

Goelzer Investment Management
Economic & Market Review and Outlook
July 1, 2004

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2004 is half over. Wow! It's been almost four years since the Sydney summer Olympics. More remarkable still is the fact that it's now been seven years since Hong Kong was returned to China. The tenor of the Goelzer EMRO articles has generally been one of measured optimism, though we temper that optimism with what we hope is a realistic appraisal of current economic and market trends. How have the changes you've experienced over the last several years affected your plans? It's important that you periodically reassess how changing circumstances and markets impact your financial wellbeing. Are your estate plan, life insurance coverage, and will—for example—up to date and capable of meeting your potential needs? While these issues aren't especially fun to address, they are critically important and require our periodic attention. Goelzer is here to help you with that process. As always, we are just a phone call away to assist with these and other financial matters as they arise.

The Economy

- The consumer price index (CPI) rose from a 1.7% annual rate to 3.1% during the 2nd quarter. Core CPI (excluding price changes in food and energy) stands at 1.7%, up from the first quarter, but still very low by historical standards.
- The unemployment rate has been holding steady at 5.6%.
- Non-farm payrolls continue to expand, with the economy adding over 1 million new jobs since the beginning of the year.
- Capacity utilization—long a leading indicator of business activity—has grown to 78% from a low of approximately 74% last year.

Outlook: As an example of dramatic changes over a short period of time, consider that it was only one year ago that the financial press was consumed with the threat of asset price deflation. Today, with the economy adding jobs and consumer and wholesale prices beginning to rise, the specter of deflation seems like a dull image in an old mirror.

The potential threats ahead are real: will the Fed act too quickly in its fight against inflation? How will China's fight against inflation and efforts to slow down economic growth affect the global economy? Indeed, how will the transition to sovereignty in Iraq ultimately impact economies around the globe? And, just to keep things interesting, how will the pending election effect economic growth and, in turn, earnings in coming quarters?

Despite the aforementioned issues, we expect the domestic economy is poised for a period of moderately-paced expansion, perhaps reflecting an annualized rate of 3.0% GDP growth for the second half of 2004, following the exceedingly robust growth we have enjoyed since the third quarter of 2003. The days of record monetary stimulus in the form of historically low interest rates are behind us, but with the recent job creation and still historically low interest rates, the economic expansion has shown signs of sustainability.

Stock Market

- The S&P 500 index is up 3.4% year-to-date, leading both the NASDAQ (+2.4%) and the Dow Jones Industrial average (+0.8%).
- With Crude oil prices spiking to over \$42 per barrel, the energy sector posted the largest gain in the S&P 500 (+15.2%) through the first half of the year. And, not surprisingly, basic materials, the sector perceived to be most negatively impacted by higher energy costs, lagged, posting a gain of 1.05%, making it the worst performing sector during the period.
- As interest rates have risen, financial stocks have performed better than feared, reflecting the diversification benefits experienced after the repeal of the Glass-Steagall Act. Our holdings in this sector have, on balance, continued to serve us well.

Outlook: Paying \$2/gallon at the pump sure was fun this spring, wasn't it? Many factors drove energy price inflation, including uncertainty about the outcome of the war effort in Iraq. Less frequently mentioned in the media was the fact that many integrated oil companies and independent refiners were restricted in expanding refining capacity to meet demand. California was particularly stern with its refining limits. With OPEC expected to

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increase output later this summer, oil prices have decreased significantly and are now down approximately 12% from their high of \$42/barrel. The performance of companies in the basic materials sector tends to be negatively correlated with that of companies in the energy sector, as materials producers rely heavily on fossil fuels in their production processes.

We are not inclined to believe that inflation presents a significant threat to the economy. In particular, the recent decline in oil prices will help close the gap between CPI and 'core-CPI' inflation. That said, the humbling science of financial forecasting sometimes seems to have all the credibility of medieval alchemy. Broad diversification among the economic sectors and a disciplined fundamental research process for identifying the best investment alternatives in a given sector go a long way toward mitigating the risk associated with future uncertainty.

Bond Market

- As expected, the Federal Open Market Committee (FOMC) raised the Fed Funds rate $\frac{1}{4}\%$ to 1.25% at its June 29-30 meeting. It was the first time in four years that the central bank had raised rates.
- Thus far in 2004, duration has had much greater explanatory power on portfolio performance than have the sector or credit quality aspects.
- As interest rates have risen through the first half of the year, short-term bonds have preserved value much better than intermediate and long-term bonds.
- Extension risk in mortgage backed securities has begun to play an increasingly negative role in total return fixed income portfolios.

Outlook: UBS trader and CNBC commentator Art Cahsin quipped yesterday that the Fed's action was as surprising as 'getting a tie for Father's Day', the Wall Street Journal reported. As mentioned, it was perhaps the most anticipated Fed move in recent memory. The FOMC again committed to continue to raise rates at a "measured" pace, and will likely prefer to move in 25 basis point increments through year end.

We expect that the Fed funds rate will be at approximately 2.0% by year end, and that the yield curve will begin to flatten with interest rates rising much more quickly at the short end than at the long end. If this bears out, it means that holders of short-term bonds will have better opportunities for re-investing maturity proceeds at higher yields. We have largely stayed clear of mortgage backed securities. As interest rates rise, homeowners will be more inclined to hold low rate mortgages obtained during the refinancing boom of these past two years. Holders of mortgage backed securities, in turn, will see their average durations extended. On the other hand, as interest rates rise, investors in short-term bonds will be able to adjust their yields upward while maintaining duration targets.

DJIA 10,435.50 S&P 500 1140.84 10 Yr. US Treasury 4.58%