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Investment Outlook Third Quarter 2005

In the face a stiff headwind created by rising short-term interest rates and energy prices, bonds rallied and stock prices held steady. For the quarter, the S&P 500 gained 1%, Nasdaq increased by 3% and the DJIA declined 2%. In the bond market, investors saw the 10-year US Treasury note yield drop from 4.46% on March 31 to 4.06% on June 30. The general backdrop of the financial markets during the quarter continued to be strong economic underpinnings coupled with low inflation expectations.

Our thesis for the past six months has been that the stock market averages wouldn't progress materially until the Federal Reserve Bank moved monetary policy back to a neutral posture. With signs of economic softness in the early weeks of the quarter, investors began to anticipate the end of the Fed's tightening phase. The yield on the ten-year US Treasury Note actually dropped to 3.90% at one point during the quarter until the Fed squelched any thought of an early end to their rate hikes when they released comments after the June 30 Fed meeting. At the conclusion of this meeting, the Fed release stated "The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Although energy prices have risen further, the expansion remains firm and labor market conditions continue to improve gradually. Pressures on inflation have stayed elevated, but longer-term inflation expectations remain well contained." Since this statement, the stock market has strengthened and the bond market has weakened on expectations of continued economic vigor.

Consensus now calls for the Fed Funds rate to settle at 3.75%-4.00% by year-end. This would imply action by the Federal Open Market Committee at 25 basis point increments through November or December of this year. Energy prices have clearly been a major impediment for the stock market this year, even though the overall economy has coped reasonably well. Nevertheless, with oil prices stubbornly holding above $50/barrel and gasoline prices now well above $2.00 per gallon, the economic risks have risen. There are concerns that if these price levels persist, consumer spending will ultimately soften. It has been estimated that every $10 increase in oil prices reduces GDP growth by 0.5%. Auto, airline and leisure industries are the most direct losers in this environment with retailers not far behind as consumers are forced to spend more of their disposable income on energy related products.

Corporate earnings growth has continued the recent pattern of significantly exceeding expectations. First quarter earnings for the S&P 500 maintained a string of double digit profit growth, posting a 13% increase over the same quarter a year ago. Projections had called for growth of 7-8%, so once again the embedded pattern where reported results far outpaced predictions was extended. For the current quarter, growth is estimated at 8%, a rate which would break the double digit profit growth string at 12 consecutive quarters. However, early indications suggest earnings reports are once again beating forecasts. Another sign concerning the health of corporate America is the record high earnings and cash flows that exist today. During the current economic expansion, corporations have, on balance, preferred to repair their balance sheets allowing their cash reserves to build as opposed to investing in capital equipment or hiring additional workers. Recently, there is evidence that in addition to share buybacks and dividend hikes, cash flows have begun to be deployed increasingly for capital equipment and corporate acquisition activities. While labor growth continues to be sub par for this point in the economic cycle, the unemployment rate has declined to 5%, until recently a level considered to be approximately "full employment" for our economy.

During the past 18 months, valuation levels have declined as earnings have risen significantly faster than stock prices. Broad stock market indices such as the DJIA and the S&P 500 are now carry mid-teens price/earnings ratios, about where they were in 1996 prior to the stock market bubble of the late 1990s. At these levels, valuation is no longer a significant inhibitor to higher stock prices.

Now that the dollar has rallied and the US federal deficit appears to be shrinking, energy prices, potentially rising interest rates and the US trade deficit are the concerns most cited by stock market investors nowadays. In the face of these concerns, we remain convinced that when investors are persuaded that the Fed has finished raising short-term rates, the stock market will produce a healthy rally. With short rates likely to plateau in the fourth quarter, we look for a year-end rally not dissimilar to last year. Many strategists suggest that large cap growth stocks are amongst the most attractive sectors in the present market environment. In a market where growth is moderating, our equity style focused on consistent earnings growth has historically produced the best results. Indeed, growth stocks have already begun to outperform the overall market in the past few months. Indicative of this trend is our own equity performance which has handily beaten the market averages this year.

In summary, our expectations for the second half of 2005 call for somewhat higher interest rates influenced by a continuation of Fed rate hikes into the fourth quarter. Energy prices should moderate temporarily as peak summer demand eases and supply steadies. Anticipation persists for corporate earnings to decelerate and inflation expectations to stay subdued. With this as a backdrop, stocks should remain constrained until we are near the end of the Fed rate increases. In this type of environment bond yields are likely to rise moderately.