

The year 2005 has started off rather unsympathetically for investors. While the losses were modest, most asset classes declined during the first quarter. Stocks are generally lower for the year and thus far the selling has targeted foreign and domestic, small and large, and value and growth stocks with more or less the same degree of contempt. Bond yields are up, which means that current bond values are in some cases lower than they were when we started the year. Stories of day trading building lots in sunny climes such as California and Florida aside, values of marketable real estate investments such as REITs have come down with rising interest rates, too. Ugh. Thinking back over the first quarter, it would be really nice to have an “undo” button to push.

We’re not sure if there is any solace in philosophy when discomfort is acute, but maybe there is a point in reflecting a bit at this juncture. For example, recall that there is an inverse relationship between risk and reward. That is, the stability of returns will be highest for low-return investments and vice versa. The football coach equivalent is: “no pain, no gain!”

This brings to mind an important question: is your portfolio structured to meet your future needs in a manner that lets you breathe easily? Is your need for gain aligned with your tolerance for pain? Like your estate plan, your risk tolerance and investment objectives change over time and must be periodically reviewed and adjusted. Perhaps your future goals and expenses can be adequately funded with less risk. Or maybe your present circumstances now require a higher return target. Whatever the case, be sure to let Goelzer know about the changes in your life. Those details matter to us personally as well as professionally.

The Economy

- Non-farm payrolls have continued to grow, albeit at a decelerating rate.
- Both producer and consumer prices have displayed modest inflationary patterns. The largest impact on that trend has been (no surprise here) the price of oil.

- The US Dollar strengthened vs. both the Yen and the Euro during the quarter, inspired in part by higher interest rates and a rising demand for US based investments by foreign investors. Curiously, the trade deficit continued to expand as well.

Outlook: The word *globalization* is loaded. For some, it conjures images of large western companies exploiting emerging market laborers. Another side sees globalization as the key to sustainable prosperity: it should lead to economic rationalization on the production side by lowering trade barriers and forcing countries to embrace their comparative advantages. Regardless of the camp you find yourself in, we can agree on the fact that, like the internet, globalization will probably be with us for a while. Thus, global economic awareness becomes even more important.

In last quarter’s EMRO we discussed the trade balance and its implications for domestic and global economic growth. Curiously, the weakness of the dollar has not provided much help for our import/export gap. We can thank China for part of that phenomenon: the Yuan, the Chinese currency, is pegged to the dollar, meaning that as the dollar has weakened so too have the relative prices of Chinese exports. Another factor is the sluggishness of European economies—France and Germany each have double-digit unemployment and slowly expanding economies.

However, on the domestic front, our economy continues to move forward, if at a modestly reduced pace, despite the twin assaults of higher energy prices and interest rates. It remains our belief that interest rates will continue to rise at a measured pace throughout 2005 and oil prices will continue their recent moderating trend from the record high of over \$58 per barrel, but remain at elevated levels. This scenario provides a backdrop for our economy to grow at a 3.5% to 4.0% annual rate through the balance of 2005.

Stock Market

- The S&P 500 index and the Dow Jones Industrial Average both gave up ground in the

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first quarter, as traders worried about the impact of rising short-term interest rates, high oil prices and their combined impact on the economy.

- Small capitalization stocks, leaders over the past several years, actually led the decline during the first quarter.
- Repeating the news from the second half of last year, energy and utility stocks have lead the way thus far in 2005 and are up 18.60% and 5.25%, respectively. Materials and consumer staples stocks also turned in positive performance for the quarter.

Outlook: Much has been written about the valuation disparity that often develops when a particular market segment or investment style moves into or out of favor. Remember the latter half of the 1990s, when growth stocks sizzled while value fizzled? Shares of large companies soared and small companies swooned? It was the extremes reached during that period that set the stage for the out-performance of both the value style and small company stocks over the past five years. We may now be reaching a point at which the contractions in the valuations of many well known growth companies are too compelling for the market to ignore. For example, while Wal-Mart's earnings have doubled over the last five years, its shares have tread water. This phenomenon has occurred countless times, as earnings must catch up with valuations reached during more optimistic times. As valuations on many stocks are at multi-year lows, balance sheets in pristine shape, and free cash flow and earnings growing—though more slowly than last year—we anticipate that many stocks which have struggled in the recent past may begin to attract investors' attention as we progress through 2005.

Bond Market

- The yield curve has continued to flatten slightly. Six month T-Bills now yield about 3.0%, up from 2.6% to start the year. The yield on ten year T-Notes increased from 4.2% to 4.5%.

- Investigations into accounting improprieties at Government Sponsored Agencies (GSAs) have strengthened the position of bond holders by way of healthier balance sheets.
- Despite this, corporate spreads have remained tighter and GSA spreads wider than we believe appropriate.

Outlook: The Fed has been acting pre-emptively to stave off inflation for nearly a year now by raising short-term rates. The bond market, however, has responded with only slightly higher yields in the intermediate range. What's curious is that we have both inflationary pressure and growing trade deficits yet rates have moved only slightly higher. Why is this? The answer to that question, like the energy issue, may be either financial or economic in nature.

A financial possibility is the carry trade. The carry trade refers to a transaction where institutional investors act like savings & loans: they borrow short-term money and invest it longer-term, thus locking in the yield differential. As the yield curve flattens, the carry trade becomes less profitable. Investors then sell their investments (driving yields up) and pay off their loans.

Economic possibilities mainly take one of two forms: 1) the market is wrong—that is, the economy *is* growing—and rates are about to move higher, or 2) the market is right and we're headed for an economic slowdown, i.e., rates should be low.

We're inclined to think that though real wage growth for hourly employees remains sub-optimal, the economy is otherwise progressing at a comfortable pace. The risk of a recession seems much farther from the minds of Fed governors than does the risk of inflation. If the market has it wrong and the Fed continues to raise rates, then the closing out of carry trade positions could well lead to significantly higher yields on intermediate and long-term bonds, and that change may happen quickly. Since mortgage rates are tied to the yield on ten year Treasury notes, this may be a good time to review any variable rate loans you might have.

DJIA 10,503.80 S&P 500 1,180.59 10 Yr. US Treasury 4.48%

