

Monthly Chartbook

July 2005

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What we like...

Solid earnings growth has not been completely factored into stock prices -- the market Price / Earnings has contracted while earnings have grown underneath the same prices.

Inflation seems to be moderating based on the indicators we use to gauge current and future levels.

Macro-economic Research

What we don't like...

Slowing money supply growth.

An interest rate environment where the yield curve may become inverted as short rates continue to rise and long rates remain low.

The Federal Reserve is “taking away the punch bowl” of loose monetary policy designed to prevent liquidity issues at the end of the century and to provide economic stimulus to the country after the terror attacks in 2001 (and corporate scandals through 2002).

Some of the tightening is likely in response to outlandish financing schemes associated with real estate transactions in isolated markets within the US.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1234.18	Trading range	↔	1100-1275	Next 6 months
Ten Year Treasury	4.27%	?????	↓	4.00%-5.00%	6 months
Inflation (all Urban)	2.54%	3.15%	↓	2.50%-3.25%	6 months
Fed Funds	3.25%	3.25 – 3.50%	↑	3.00 – 3.75%	6 months
S&P 500 Earnings	\$61.69	\$63.50	↑	\$62 - \$68	4Q 2005
	Legend:	↑ Higher	↓ Lower	↔ Indifferent	

Inflation expectations

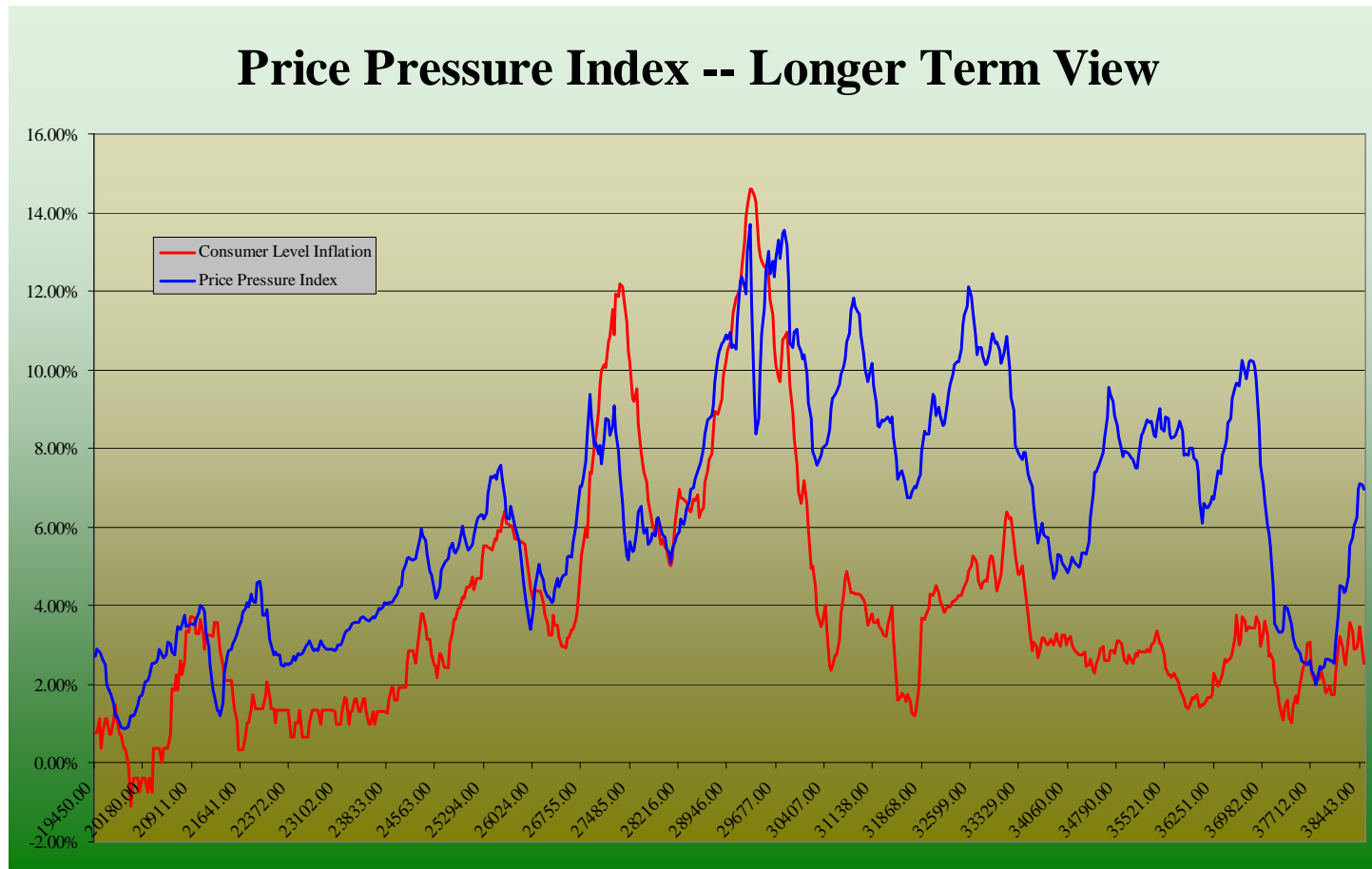
Our expectations for inflation are that it will moderate and remain in a range between 2.5% and 3.25% over the coming period.

All indicators seem to provide a consistent read on this critical measure of price stability...

- Predictive models – our price pressure index has moderated in the past two months.
- TIPS – the market's anticipated long-term rate of inflation is about 2.5%.
- CRB – the increase in commodity prices has slowed considerably on an annualized basis.
- PCE – the Personal Consumption Index readings are consistent with the current year-over-year inflation measures as well as the other predictors / observations provided above.

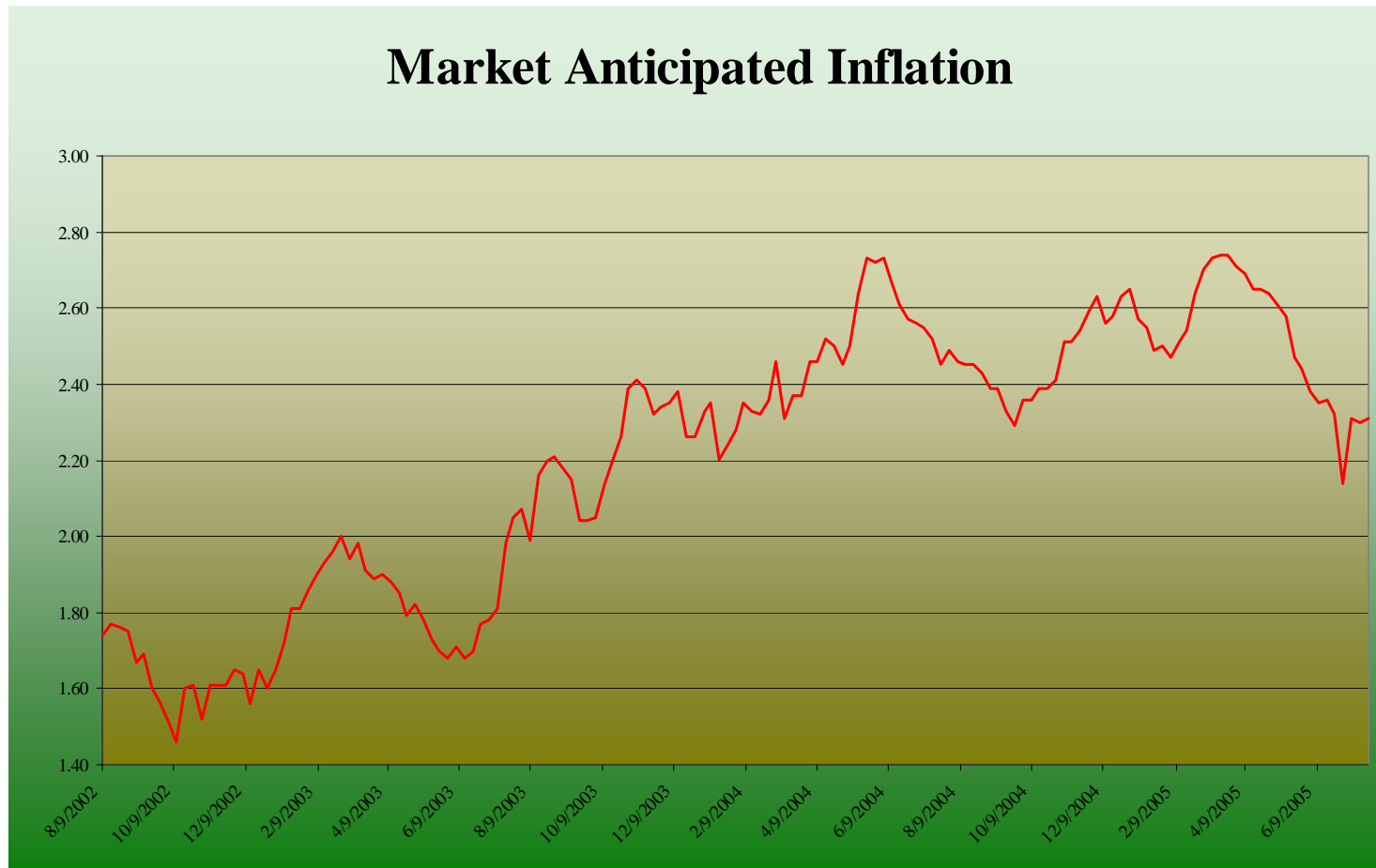
It is important to note that, in our opinion, stable and expected inflation levels are as important as the aggregate level of price increases.

Inflation Expectations



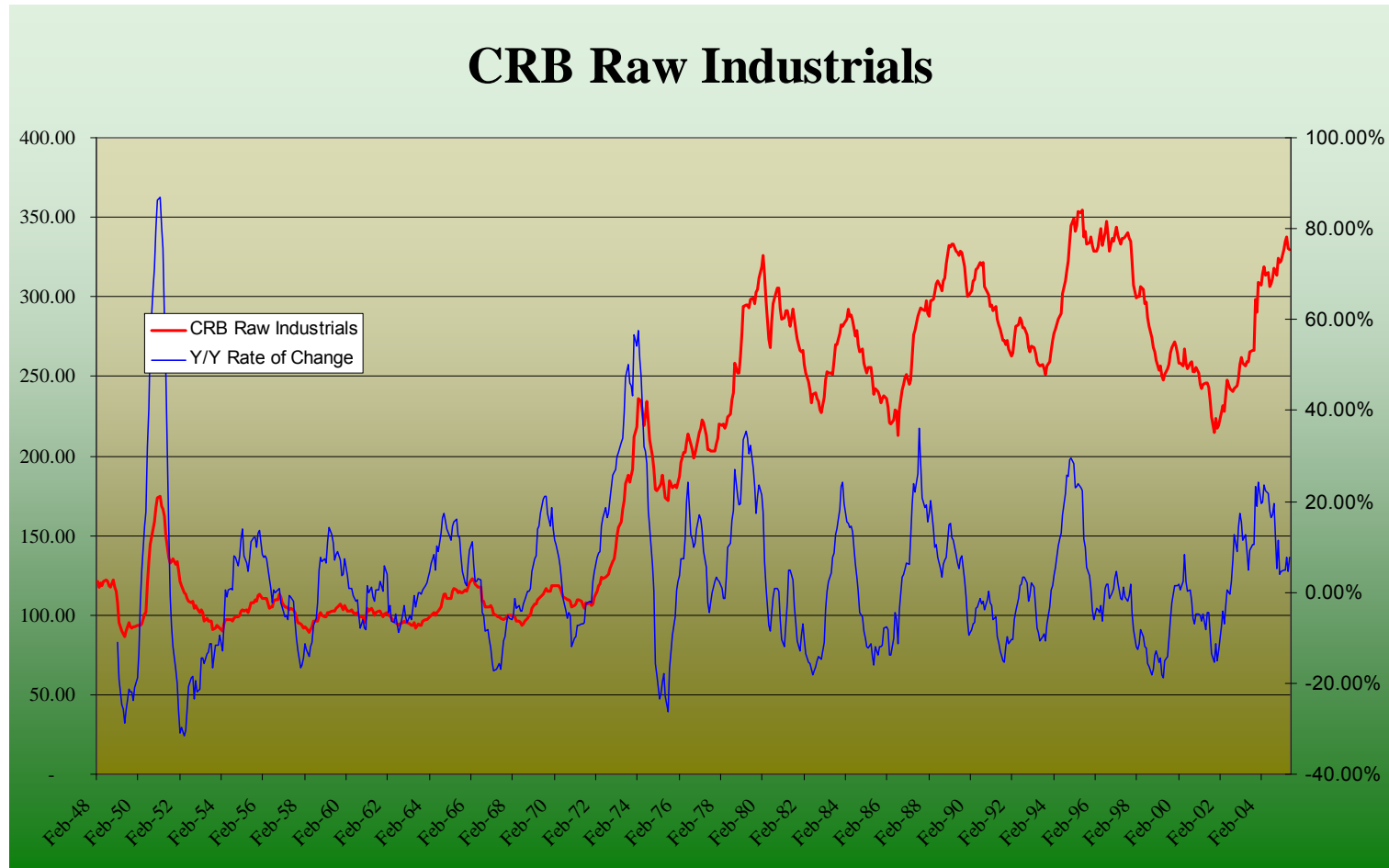
The Price Pressure Index is a proprietary leading indicator for predicting inflation, and its measure has leveled off in the last two months.

Inflation Expectations



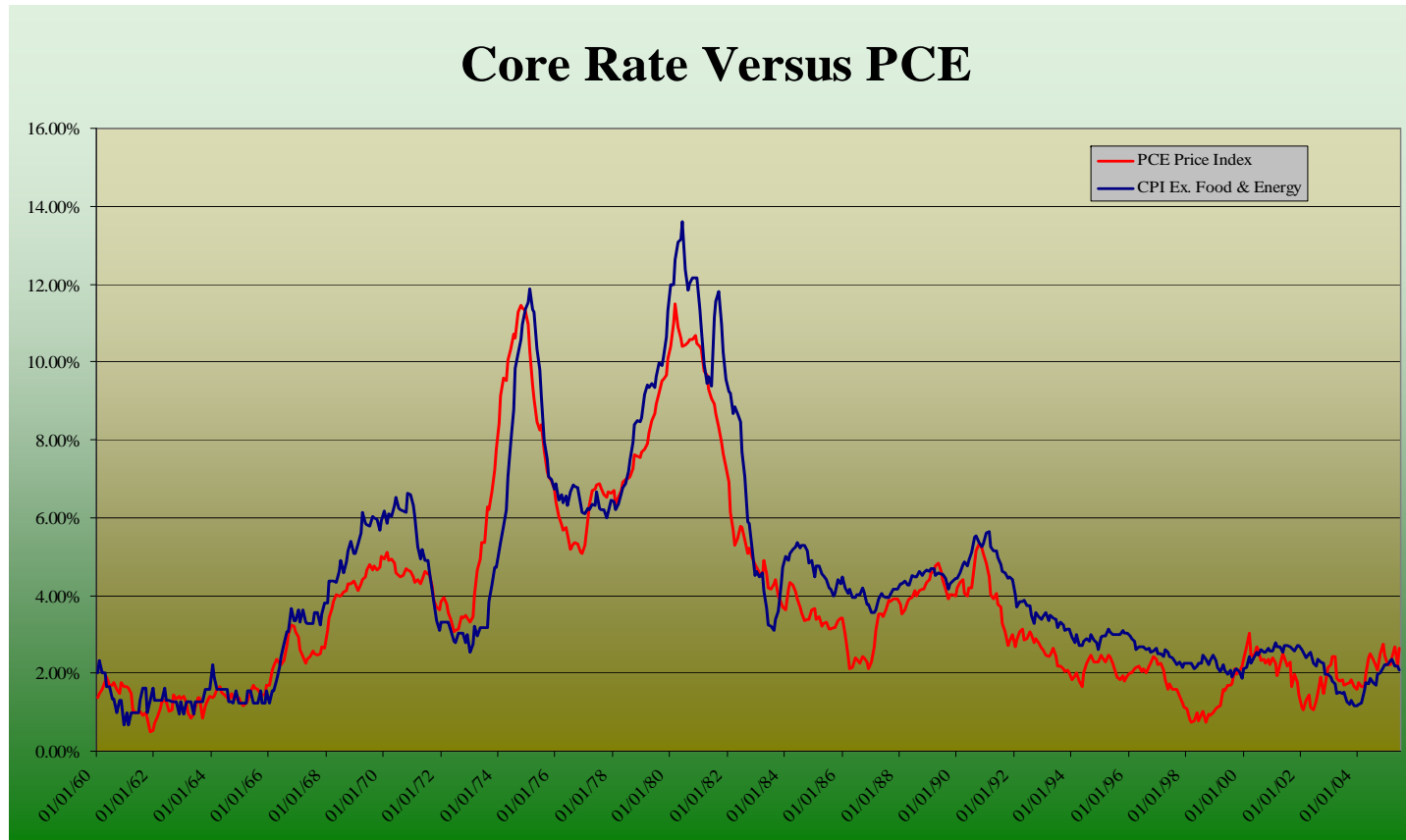
Using TIPS bonds to gauge inflation sentiment over the coming ten year period, the market as a whole is forecasting moderating inflation, with an implicit forecast of 2.3%, down from a peak of 2.73% in March.

Inflation Expectations



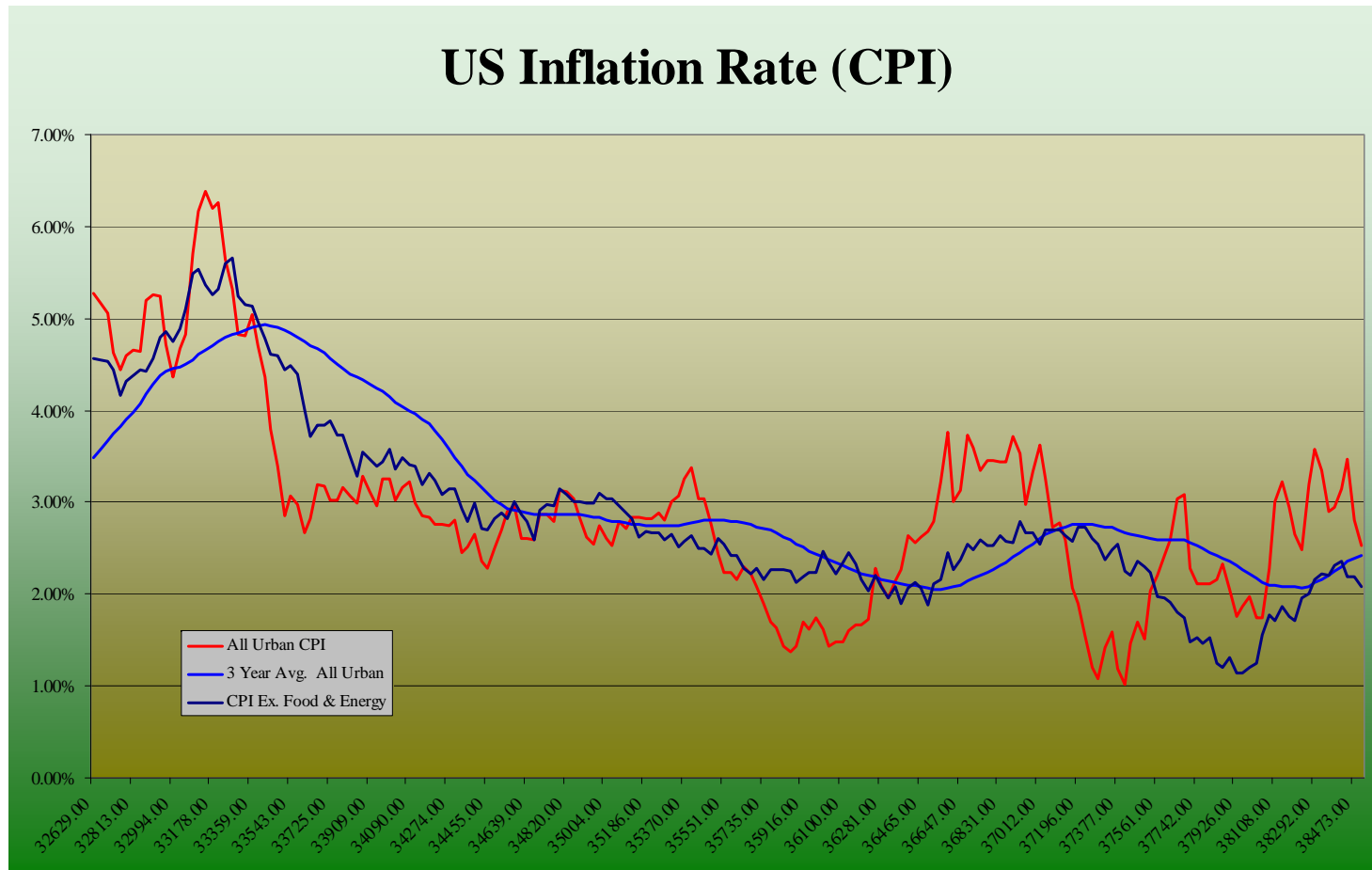
The Y/Y percentage increase in commodity prices continues to moderate. Globally, supply is rising to meet demand.

Inflation Expectations



Last month's measure of Dr. Greenspan's professed favorite inflation number, the Personal Consumption Expenditures Price Index, was 2.65% on a year-over-year basis. This is consistent with other inflation measures and predictors that indicate the prices for goods and services are stabilizing.

Inflation Expectations



Inflation on a year-over-year basis reflects both this change in sentiment and the decrease in commodity prices as it declines to a 2.5% annual rate of increase.

Federal Reserve Watch

The Federal Reserve reacted properly to the potential threat of inflation from increasing global commodity prices. Part of this strategy was to tighten monetary policy without harming the fragile recovery that has been in place for the last two years.

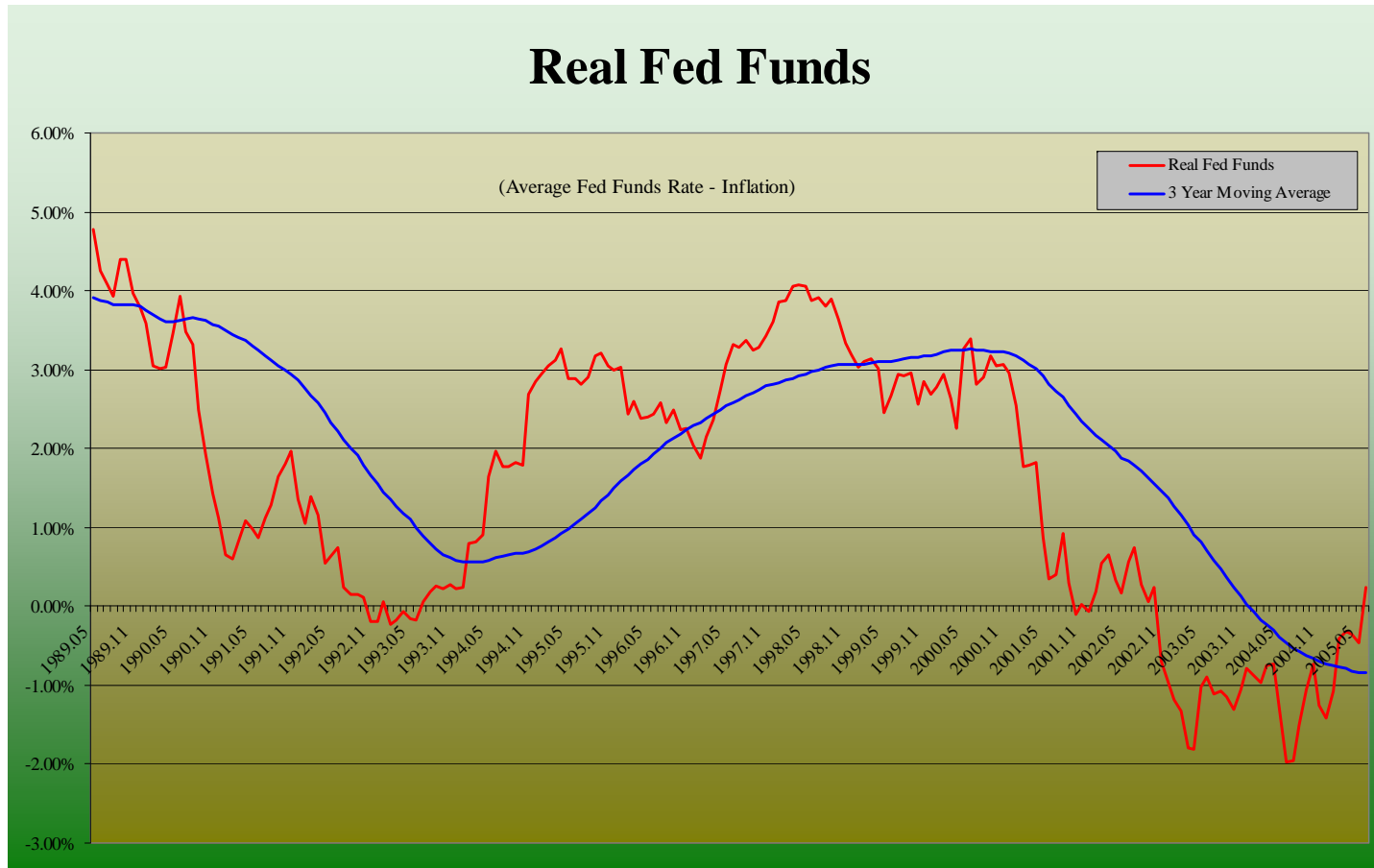
The two ways this is being accomplished are:

- higher short-term interest rates
- slower money supply growth

The wild-card in their strategy has been that long-term interest rates have not only not moved higher, but they have actually decreased in the present environment.

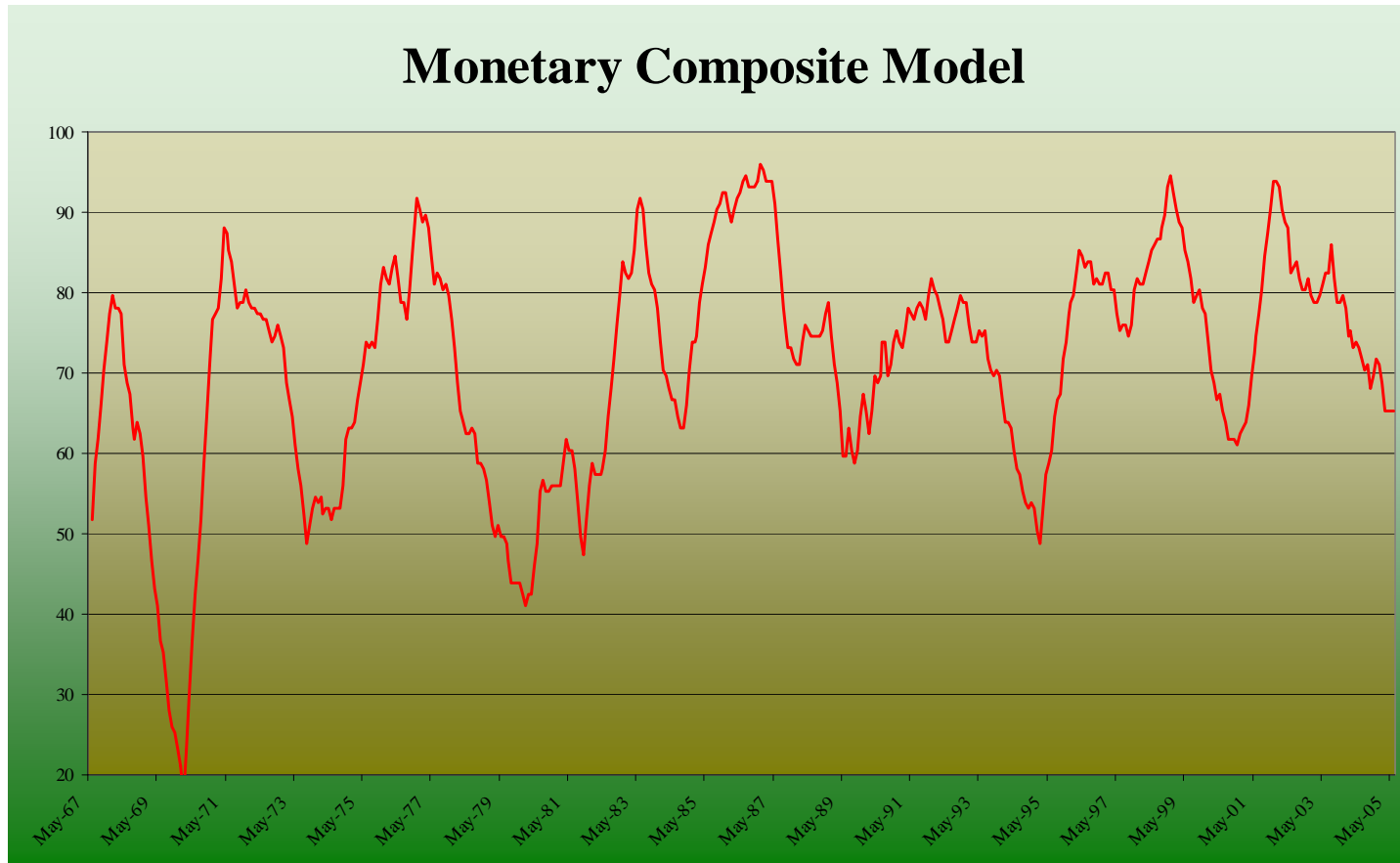
We need to begin thinking about the effects and inverse yield curve may have on stock prices and the broader economy.

Federal Reserve Watch



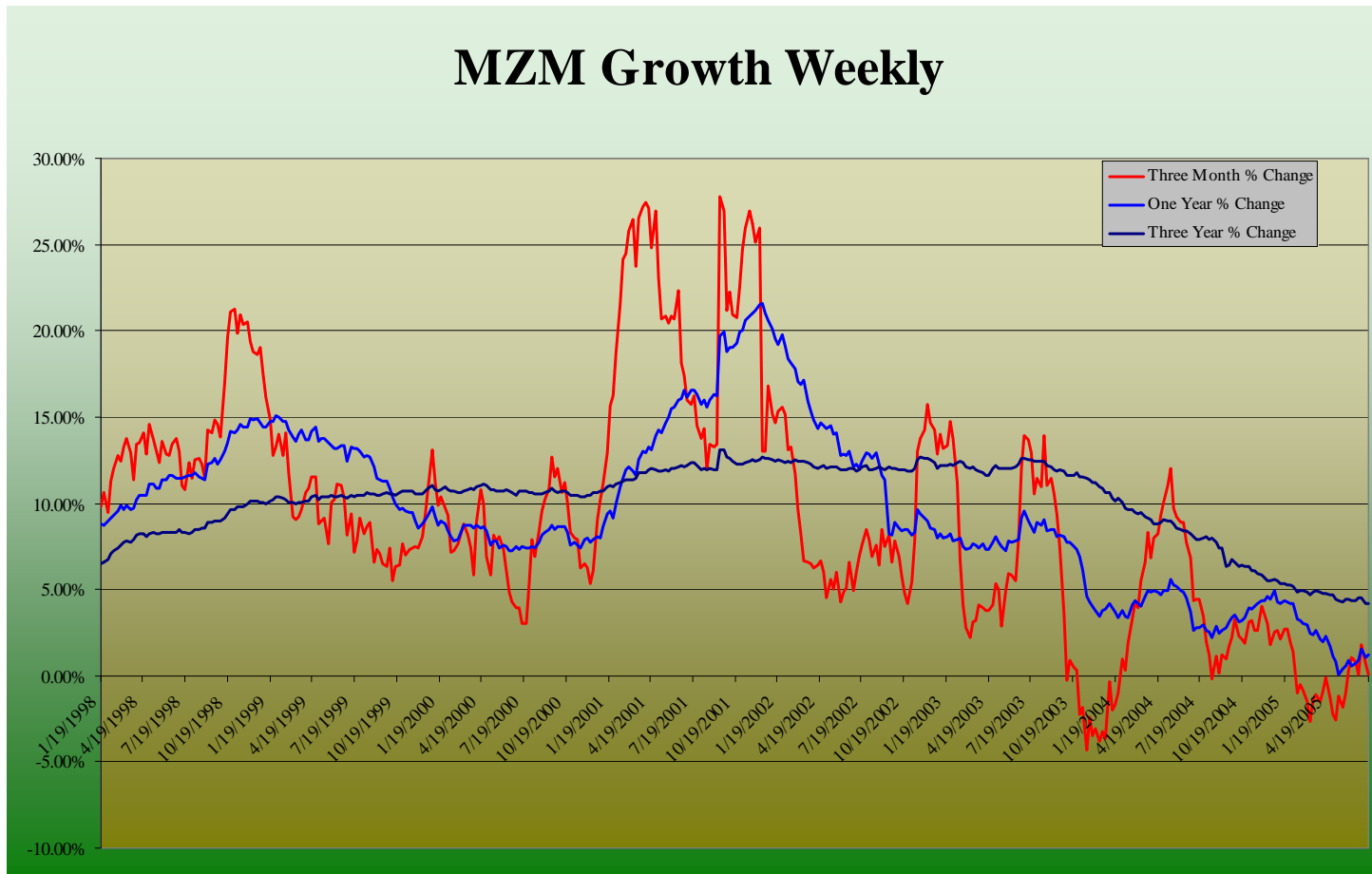
The real Fed funds rate (defined above) is positive for the first time since January of 2002 after the decline in CPI and the most recent increase in short-term rates.

Federal Reserve Watch



A value above 50 indicates the Fed's policies are accommodative, but the trend is just as important. Monetary conditions & liquidity continue to deteriorate as short rates increase during a period of slower monetary growth. **Some of these factors will likely get worse for money conditions before they get better.**

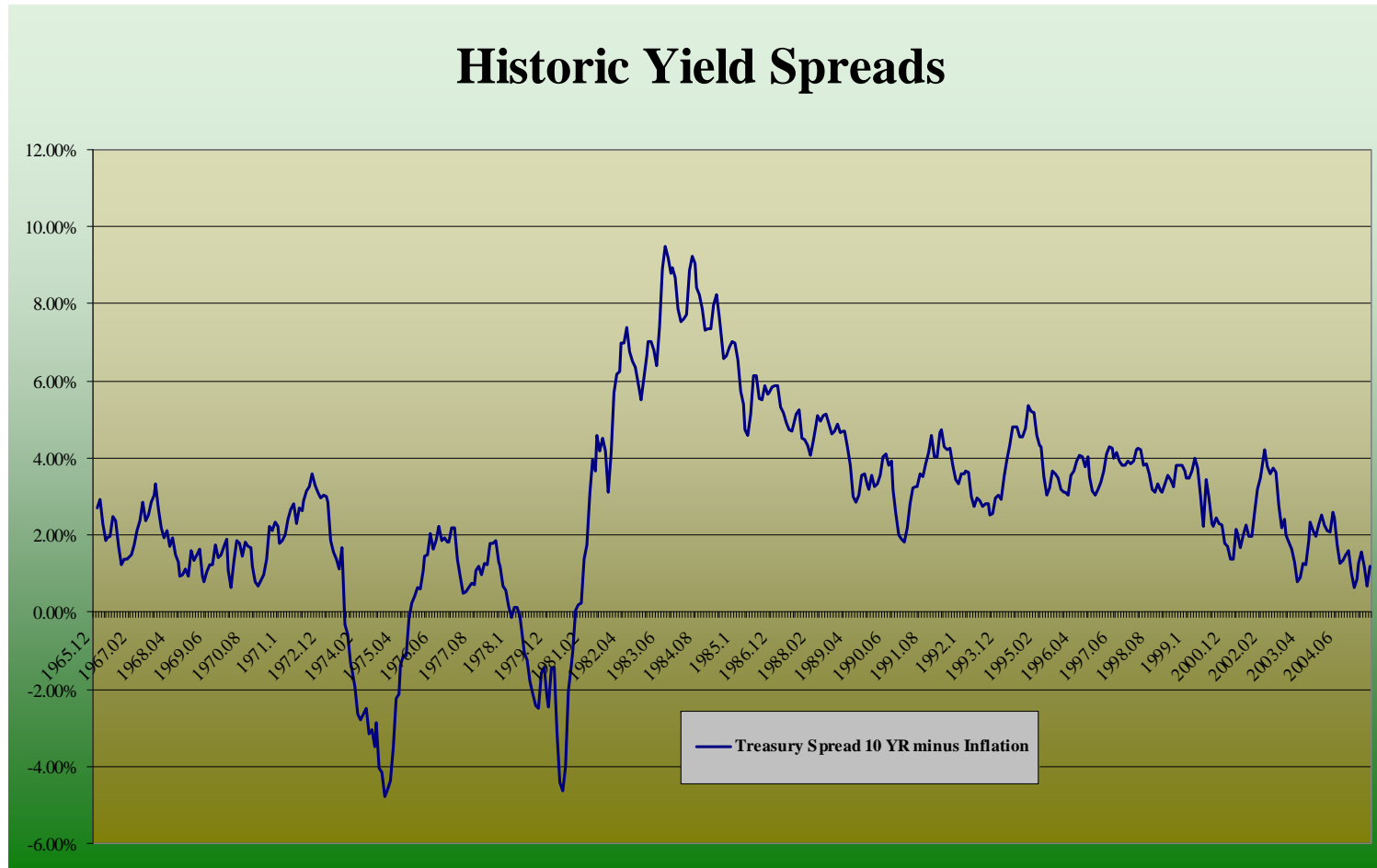
Federal Reserve Watch



Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices.

The Fed is slowing money growth, and that should be a strong signal to the markets.

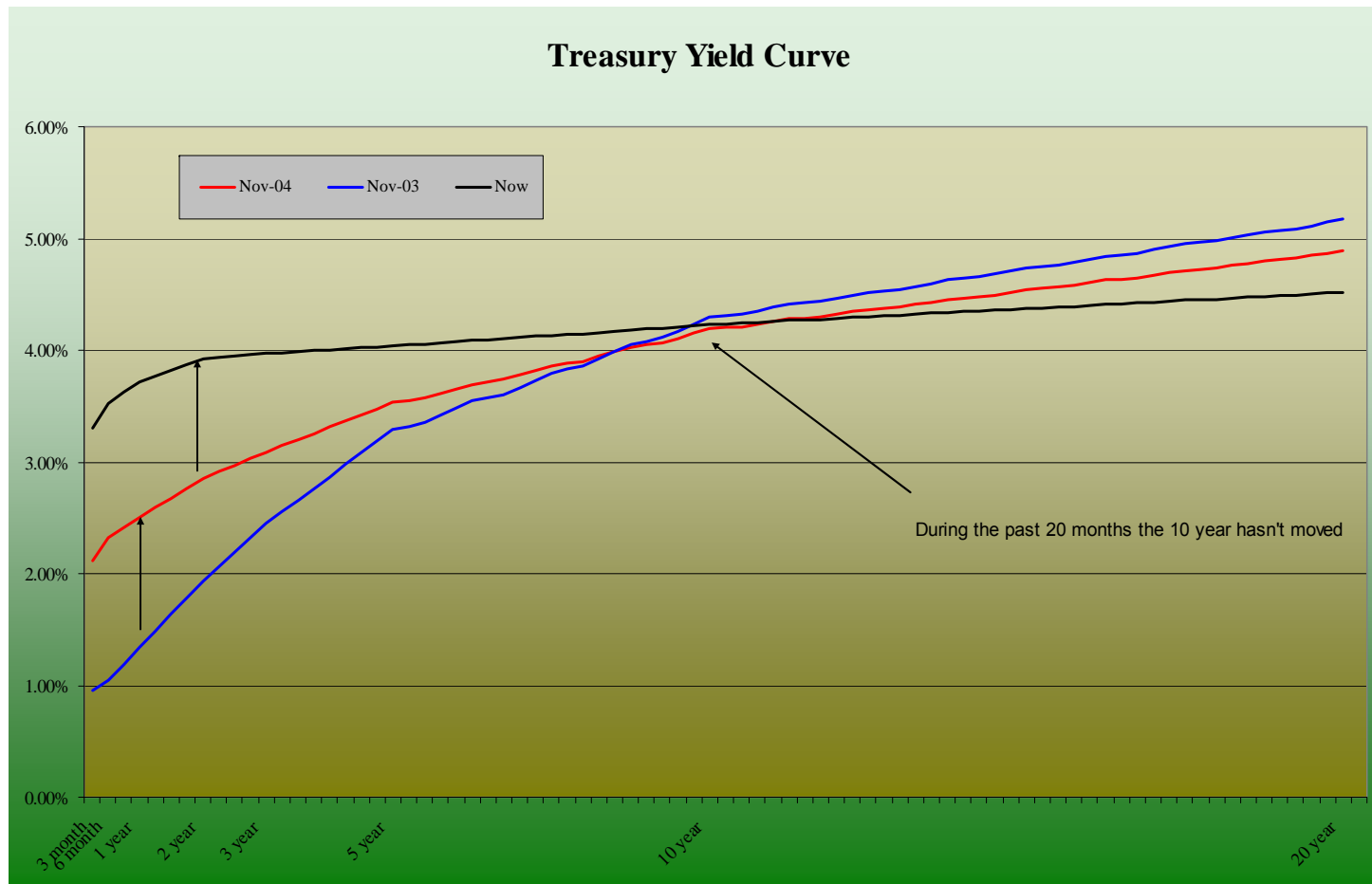
Inflation Expectations



Real long-term interest rates, as measured by the 10 year US Treasury minus All Urban CPI, are at levels not seen since the middle of the 1960's.

Is this a return to more normal long-term trends or an unusually low period in interest rate history?

Federal Reserve Watch



Short rates are increasing while long rates have declined. This could be predictive of an inverted yield curve in the near future.

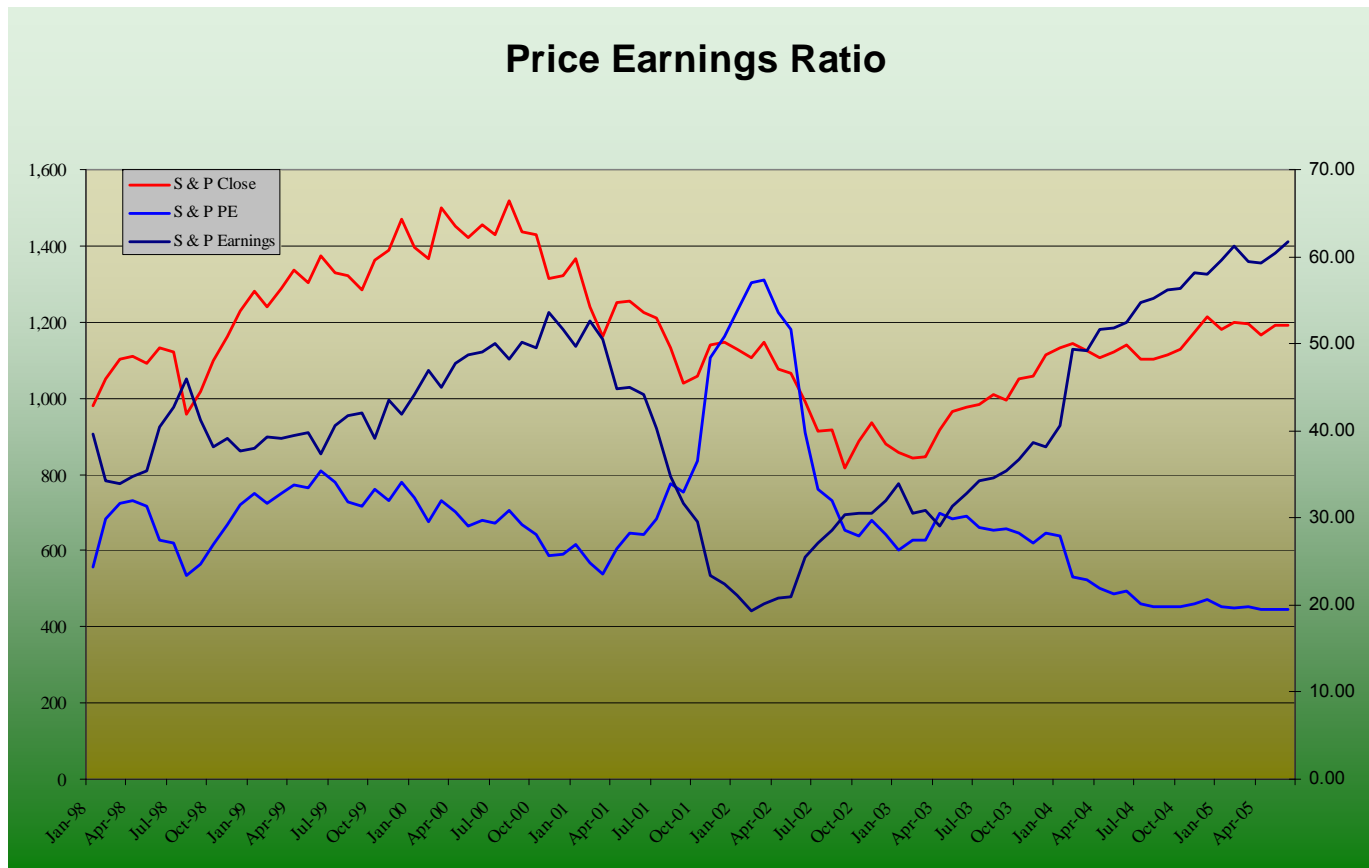
Outlook

We feel the market is at fair value going into some strong headwinds, primarily a tighter monetary policy and a potentially downward sloping yield curve.

Earnings have been (and continue to be) strong; but, the stock market has not really provided investors much return for the risk they have assumed over the past cycle.

Currently, economic momentum is a little weak and we are entering a seasonally weak period of the year; this leads us to be cautious but to view significant retracements by the market as buying opportunities.

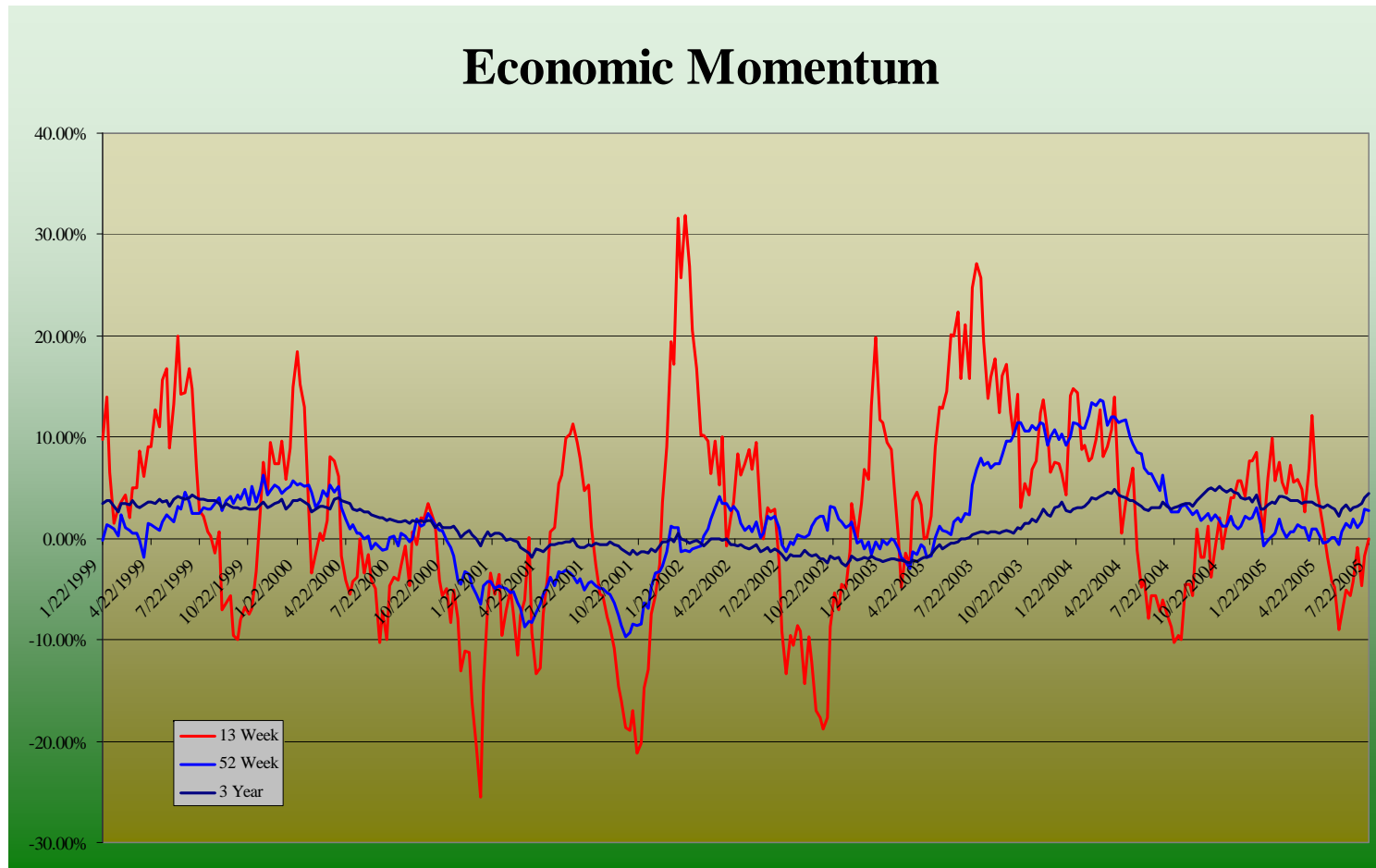
Outlook & Forecast



Earnings growth has been fantastic since early 2002, but there has been no price movement as the market PE continues to contract.

Based on past Chartbook research, PE ratios approximate 20 when CPI is less than 5% year-over-year; so, there is upside potential if earnings continue to grow.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).
Once again, this leading indicator has stalled out; economic growth is flat at best.