

Monthly Chartbook

July 2004

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Executive Summary

Buy, Sell, Hold? Which way is up?

We have transitioned to a sustainable rate of growth consistent with low inflation, job growth and profitability. **Or have we?** The bears would have you think that the economy is so leveraged to interest rates that the small rise in the Fed Funds rate combined with stubbornly high energy prices is going to tip us back into recession, or worse. The Pollyanna's that are bullish are putting a high forward P/E on the \$65 to \$75 dollars worth of forward EPS on the S&P 500 to get a forecast of 1300 to 1500 for the S&P 500. Neither is right. Growth can, will and is continuing, but the P/E multiple contraction continues as well.

As we are stuck in a trading range that seems to want to take this market down, this month we take a **fair and balanced look at the market.** We will look at the bearish perspective and the bullish perspective. What are the opportunities? What are the risks?

Executive Summary

Risks:

- Terror premium in oil becomes real and oil terror disrupts supply from the Middle East, Russia, major pipeline, Etc.
- Domestic terror causes US citizens to hunker down, stay home, and not spend.
- Consumer slowdown as refinancing boom ends.

Opportunities:

- Global growth led by China continues.
- Energy prices moderate.
- Market is undervalued if trendline growth persists over the next 4-6 quarters.

Bear Case

- Stocks are outrageously overvalued versus history.
- The consumer is over leveraged
- The dollar is verge of downward spiral due to our spendthrift ways.
- We are living on the kindness of China & Japan to finance our deficit.
- The USA is no different than Japan post-bubble
- Chinese growth and, hence, global growth is at risk.

Bull Case

- The market on a forward earnings basis is undervalued at 15.8 times forward earnings versus a high teens historical average when rates are this low.
- Moderating growth will give the expansion legs to persist well into the future.
- Inflation and interest rates are low historically and likely to stay moderate.
- Corporate balance sheets are strong, and profits as a percentage of GDP are high historically.

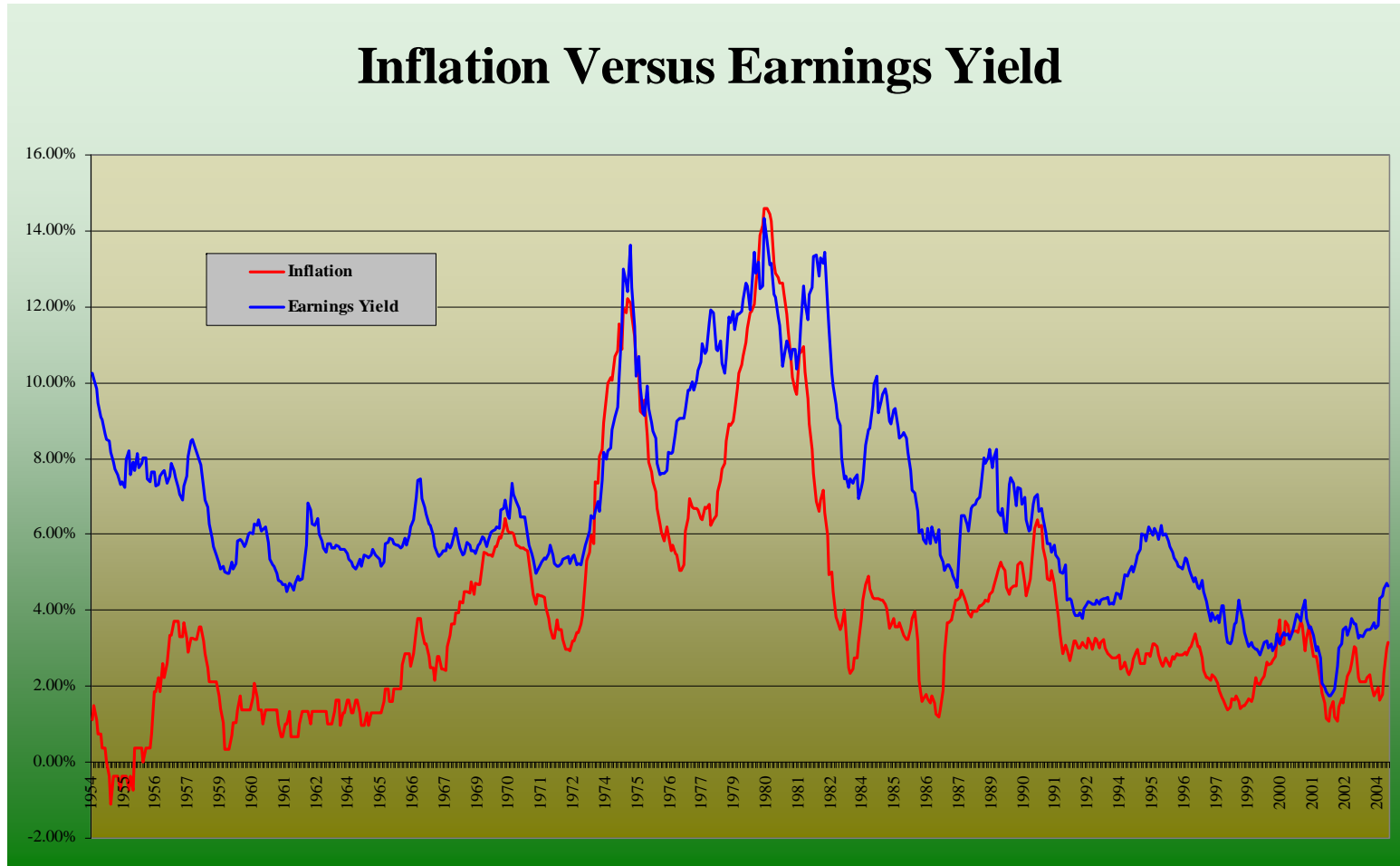
Rebuttals to both the bears and bulls

A Dow Jones Industrial Average at 5000 (a popular target for the bears) would imply a trailing P/E ratio of 8.99, which would be a screaming “**Buy**” versus current interest rates. The long bond would need to be 9-11% to have this low of a P/E. Likewise, it is equally foolish to put a “dot-com boom” multiple of 20+ on the market. The median P/E on the S&P 500 since the second world war is 15.5; so, at worst, the market is fairly valued on a forward earnings basis.

Consumers are more leveraged than any time in history, but the bulk of the leverage is tax advantaged mortgages. The Fed’s financial obligations ratio for homeowners is 15.54% of disposable personal income, after having peaked in 2002. Is housing in a bubble? Or are prices just symptomatic of the fact that money supply has grown 47.55% over the last four years and GDP has growth 18.59%?

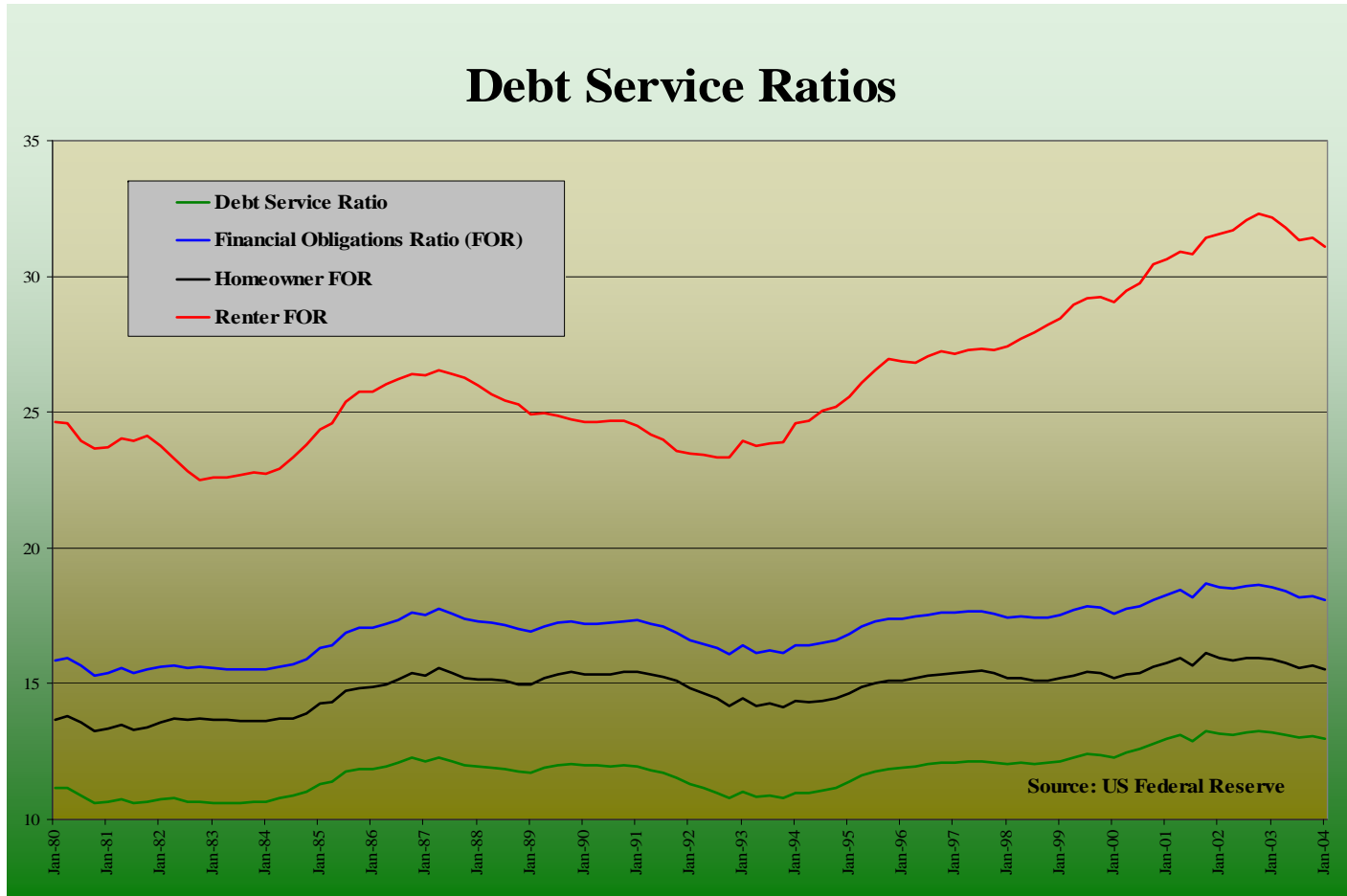
Financing the deficit is a structural problem that both bulls and bears would agree needs to be addressed. But we are at war....

Macro-economic Research



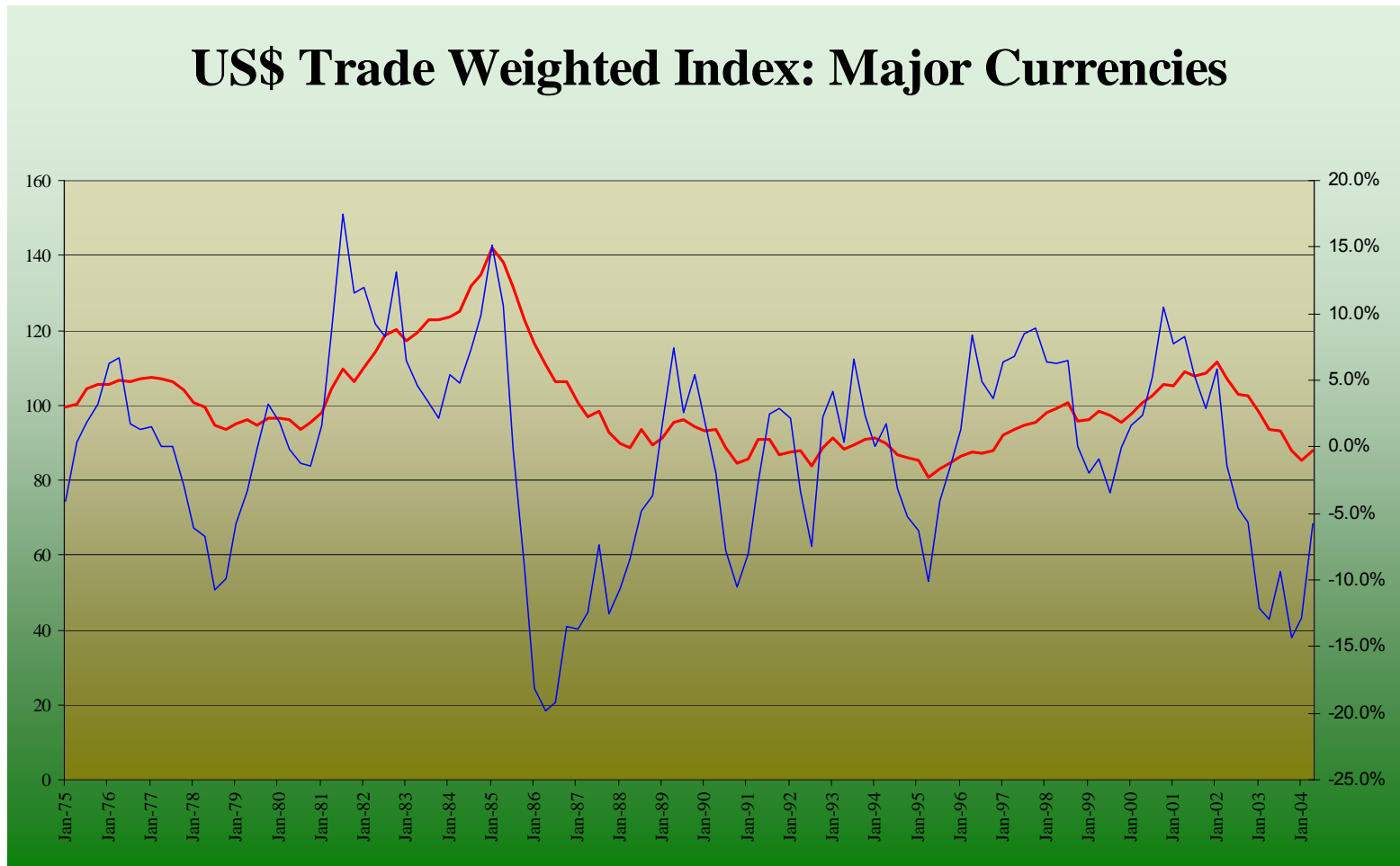
The earnings yield (1/trailing P/E) is positively correlated to the rate of inflation.

Macro-economic Research



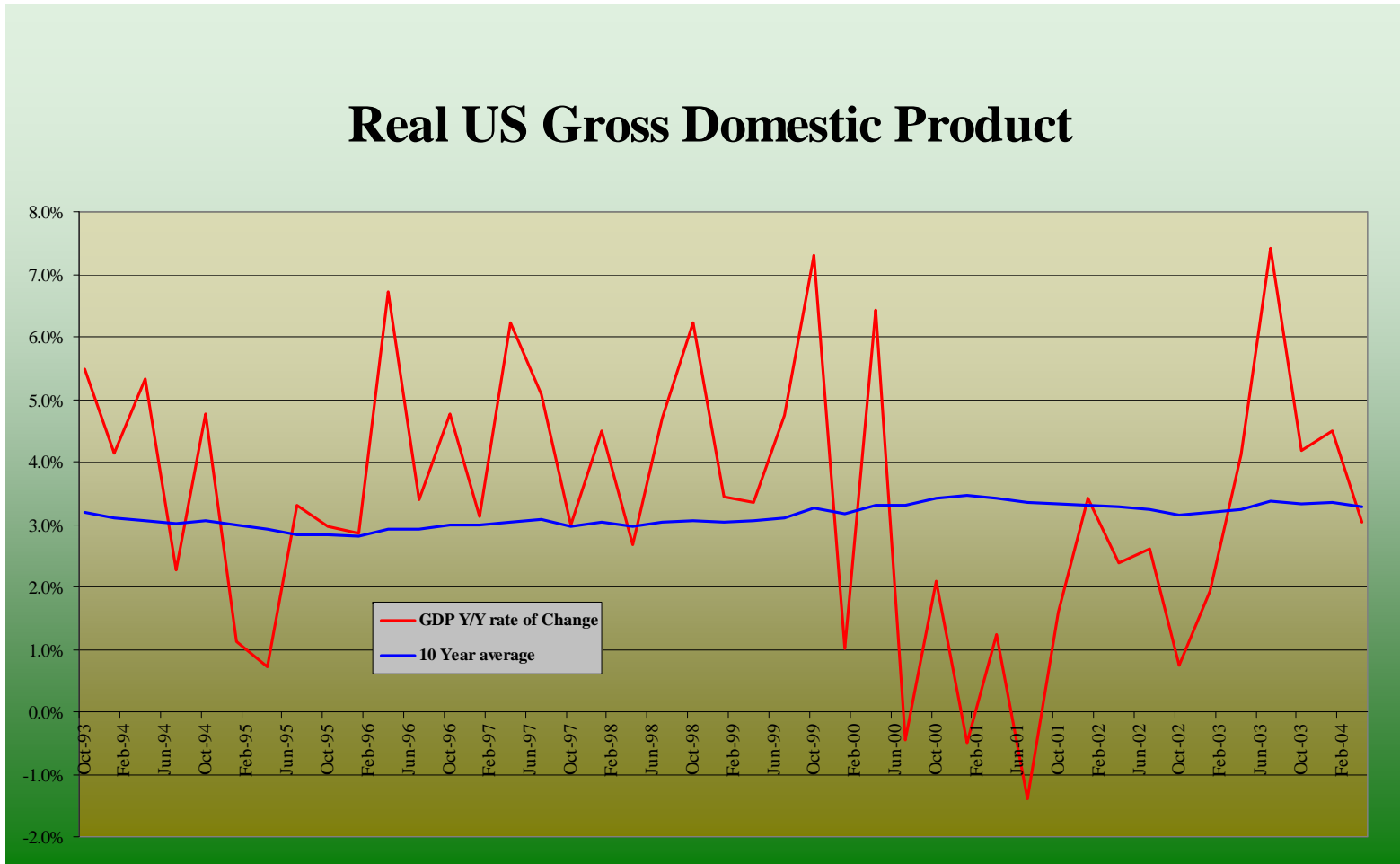
Based on cash flow, and not absolute levels of debt, consumers look okay--except for renters. This makes perfect sense because they haven't benefited from rising home prices.

Macro-economic Research



The dollar has been stronger and it has been weaker as well. Our status as the world's reserve currency allows us to monetize our debt with few consequences. Over time, that might change.

Macro-economic Research



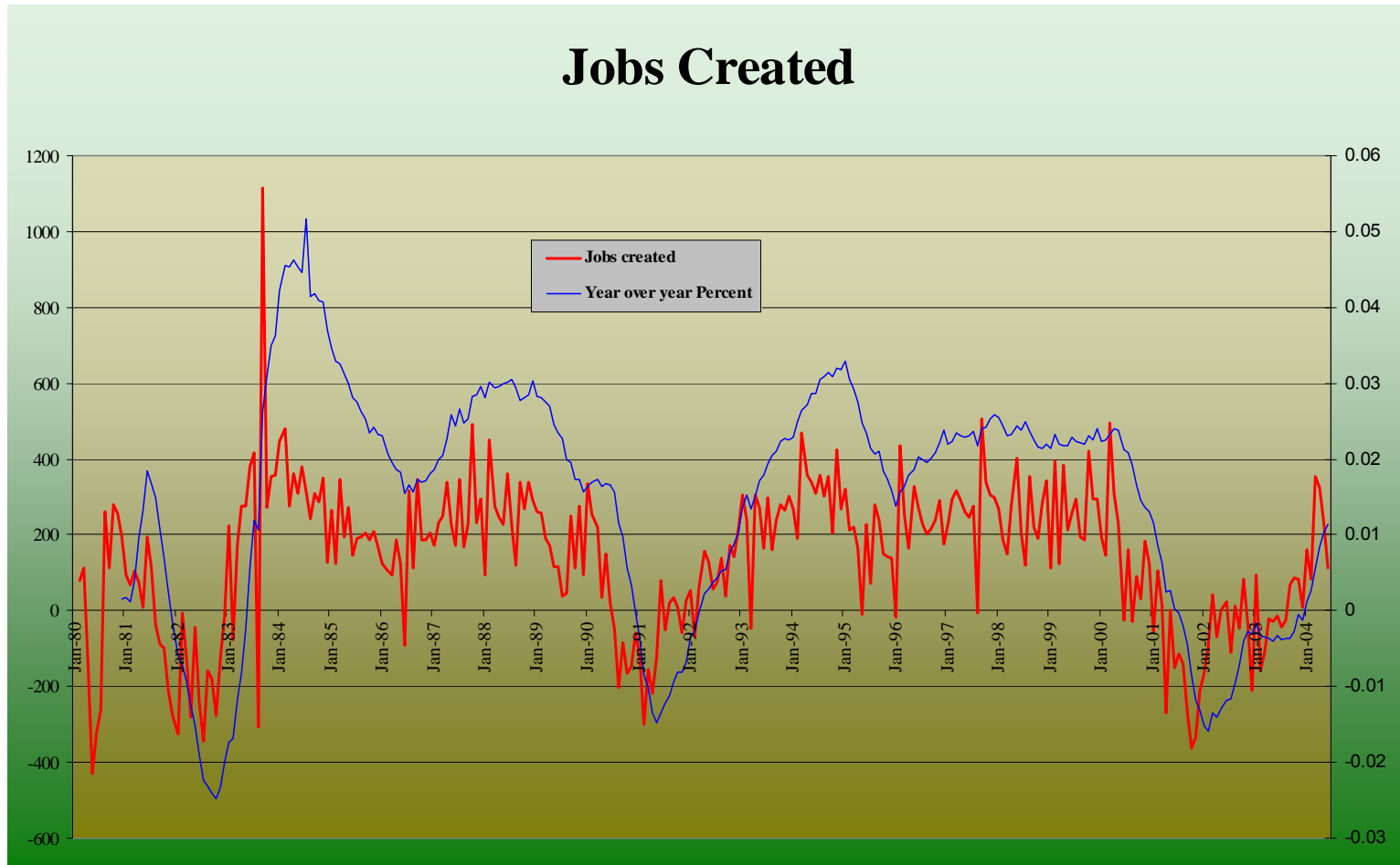
Real GDP growth contracted in the second quarter and is running below the 10 year average trendline.

Macro-economic Research – Current employment

Continued gains in employment are critical at this point in the business cycle. Employment is widely viewed as a lagging indicator, made worse by the large investment in technology over the last 10 years in the USA. One man's productivity gain is another man's job loss.

- Red hot job creation – almost 1 million new jobs in the past three months, has cooled. But growth has not stopped.
- Initial jobless claims remain below 350,000 -- a level consistent with robust job growth.

Macro-economic Research



The past three months have shown continued strong job creation, running at an annual rate of 1.34 million a year versus a red hot 2.8 million a year in the prior month. The percent of jobs created year over year remained above 1% for just the second month.

Macro-economic Research



Jobless claims remain below the critical 350,000 level indicating continued growth in the labor markets.

Earnings, Earnings, Earnings...

For the quarter they have been quite good, but the market is more worried about the future direction of earnings.

The percent rate of growth may have indeed peaked for the cycle, but absolute earnings have not.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1101.72	Trading range	↑	980-1180	End of 2004
Ten Year Treasury	4.47%	4.65%	↔	4.35%-4.875%	9 months
Inflation (all Urban)	3.00%	2.75%	↔	2.50%-3.10%	6 months
Fed Funds	1.25%	1.25%-1.50%	↑	1.25%-1.75%	4 months
S&P 500 Earnings	\$52.52	\$58.50	↑	\$55-59	3q2004
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

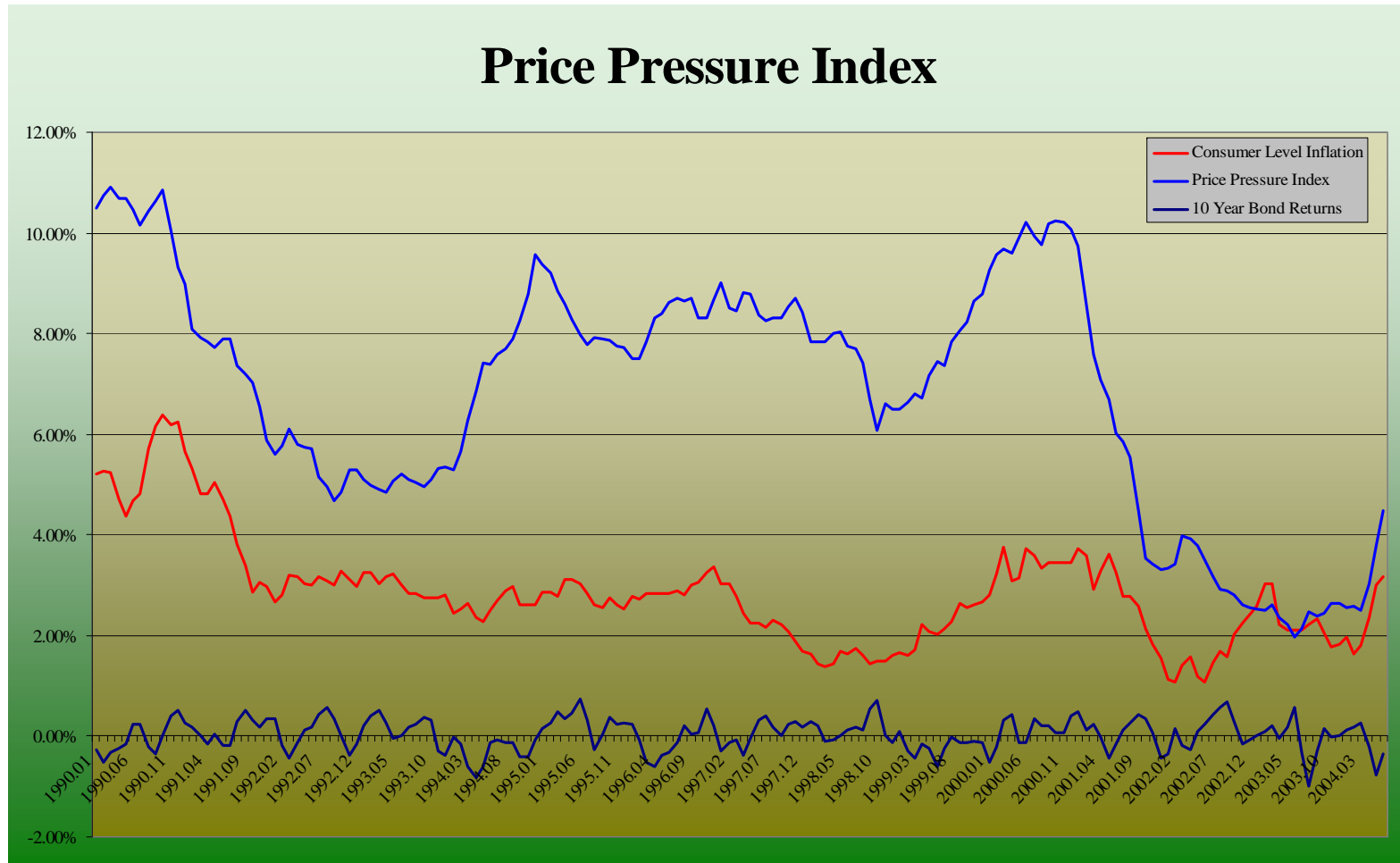
Inflation expectations

The Fed has worked hard over the last couple of years to fight off deflation and reflate the global economy, and it is working.

Pricing power has returned. Prices on the wholesale level and the consumer level have both moved up. Core rates that exclude food and energy have moved up as well.

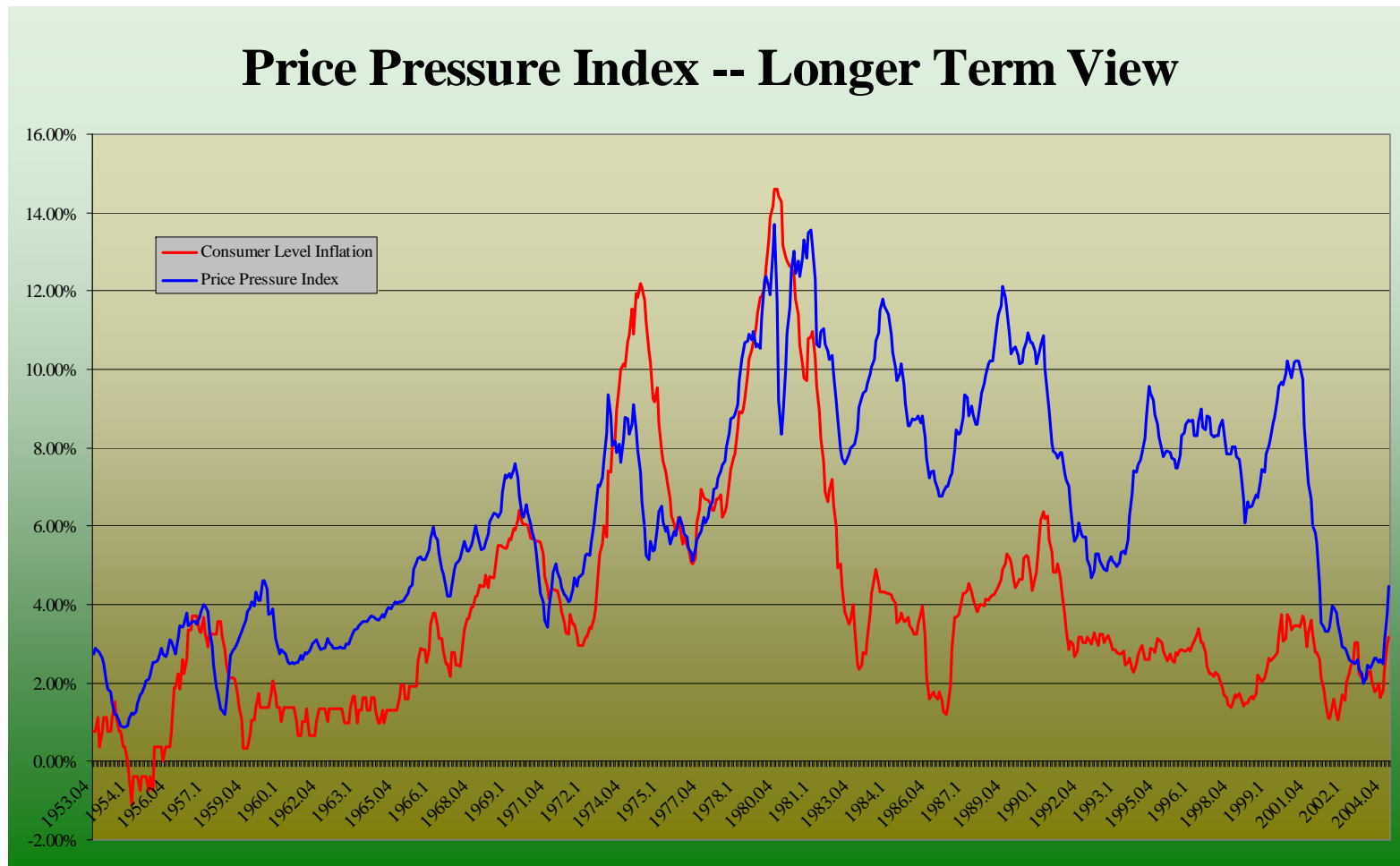
Prices need to moderate over the remainder of the year for the expansion to remain “balanced”. If not, the Fed will have to work rates higher faster, and that would hurt growth and rates at the same time negatively affecting stock prices.

Inflation expectations



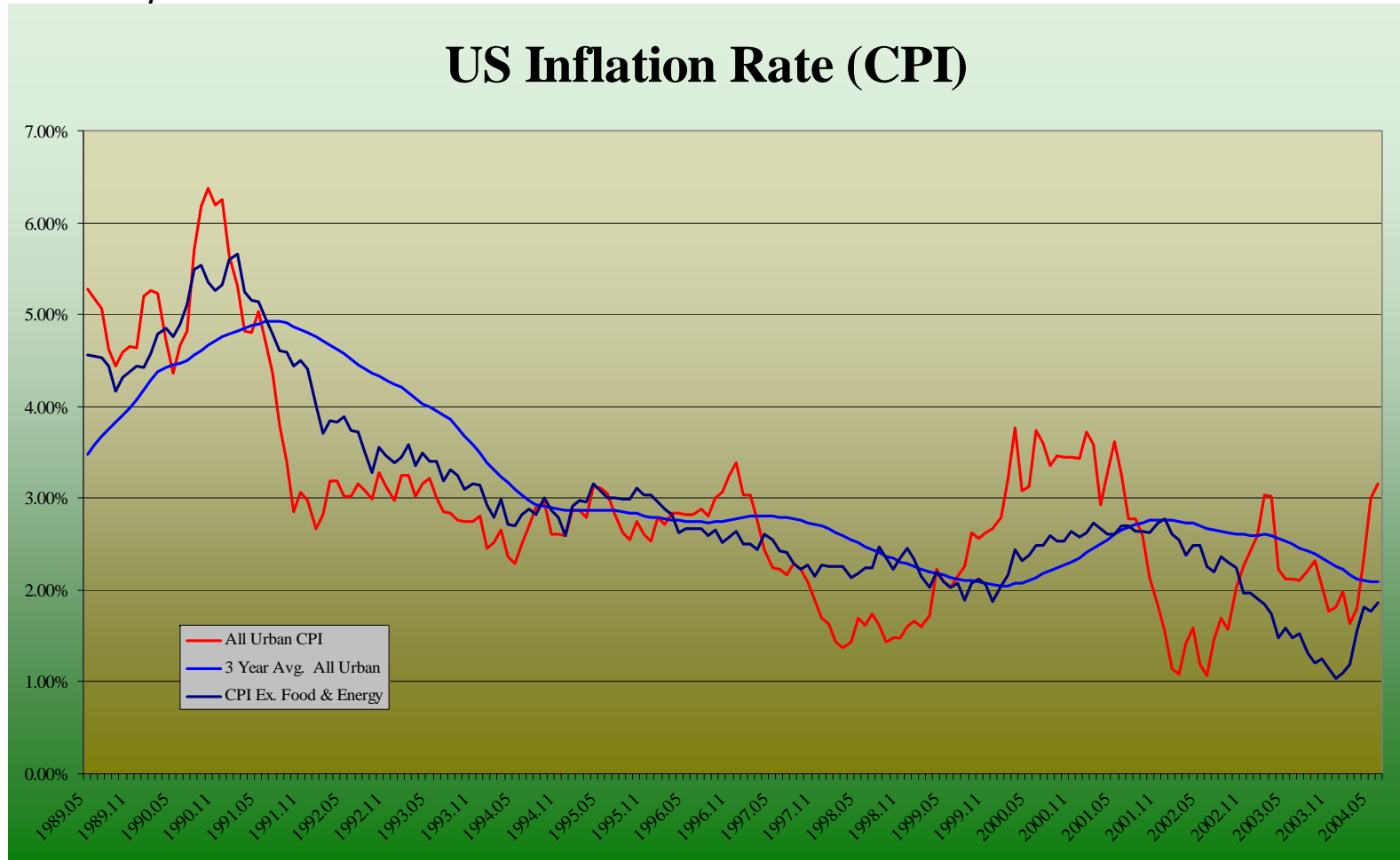
Price Pressure Index remains sharply higher. Good news for pricing power, bad news for rates.
This causes us to maintain a bearish outlook on bonds.

Inflation expectations



Although it moved off its low this month, price pressure and consumer level inflation are still well within reasonable levels. The long run average in inflation is 3.10% so recent history has been abnormally low.

Inflation Expectations



To the extent that higher prices are demand driven and not caused by supply shocks, higher prices are bullish for stocks.

Federal Reserve Watch

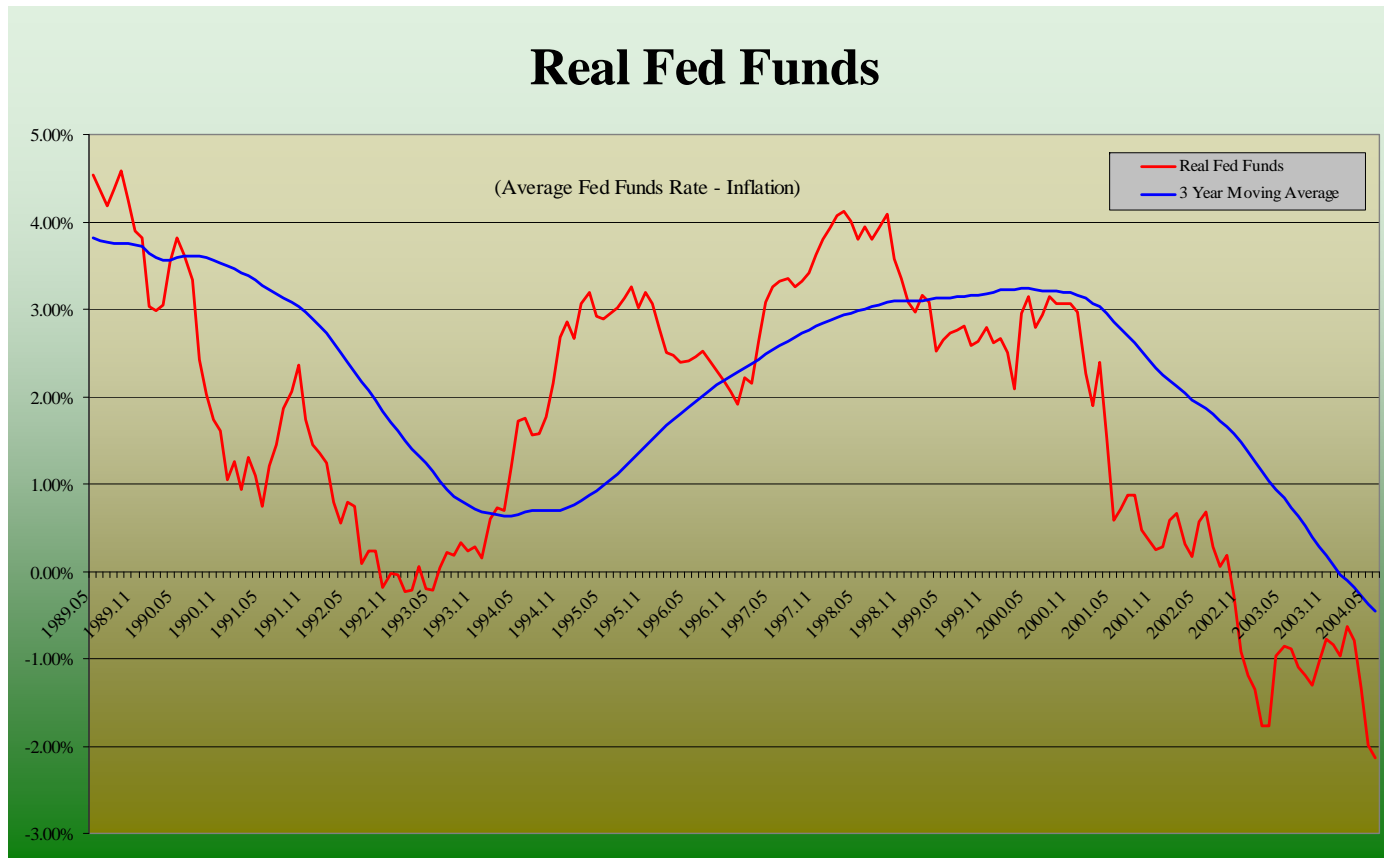
Monetary policy is starting to lose it's punch, or said another way Dr. Greenspan has started taking the punch bowl away.

Going from negative real rates to positive, if done slowly enough should not cause major dislocations within the economy.

That said...

Be warned! Financials are more than 21.35% of the US market cap and have done quite well over the last couple of years. This is in part due to the refi boom and a negative cost of funds via the negative real rates. It's hard not to imagine financials at least underperforming the broader market over the next couple of years.

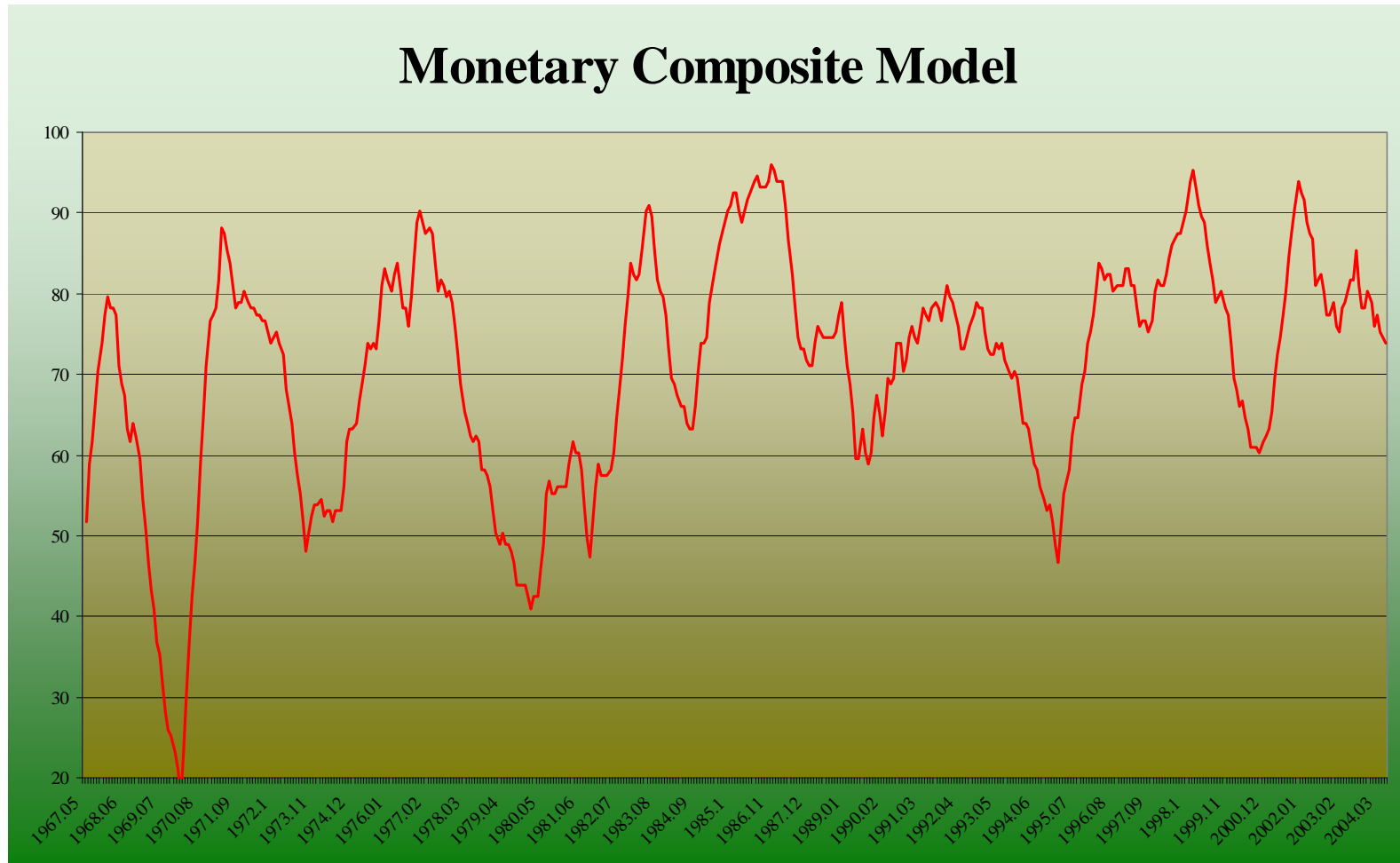
Federal Reserve Watch



Even with the rate increase, real interest rates are strongly negative as inflation has increased more than rates have.

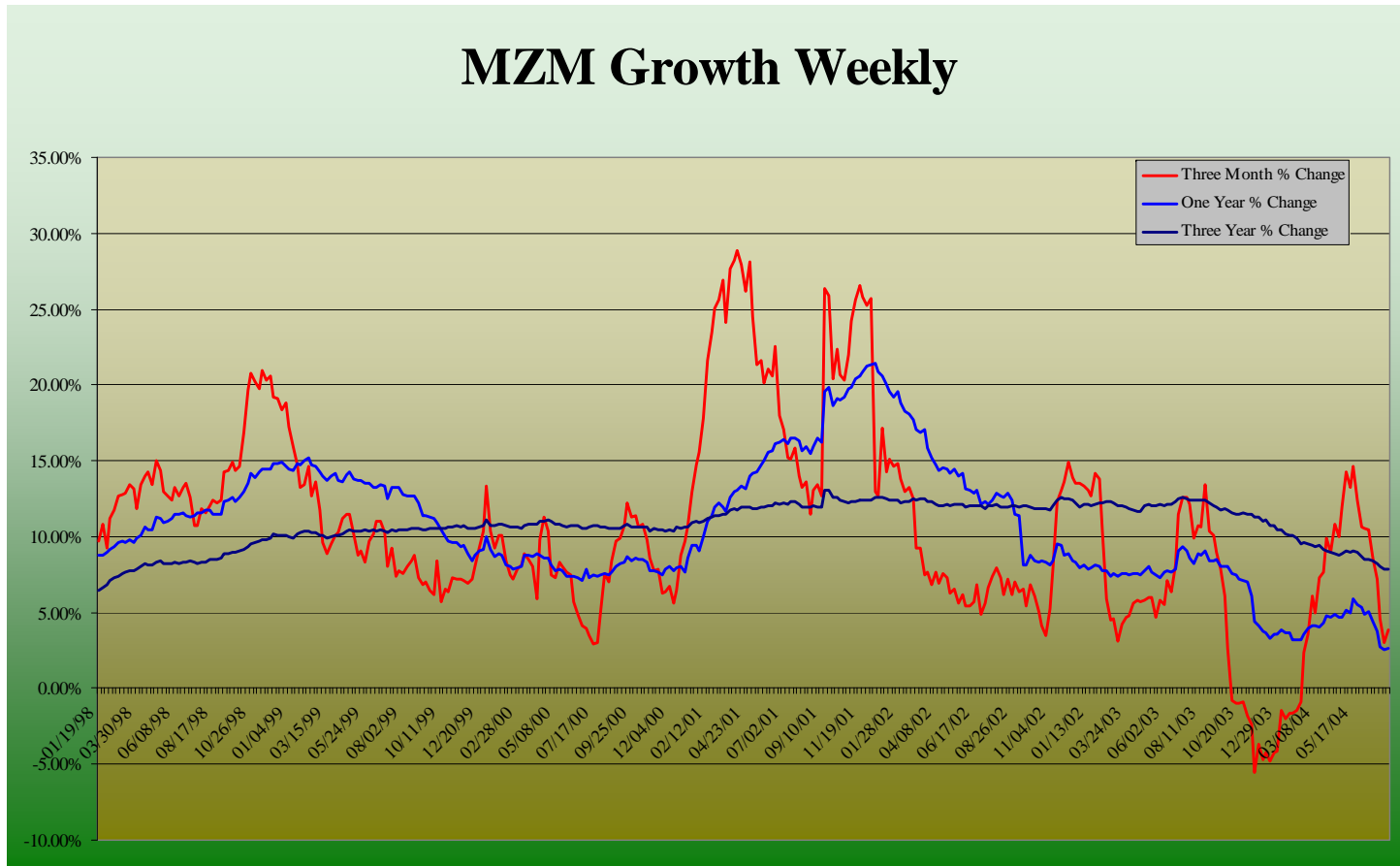
The year over year changes for inflation will likely moderate while interest rates gradually rise over the remainder of the cycle.

Federal Reserve Watch



The direction of trend in this series is as important as the level. A score above 50 indicates the Fed's monetary policy is accommodative. Higher interest rates as well as slowing money supply have affected this model and will likely continue to do so as its measure declines. Monetary policy could be a headwind for some time to come.

Federal Reserve Watch



Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices. The 3 month growth rate of money supply has declined after rapid growth since the beginning of the year.

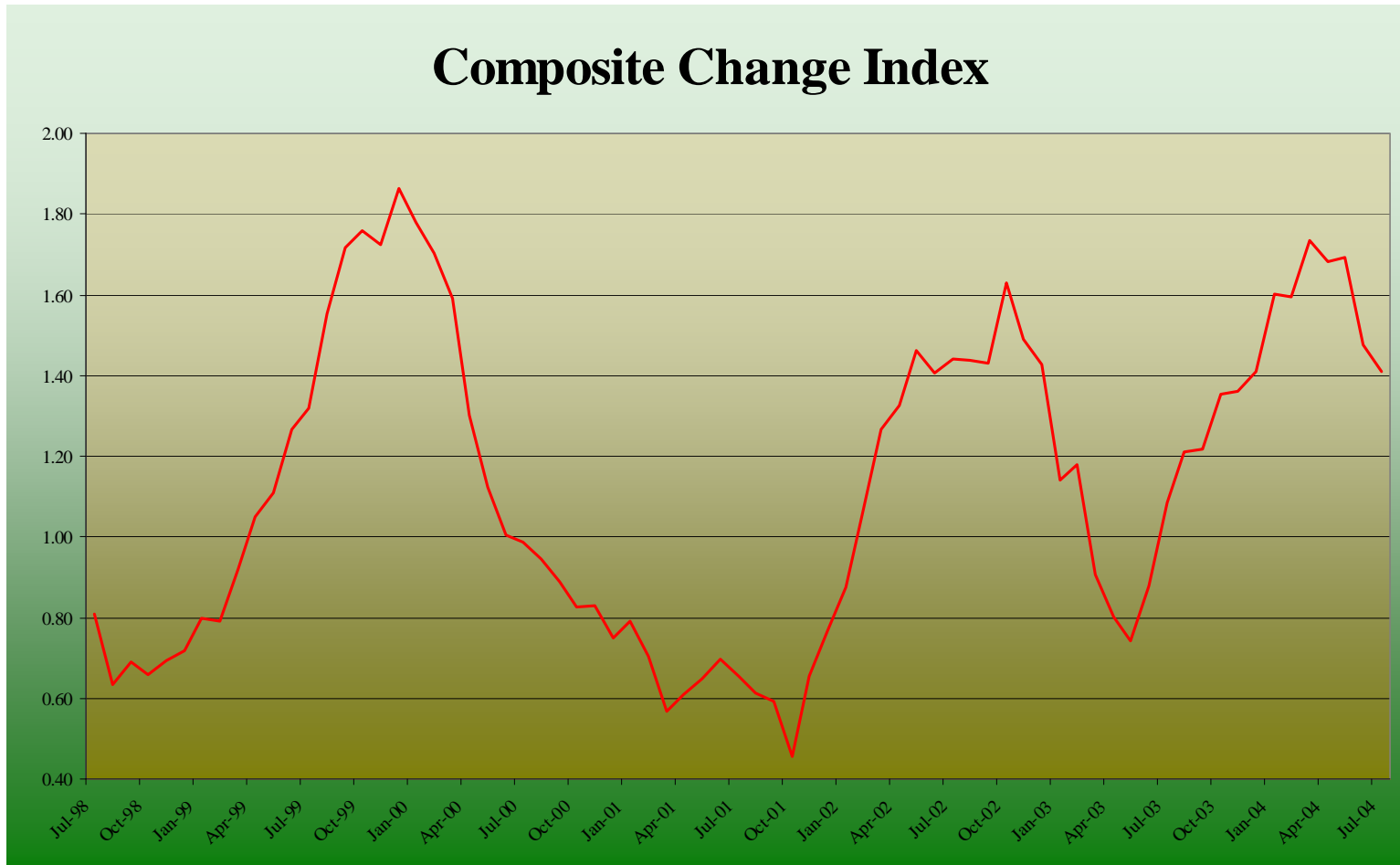
Outlook & Forecast

We are now living in an 8% world.

After two decades of 15% to 18% annual returns driven by falling inflation and rising P/E ratios, investors had better be prepared for lesser returns and a stock market driven by earnings growth.

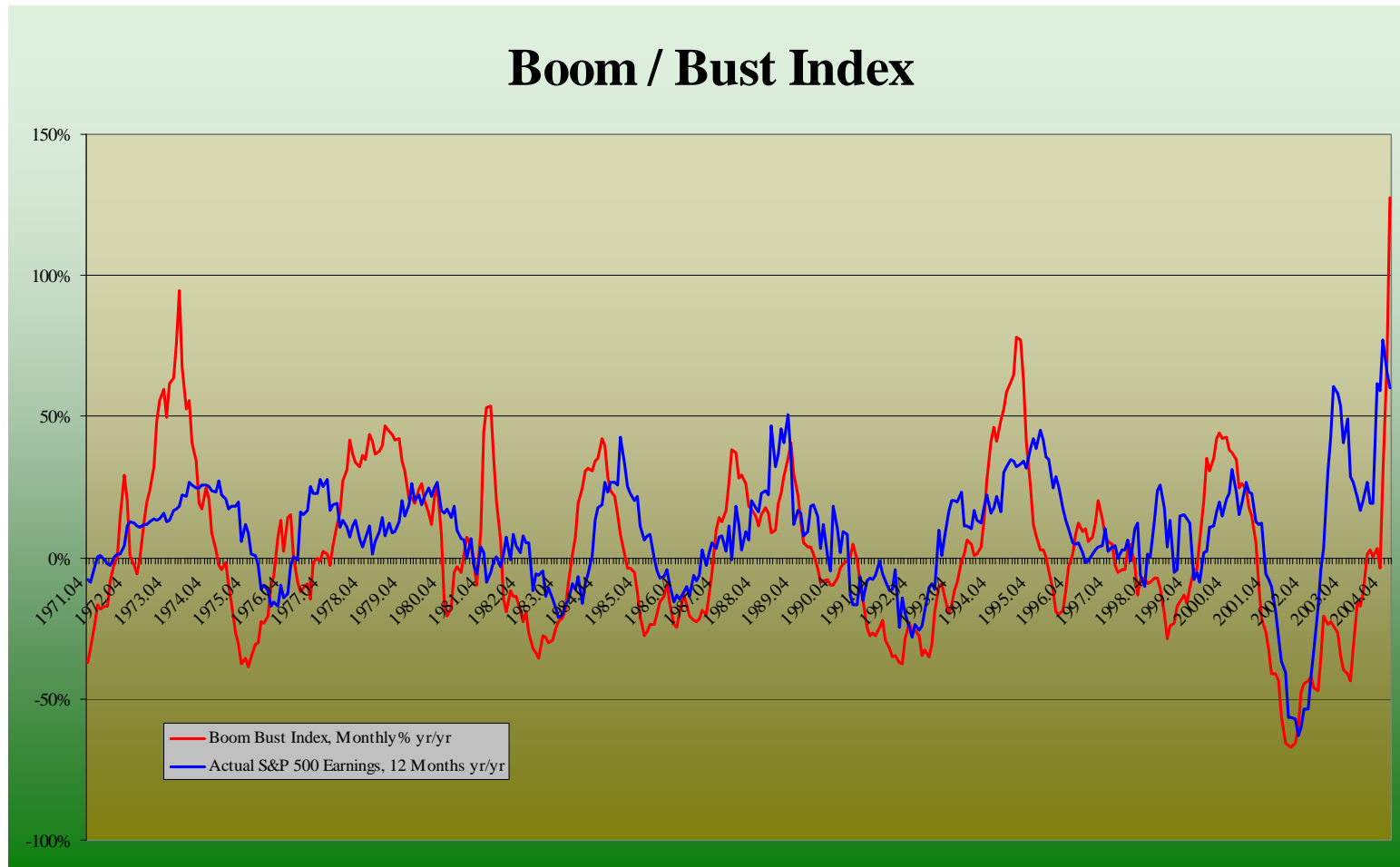
With growth moderating and inflation in a least a cyclical upturn, return expectations need to moderate to a least the historic norm if not below them.

Outlook & Forecast



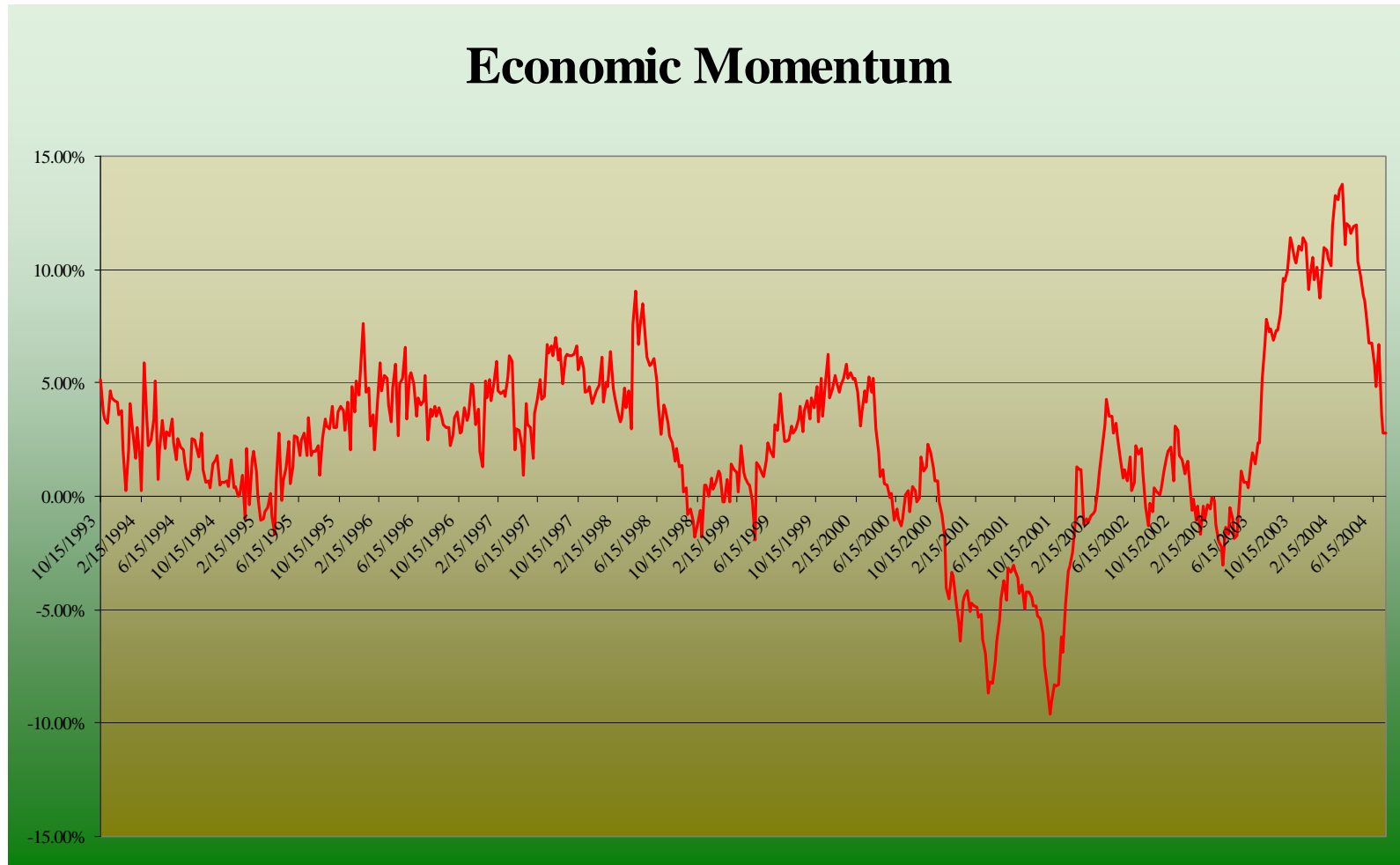
The composite change tends to lead earnings, and values over 1.00 are considered bullish. Growth for the cycle may have peaked but positive growth continues.

Outlook & Forecast



The Boom/Bust Index tracks key variables within the economy that correlate with earnings. The red line is predicted S&P 500 earnings direction, indicating positive movement continuing. The return of some pricing power has the boom/bust index at almost ridiculous levels.

Outlook & Forecast



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

The 52 week rate of growth has contracted dramatically to just +2.8%, reflecting the slowdown in momentum in the second quarter. Continued weakness bears watching, **closely**.

Final Thought

At worst, the US stock market is fairly valued, and the future trend of rates and earnings are extremely important. No wonder the market is worried that growth has slowed...

Over the next few months, it will become clear whether the summer slowdown was just that...or something much worse.