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Investment Outlook Fourth Quarter 2004

In keeping with history, the third quarter once again proved to be a difficult period in the stock market. Financial markets began to discount a slowing economy as employment growth displayed signs of slowing as summer had begun. And in what seems contradictory, just as the Fed began to raise short term interest rates, intermediate and longer-term rates actually declined. In reality, this action where the yield curve flattens is much in keeping with a slowdown in economic growth. Our best analysis suggests that as economic growth continues, the yield curve may indeed flatten further, but the overall level is also likely to rise. Over the next year, we look for the rate on the ten-year US Treasury Note to rise to over 5% from around 4% currently. At the same time, we expect the Fed to continue the process of raising the Fed Funds rate from the current level of 1.75% to between 3% and 4% by the end of 2005.

As we write this outlook, the stock market is plagued by uncertainty over the outcome of the US Presidential Election, high oil prices, the threat of terrorism and concerns over slowing corporate profits. While we share these concerns, we are increasingly optimistic that a post-election rally is possible. The market seemed to be rallying in September when most polls suggested that President Bush had built a big lead. After the debates, with the polls now showing a dead-heat, the market has retreated. When an incumbent wins re-election, the market has rallied 90% of the time. With the election outcome still in question, the market is behaving tentatively. It is our belief that we will experience a post-election rally regardless of who wins the election. If President Bush wins, investors will be comforted that a pro-business, pro-growth candidate will govern for the next four years. His re-election will likely spark a rally in healthcare stocks, energy stocks and property & casualty insurance stocks. If Senator Kerry wins, the positive reaction may not be immediate, but investors have historically benefited from the gridlock inherent in a divided government. With Republicans likely to retain or extend their control of both houses of Congress, Democrats would control the White House and Republicans would control Congress, similar to most of the 1990s. Government spending would almost certainly slow, allowing the private sector the resources necessary for accelerated growth. On the downside, a Kerry Presidency would likely be less favorable with regard to taxes, particularly taxes on capital. While a Republican Congress may not go along with all of Kerry's proposed tax rate hikes on income taxes, many of the Bush tax cuts would likely sunset in the 2006-2008 timeframe.

The war on terror has taken center stage in the Presidential Election and is clearly weighing on investor's minds. Investors are demanding a greater risk premium when it comes to equity investments and this has revealed itself in contracting valuation levels. The threat of terror has also had an impact on energy prices. Oil prices have pierced $50/barrel as a perfect storm of accelerating demand, moderating supply and the threat of a terror attack on a major oil pipeline has driven prices to record

levels. On an inflation adjusted basis, oil prices are still some $30/barrel below the peak price in the late 1970s and oil has steadily declined in importance for the US economy.
Still, economists believe that every $10 increase in the price of oil translates into a loss of approximately 0.5% in GDP growth. In addition, the terror risk premium on oil prices has been estimated at between $10-$15/barrel. With oil hovering near $55/barrel, GDP growth would suffer by close to 1% if these high prices were sustained. And with increasing demand from China and India and the unlikelihood that the terror threat will dissipate anytime soon, it is safe to assume that higher prices will be with us for the foreseeable future. The concern of high oil prices for financial market participants is not only one of reduced GDP growth expectations, but also the inflationary effects high oil prices may have on businesses and consumers. Thus far, with consumer prices in check, investors appear to be more worried about growth than inflation, but the longer-term implications of rising oil and other commodity prices must not be ignored.

With oil prices at elevated levels, the Fed determined to raise interest rates further, record federal budget and trade deficits, a fragile dollar, slowing corporate profit growth, and an uncertain Presidential election, one may ask why we believe a stock market rally is at hand? First, our expectation is for a short-term trading move that carries stock indices higher by 5% - 15% in the next three to six months. Although corporate profit growth is indeed slowing, the rate of growth is still very respectable and sustainable. And while consumer spending has slowed somewhat, the indications are for a decent Christmas selling season for most retailers. In addition, the fourth quarter tends to be the strongest economic quarter of the calendar year. Coupled with favorable flow of funds from retirement plans and employment bonuses, and a lackluster performance year-to-date, we believe a year-end rally is probable.

It is much harder to build a case for a long sustained bull market given current conditions. While valuation levels are fair given current interest rate and inflation expectations, our concern is that both inflationary expectations and interest rates are likely to trend upward, pressuring price/earnings ratios. We are increasingly apprehensive about the outlook for stock prices in the multi-year timeframe. Any student of history will relate that it takes a good decade or longer after a financial bubble bursts before markets are able to normalize. With the bursting of the internet and telecom bubble in 2000, that would suggest that stock market gains may continue to be sub-par through the end of the current decade.

With this in mind, we are redoubling our efforts to identify economic sectors, asset classes and alternative investment vehicles that may provide better rates of return in the years ahead. The types of ideas we are currently evaluating include international investments, commodity and currency funds, inflation-linked securities, principal protected securities and energy related investment vehicles. Our analytical emphasis is not only on improving returns in a low-return environment, but on reducing risk through additional diversification. Over the next six months, it will be important for us to discuss the appropriateness of these alternative investment vehicles with each client. We look forward to having these discussions.