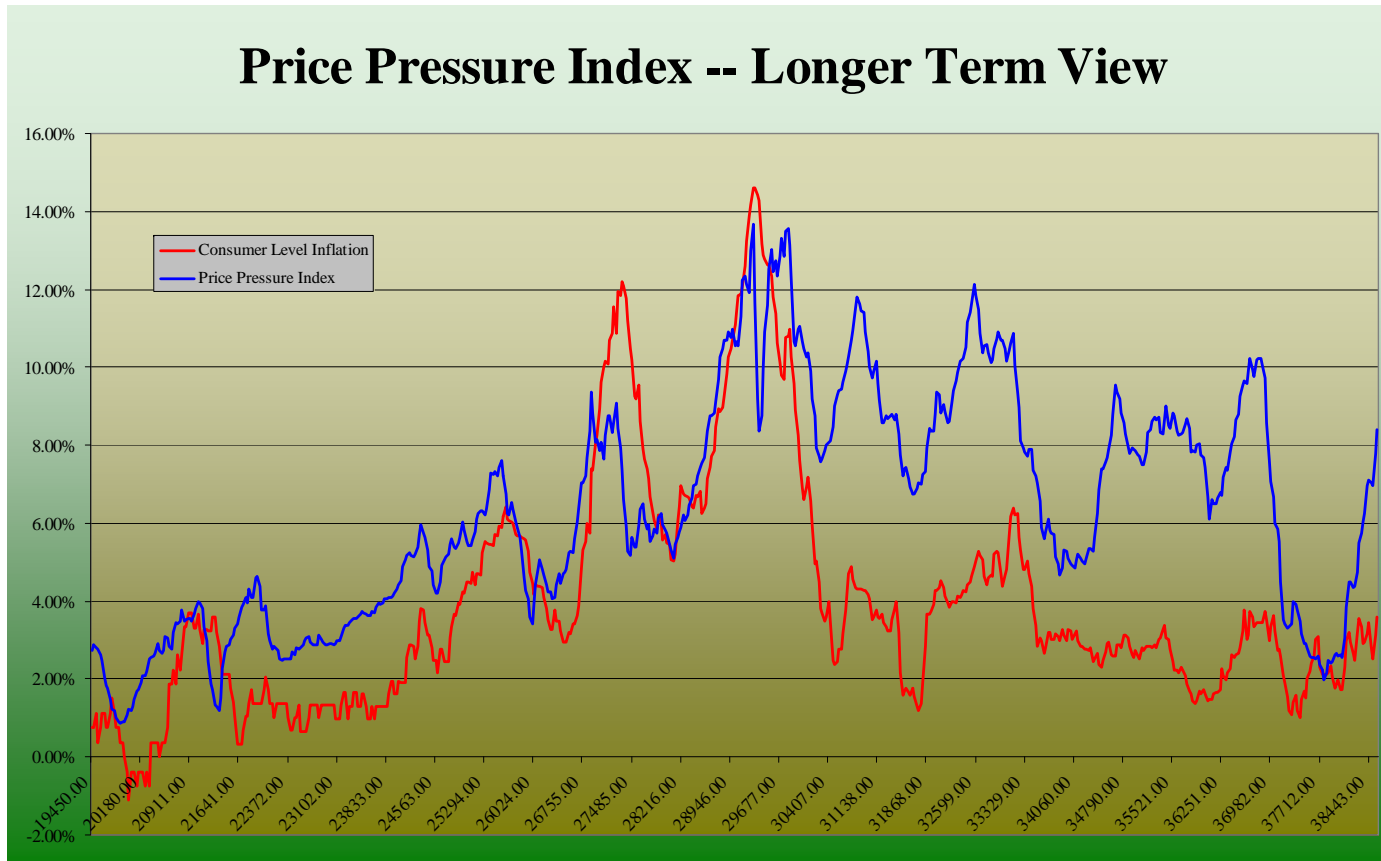
Based on continued increases in energy prices, we believe inflation can potentially increase and will likely remain in a range between 3% and 3.5% over the intermediate period.

In the last Chartbook (drafted in July), each of these indicators seemed to provide a consistent read on this critical measure of price stability, and they do so again as detailed in the following pages...

- Price pressure index
- TIPS
- CRB
- Personal Consumption Index

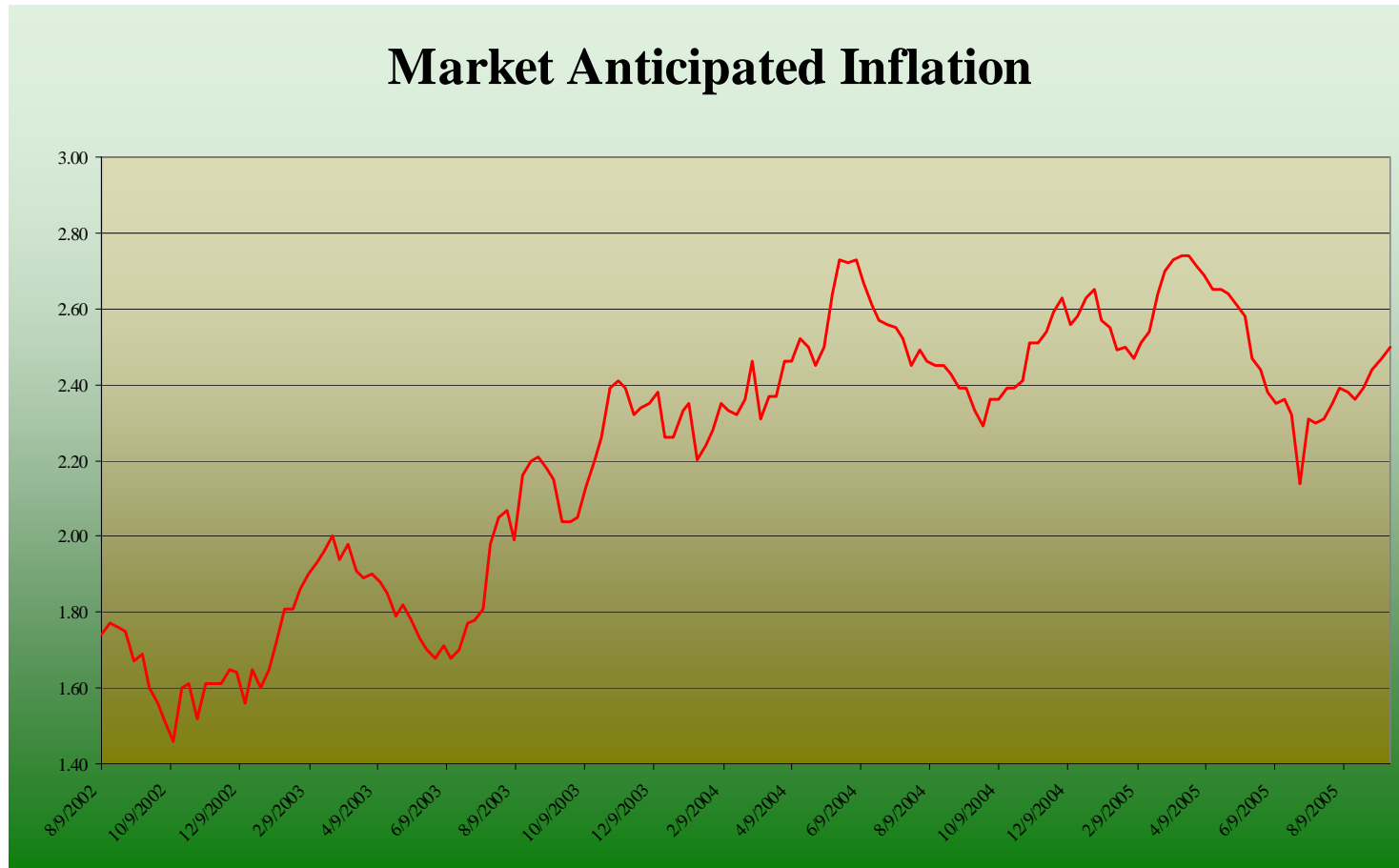
However, this time many of the indicators have moved off of their recent bottom for inflation and are predicting a slight rise.

Inflation Expectations



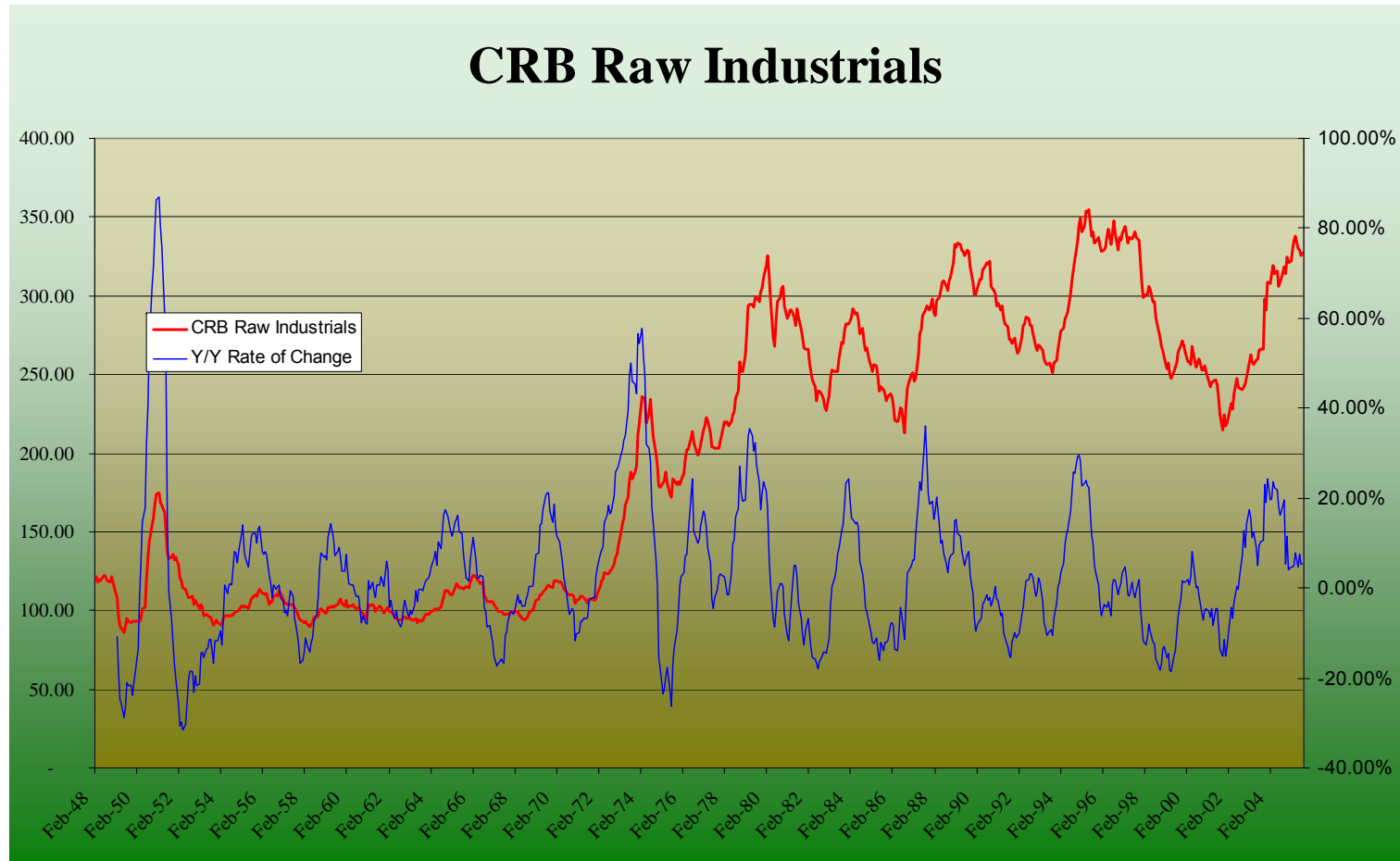
The Price Pressure Index has skyrocketed in the past couple of months. This indicator is a proprietary algorithm for predicting inflation, and it often leads increases or decreases in that measure (high correlation to direction, but not necessarily a good predictor of magnitude).

Inflation Expectations



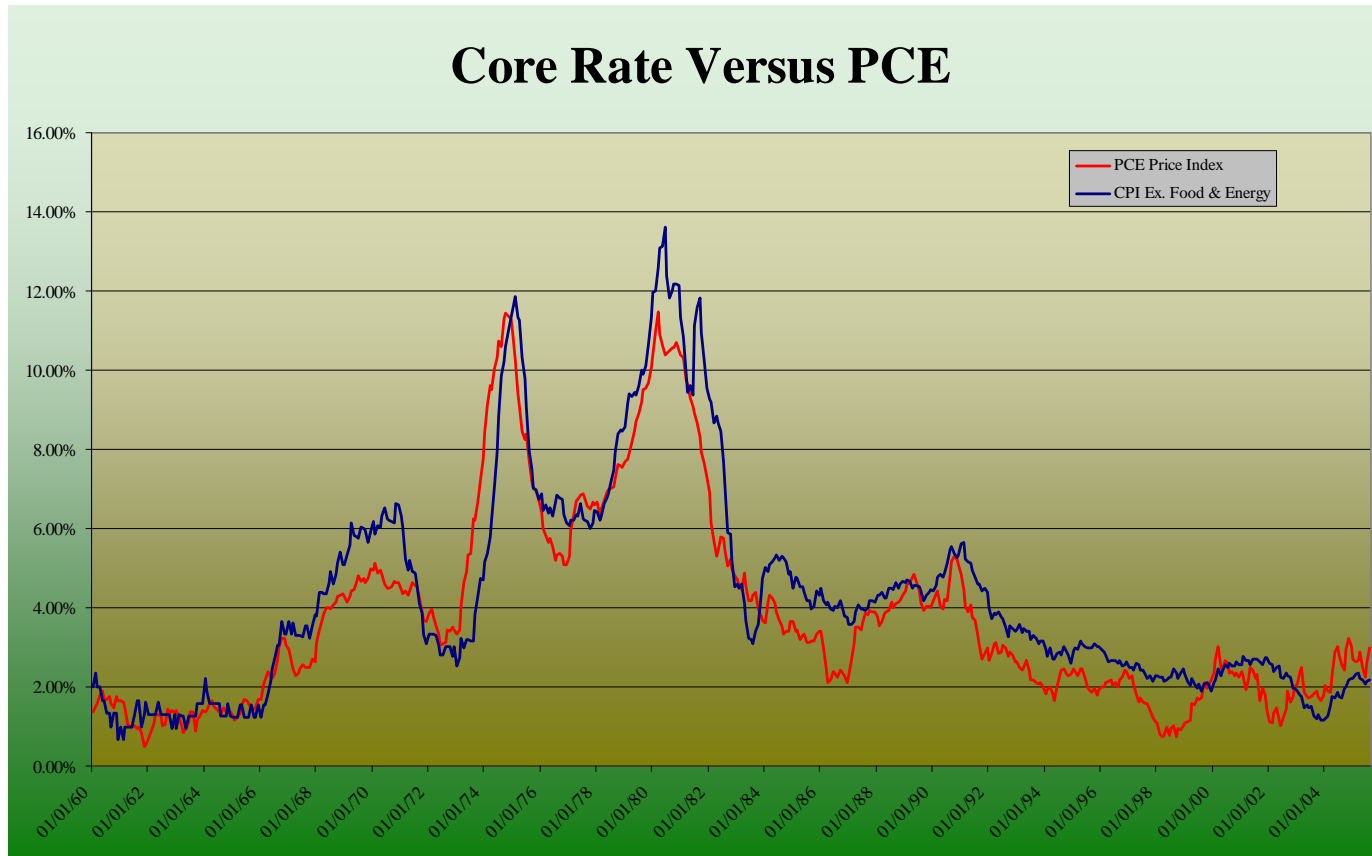
Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting moderating inflation, with an implicit forecast of 2.53%, up from recent lows but down from the peak of 2.73% in March.

Inflation Expectations



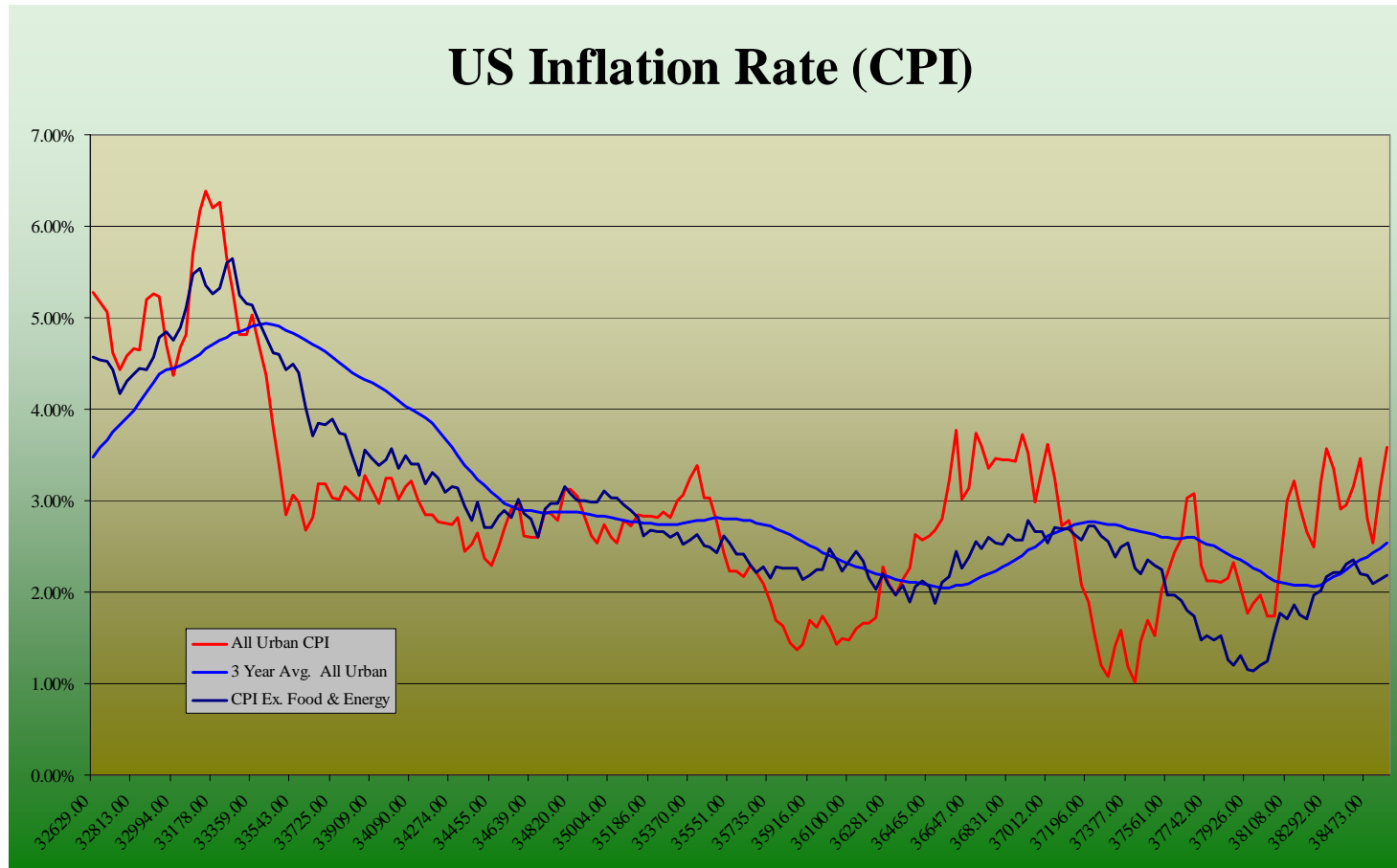
Commodity prices are moderating with the exception of energy as global supply is rising to meet demand.

Inflation Expectations



The Personal Consumption Expenditures Price Index provides insight into price increases across the economy, but it is different from the CPI in one major respect – the “basket” of goods is not fixed, meaning consumers can substitute purchase decisions based on price. This measure offers a good idea of how consumers are being affected by rising prices. The measure stands at 2.98% on a year-over-year basis.

Inflation Expectations



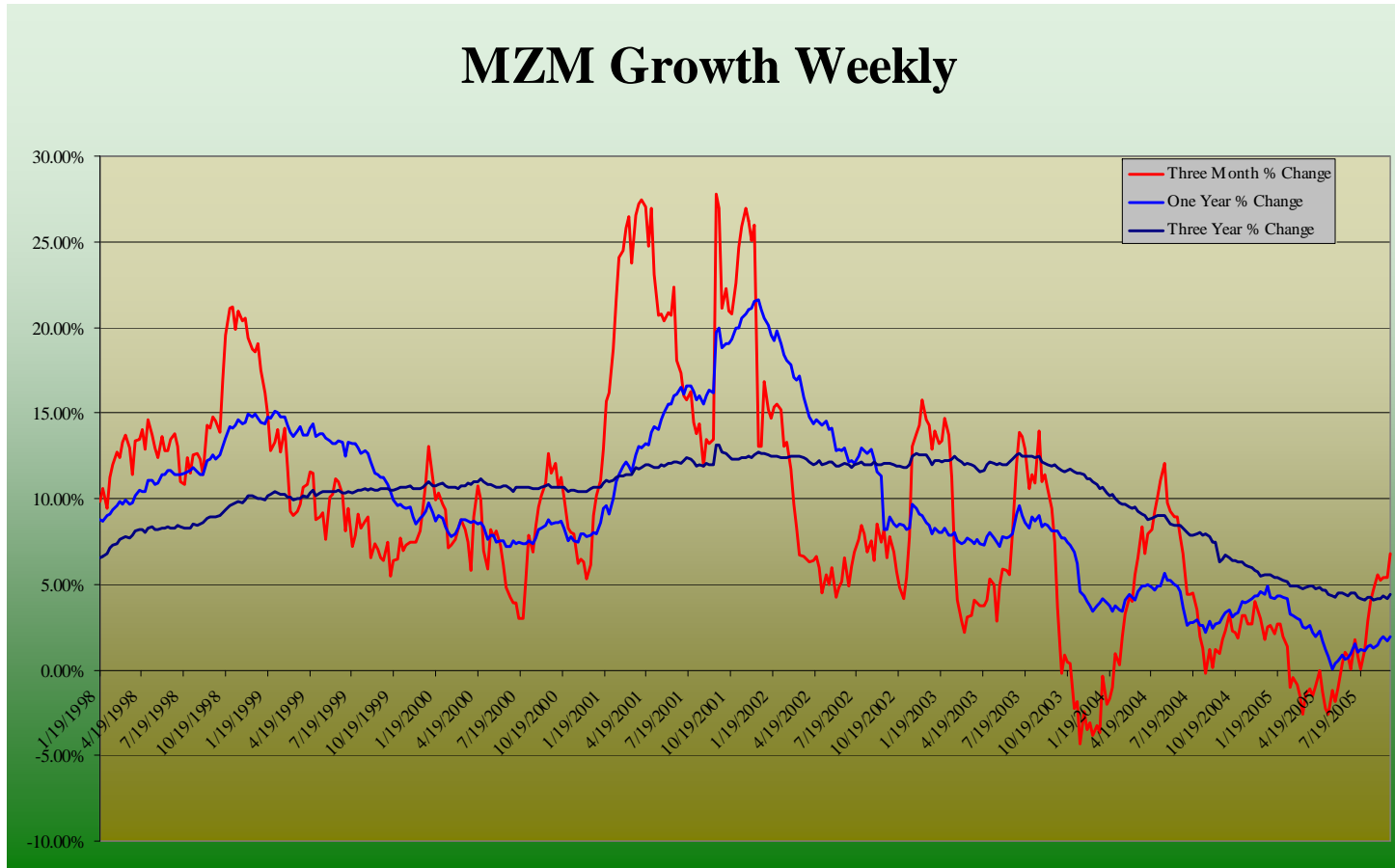
Inflation on a year-over-year basis has increased to a recent high of 3.59%

Federal Reserve Watch

This is the most difficult piece of the puzzle to interpret...

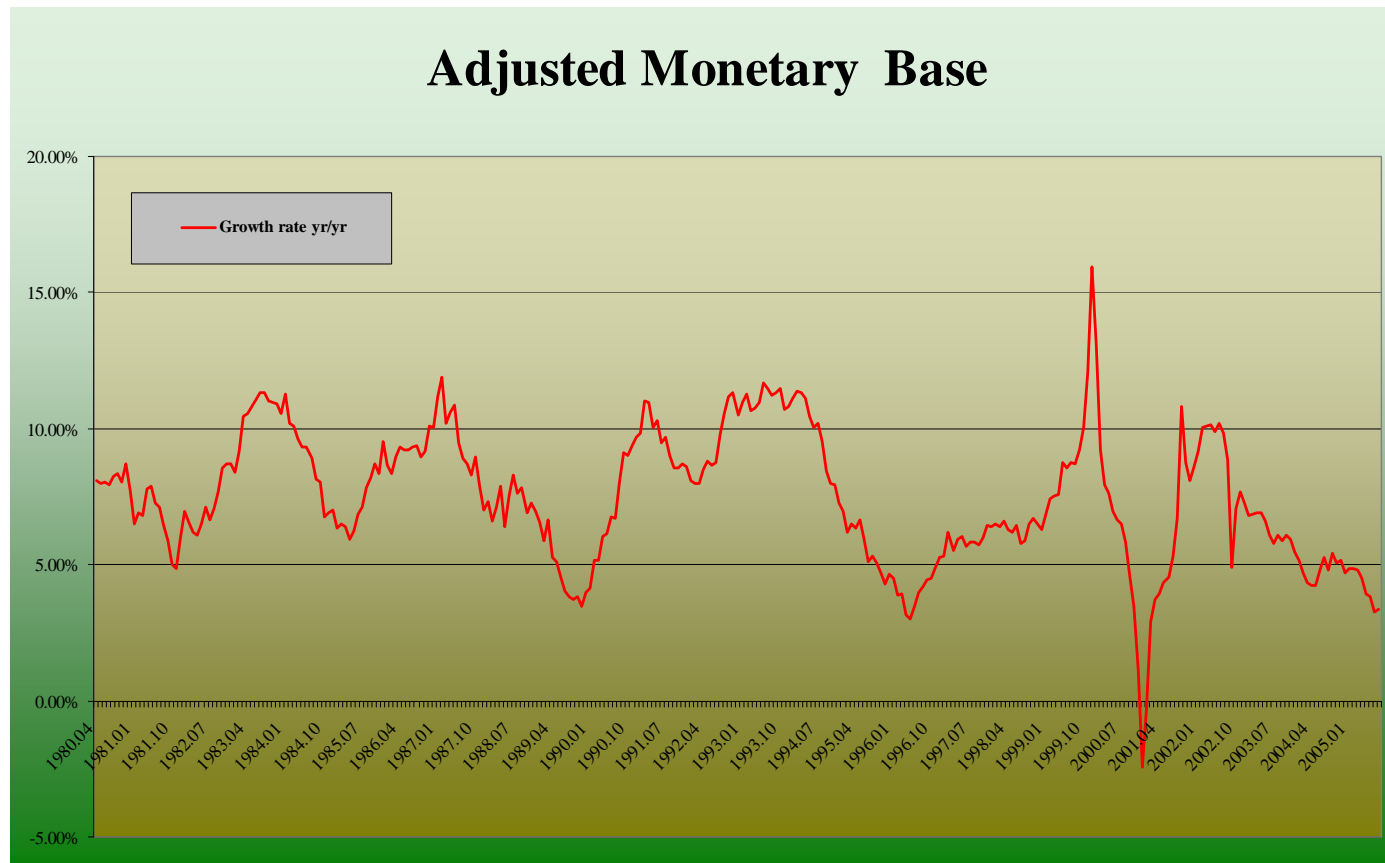
- near-term monetary growth has been very strong, but intermediate- and longer-term growth rates are still low.
- short-term interest rates have increased to the point where the yield curve is almost flat.
- foreign buyers continue to show an appetite for US debt, but it has diminished somewhat.

Federal Reserve Watch



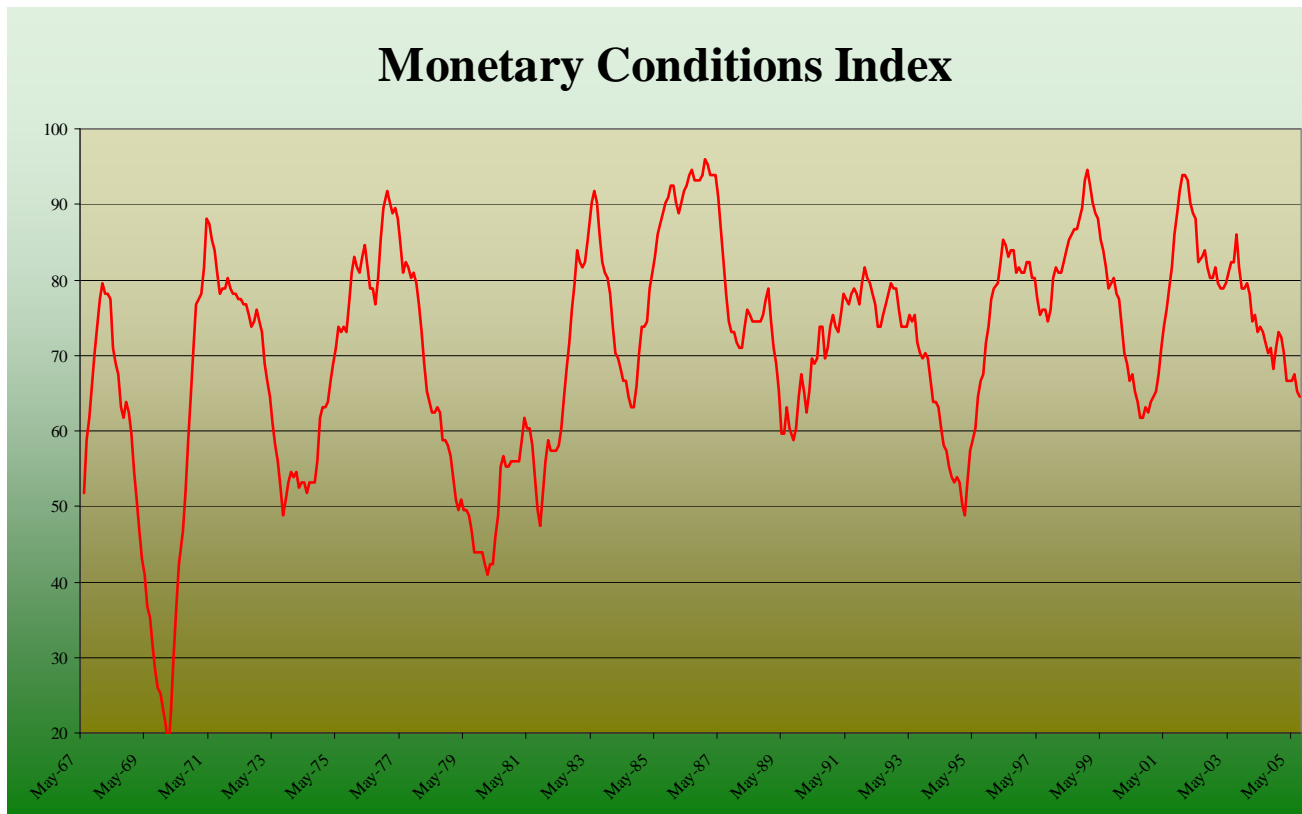
Monetary growth has really picked up since the summer, with short-term growth rates leading all measures higher.

Federal Reserve Watch



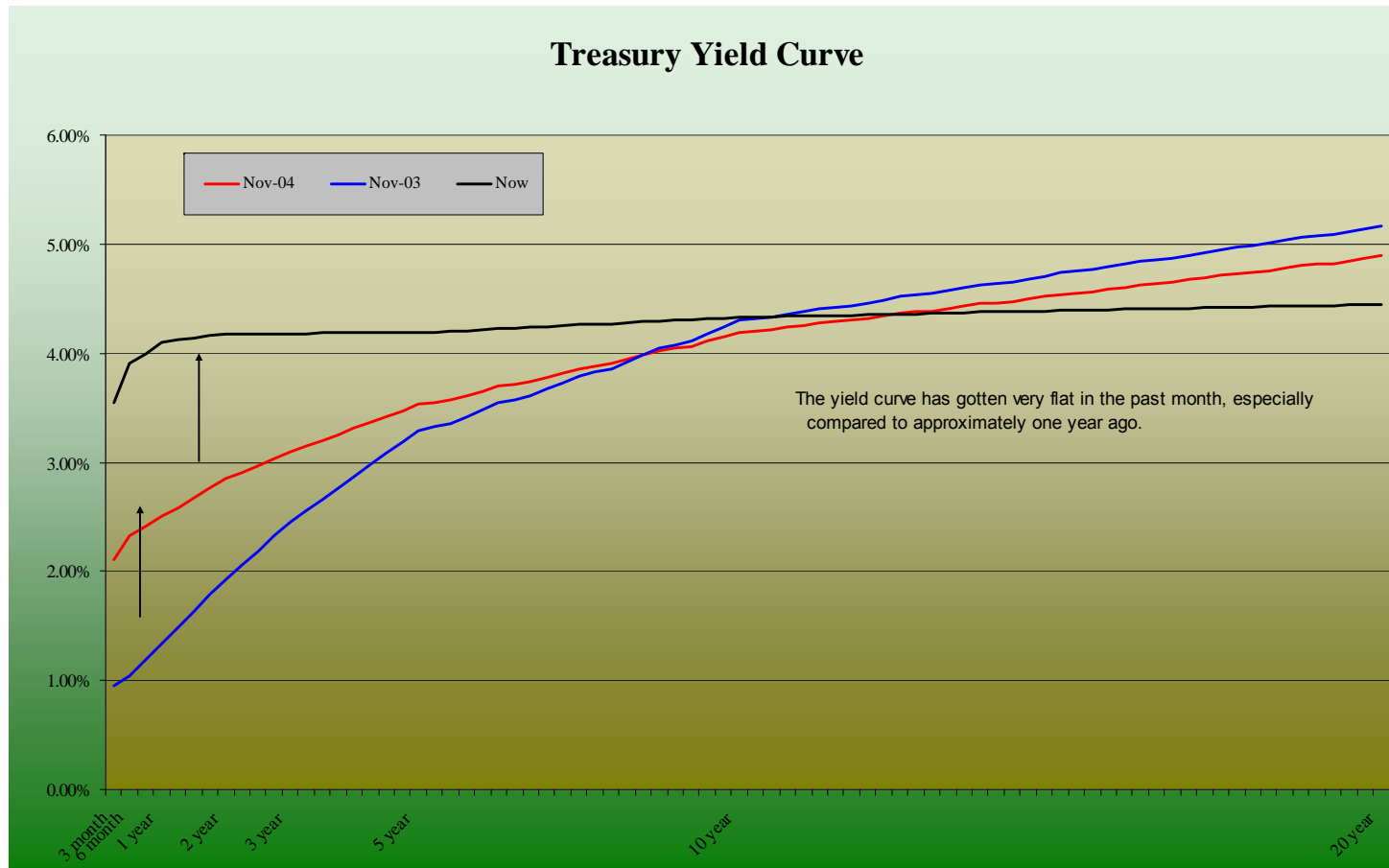
But, the growth rate for the monetary base is extremely low relative to historical standards.

Federal Reserve Watch



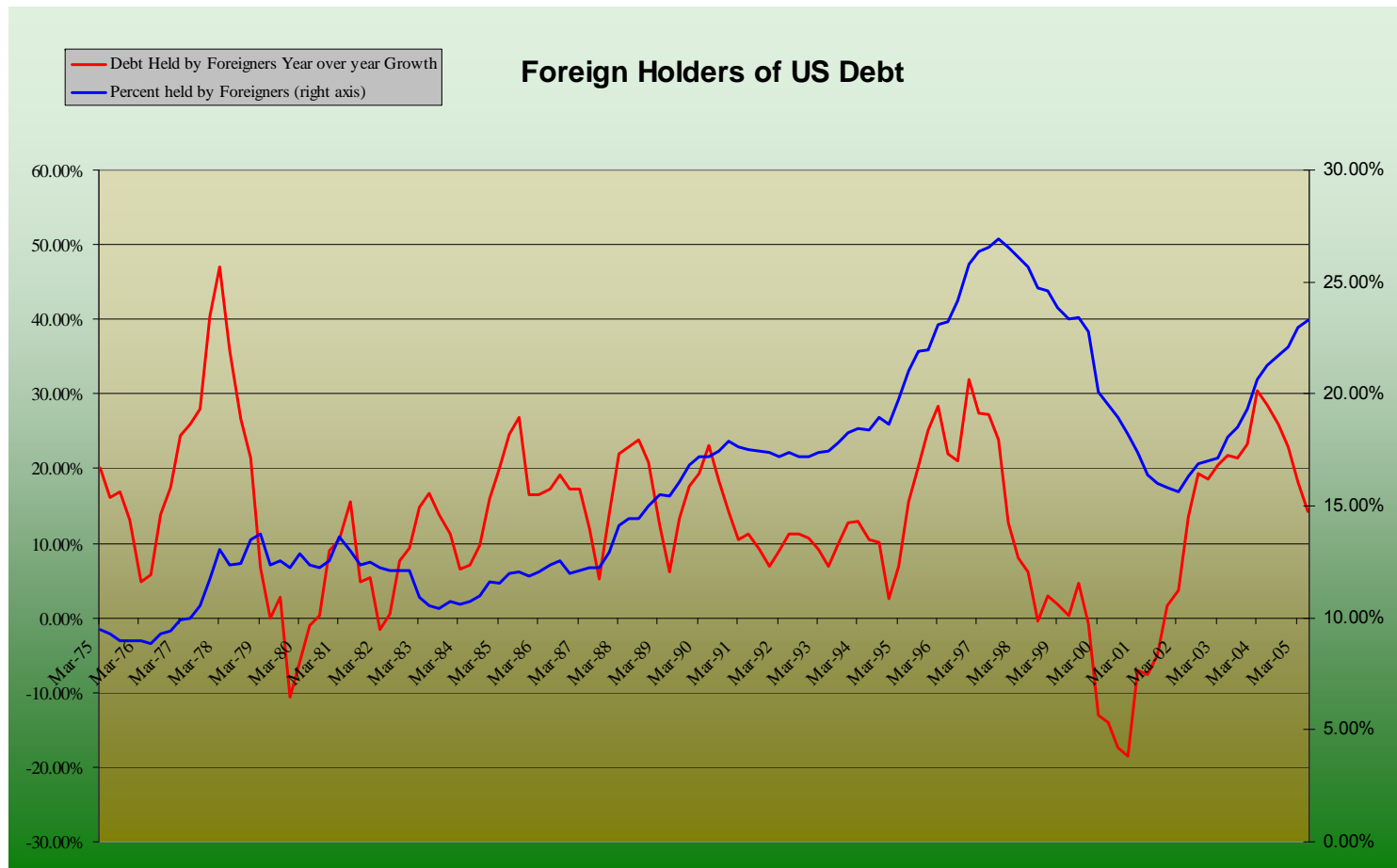
A value above 50 indicates the Fed's policies are accommodative, but the trend is just as important. Monetary conditions & liquidity continue to deteriorate as short rates increase during a period of slower monetary growth. **Some of these factors will likely get worse for money conditions before they get better.**

Federal Reserve Watch



Short rates have increased sharply in the past few months, and the yield curve has flattened considerably...

Federal Reserve Watch



... but, foreign countries have not lost their appetite for the “world’s reserve currency.”
Although, the growth rate has slowed somewhat.

Outlook

The US stock market is neither over- nor under-valued.

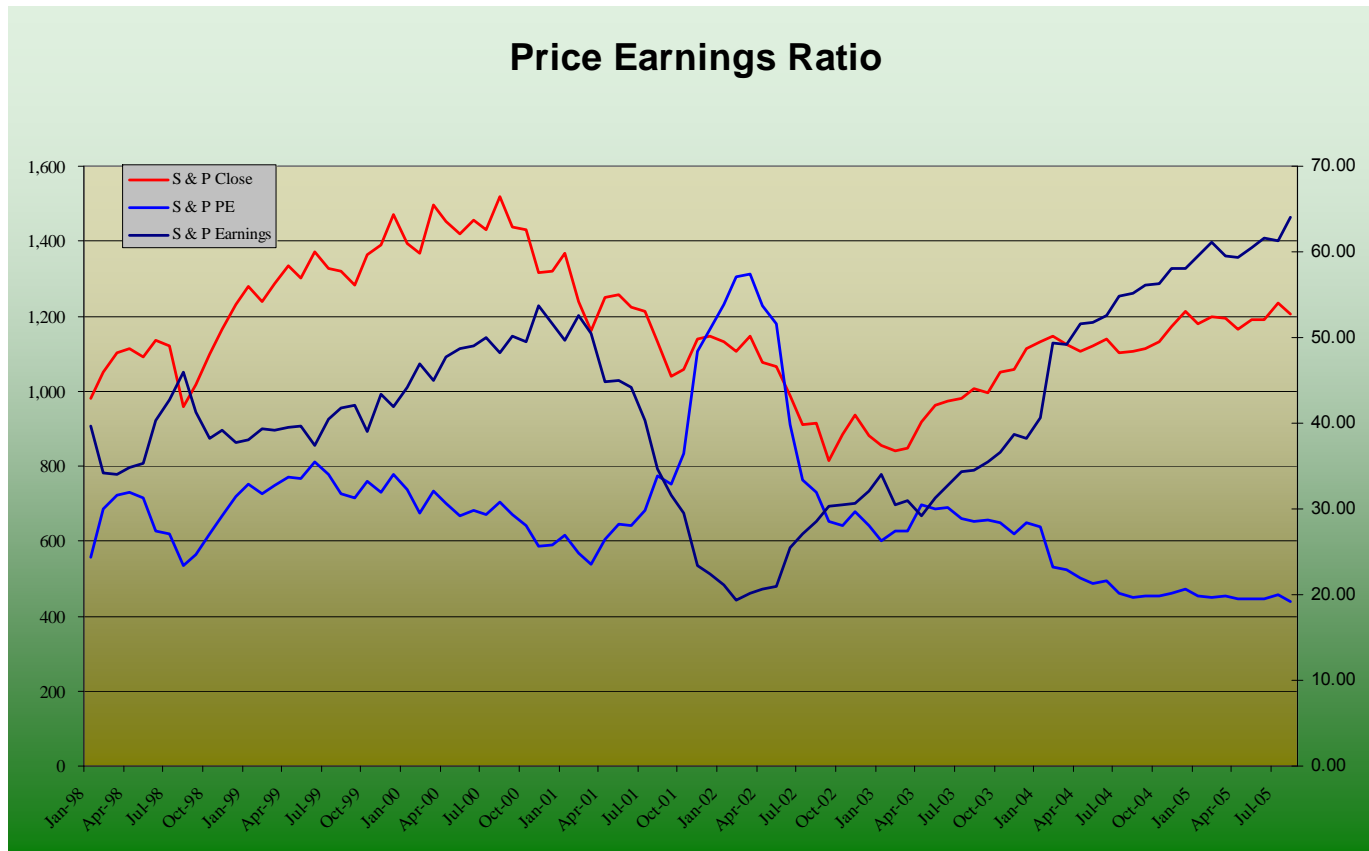
The upside potential is dependent upon:

- Continuing strong corporate earnings
- A sustained decline in inflation, which we feel will occur after the price for energy commodities is normalized.

At the same time, the market is going into some strong headwinds with respect to tighter monetary policy and a potentially downward sloping yield curve.

Perhaps its time to increase the international allocation within client portfolios...

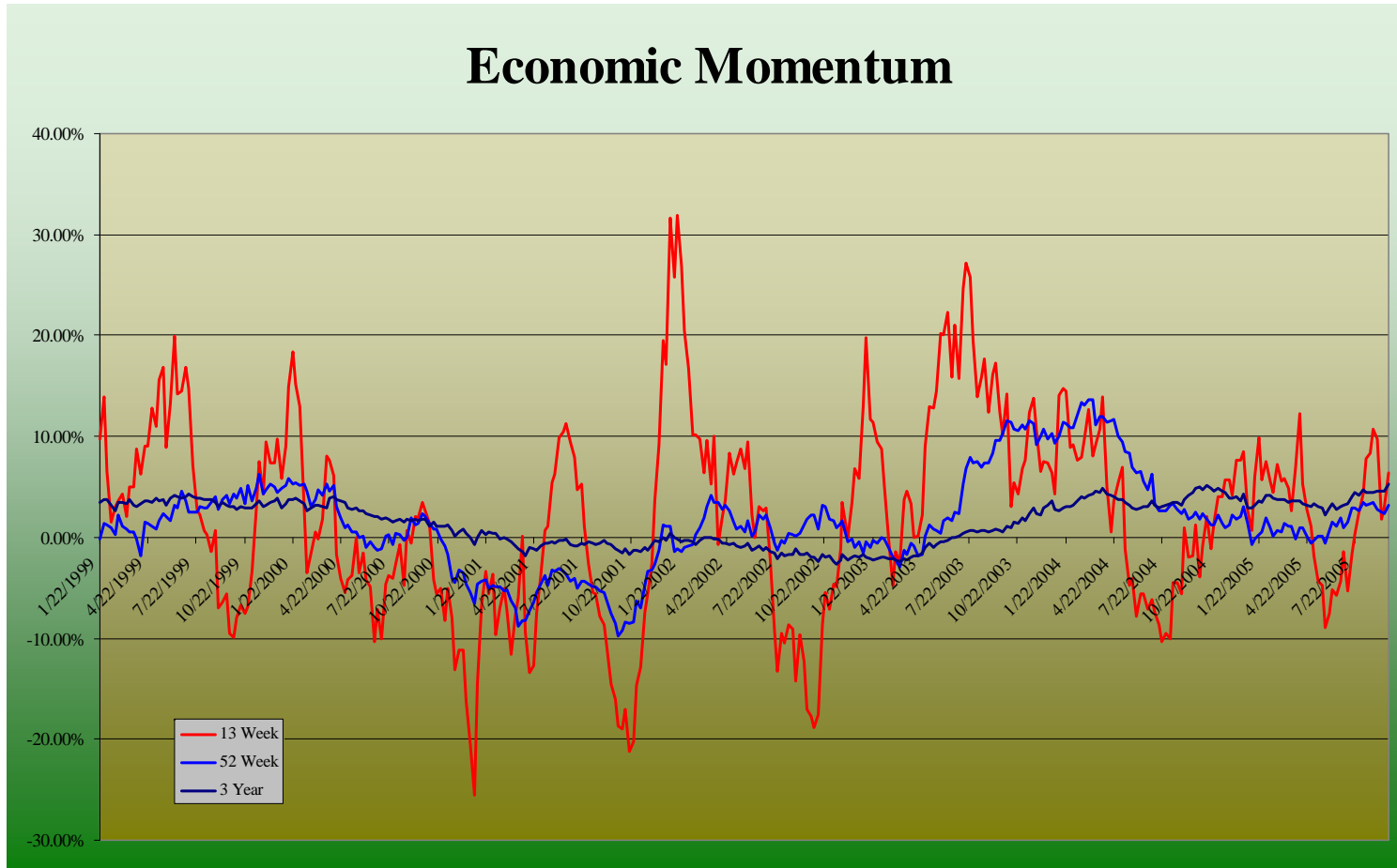
Outlook & Forecast



Earnings growth has been fantastic since early 2002, but there has been no price movement as the market PE continues to contract.

Based on past Chartbook research, PE ratios approximate 20 when CPI is less than 5% year-over-year; so, there is upside potential if earnings continue to grow.

Outlook & Forecast



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