Monthly Chartbook

May 2004

CORNERSTONE
Investment Management and Consulting

www.investwithcornerstone.com

5/28/2004

Table of contents

Executive Summary

The marketplace has been dealing with several sources of uncertainty in the way it typically does… discounting the value of securities.

The two most significant causes for this uncertainty are oil prices and their potential effect on inflation.

However, oil prices recently have reflected far more than simply supply and demand, although demand has increased (and will continue to do so) as a result of the global recovery.

Yet, on an inflation-adjusted basis, oil prices are at the top of recent trading ranges– not at all-time highs.

Executive Summary

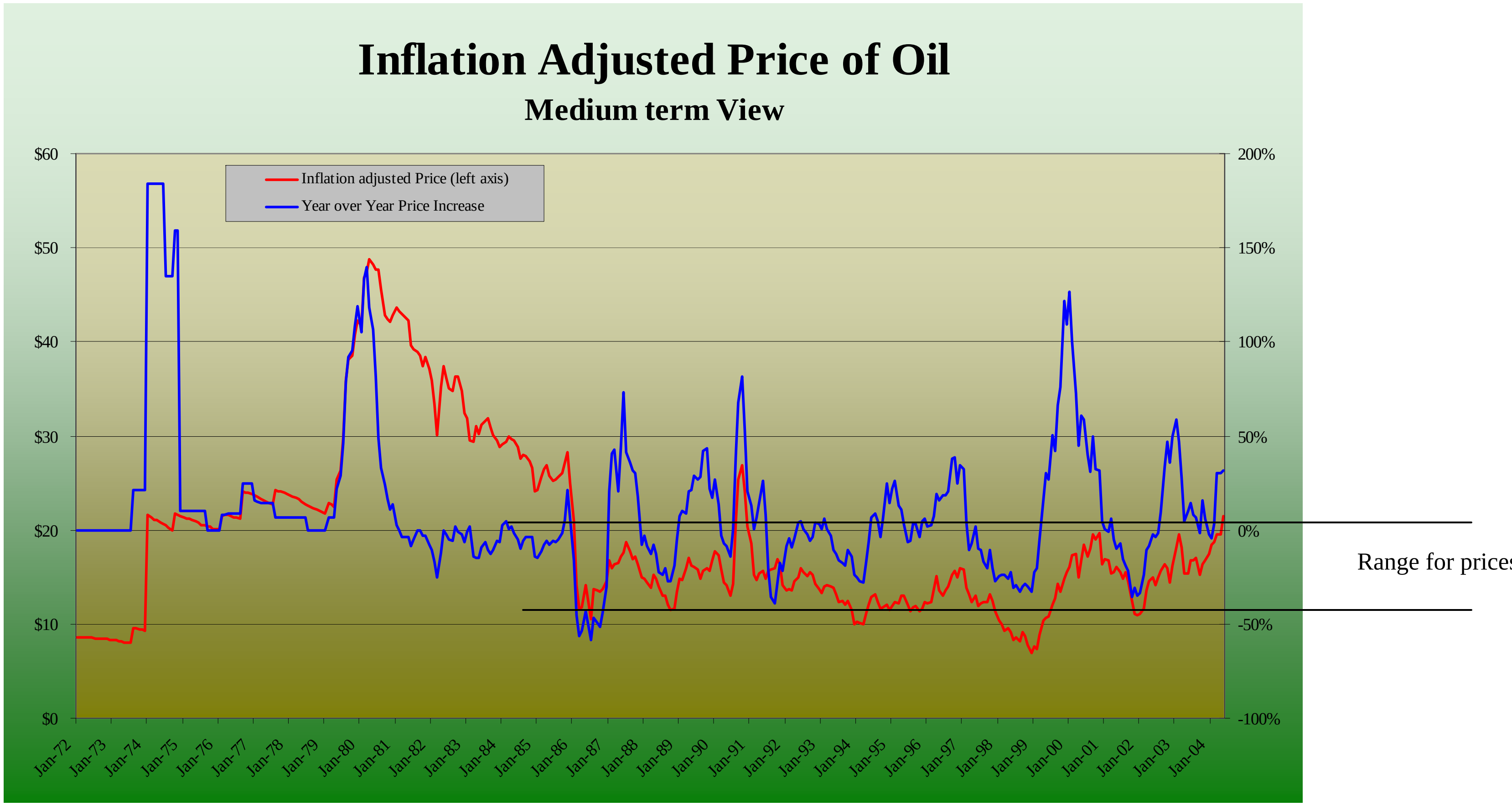
In other news, the employment situation continues to improve with another month of significant job creation.

Inflation (on a year over year basis) experienced a spike this month both on an overall basis and when the more volatile measures of food and energy are excluded.

- however, the market still anticipates intermediate term inflation to remain under 3%, which is consistent with a higher multiple environment for equities

The anticipated interest rate increase has been priced into the market yields. Frankly, we believe the capital markets would react negatively if there were not a rate increase in June.

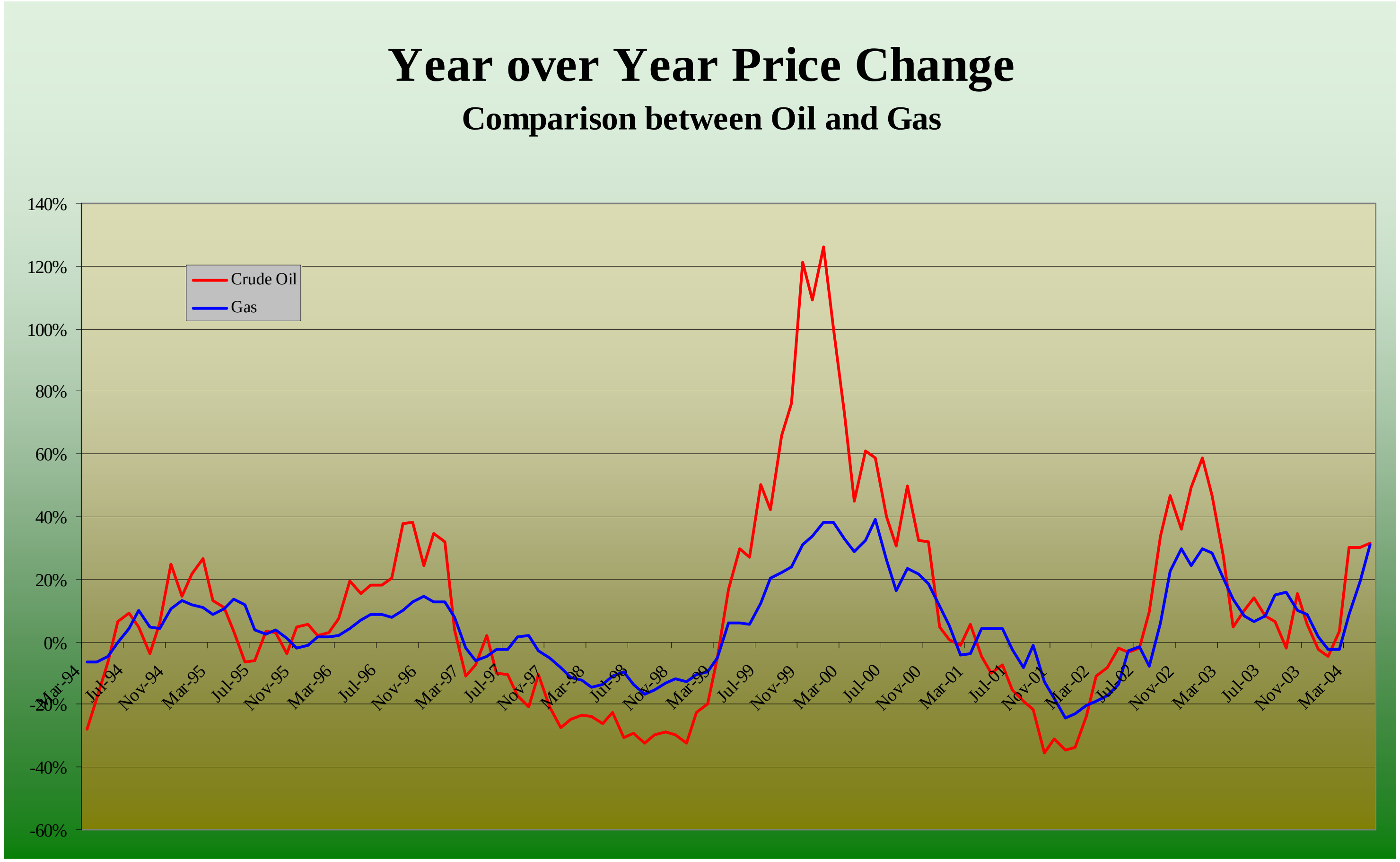
Macro-economic Research



Recent prices for crude oil are near $40 a barrel; but, on an inflation-adjusted basis, prices are only at the upper end of a range between $10 and $20.

Although it could be a political issue because the consumer feels the increase, oil is not out of line relative to its past pricing.

Macro-economic Research



Gas prices generally follow oil prices, but changes in oil are not completely reflected in final price at the pump.

State and Federal taxes account for almost 40 cents a gallon, and the price of oil only accounts for approximately 60 - 65% of the cost (versus an average of 43% in 2002).

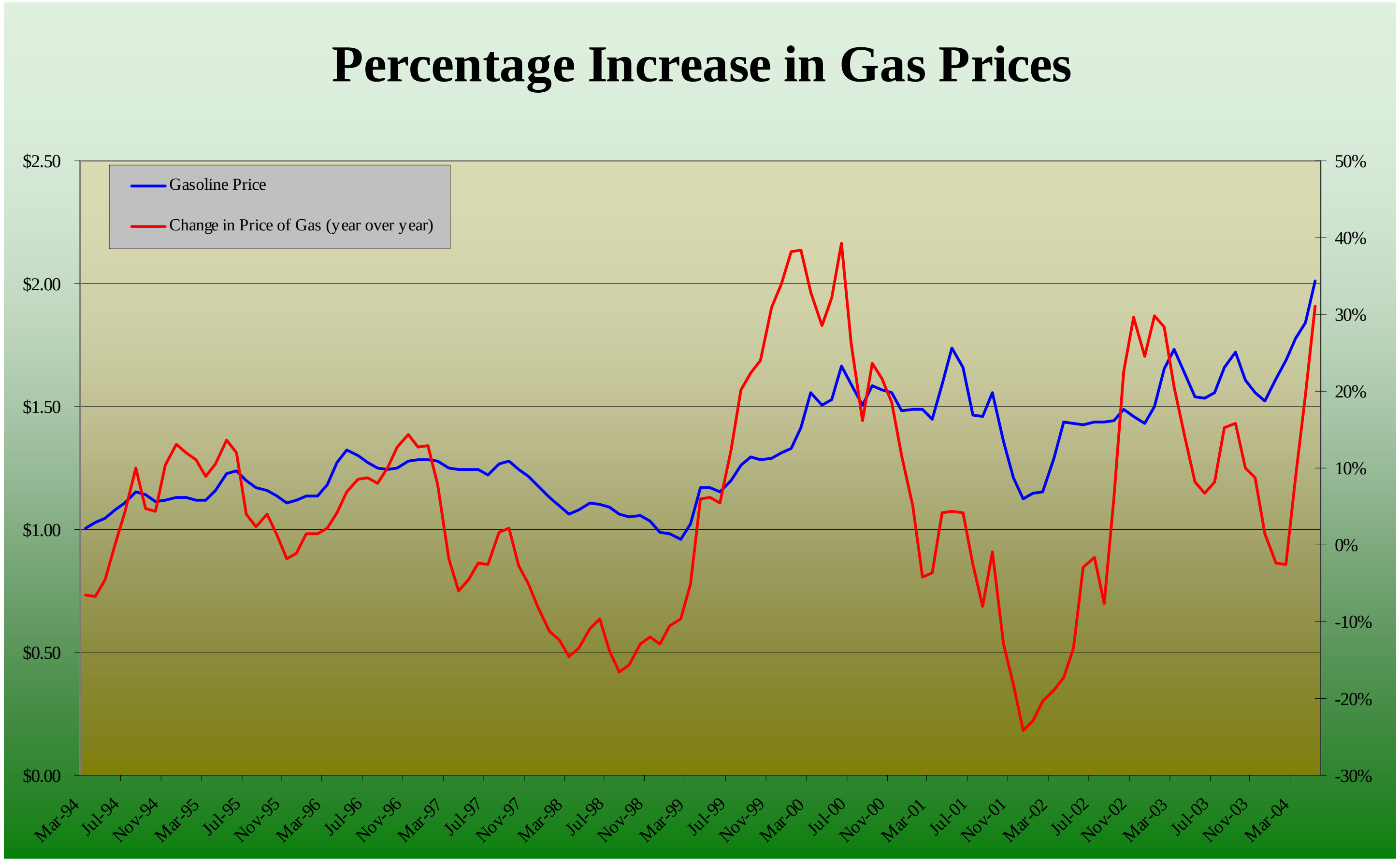
Why is the price of oil high?

- Supply has not decreased, rather demand has increased -- there is a global recovery, and all economies are demanding oil.
- Traders have incorporated a "terrorism premium" into the price. The U.S. continues to fill its strategic reserves, even at high prices. Does our government know something traders don't, and what could its impact be? This premium is estimated to be between $6 and $8 per barrel.

Although the inflation-adjusted price is on the high end of its range, it is not exorbitantly so relative to past pricing. However, there is a psychological impact of higher gas prices that make them a political hot-button.

Each week, millions of Americans pay more at the pump, but the direct impact to their disposable income is not as harmful as they might think. If a consumer fills up a fifteen gallon tank each week and the price of gas is now 50 cents higher than a year ago, the total cost is less than $400 (about $33 a month).

At the same time, an increase in the price of oil is also viewed as a "tax" on consumers, as they are almost required to spend up on the commodity (and, thus, are unable to acquire other goods).



The price of gasoline has increased dramatically in the previous few months on an annualized basis. This "tax" has an effect on consumer's spending and takes an emotional toll as they are reminded of its increasing costs weekly.

Macro-economic Research

LIGHT SWEET CRUDE **(NYMX CL)**

1,000 bbl.- dollars per bbl.

41.75	21.24	Jul 04	41.75	39.65	39.93	—	1.37	236,104
41.20	21.22	Aug 04	41.20	39.30	39.56	—	1.20	62,774
40.52	21.20	Sep 04	40.52	38.75	39.01	—	1.07	49,634
39.86	22.89	Oct 04	39.86	38.20	38.46	—	.93	32,086
39.15	22.82	Nov 04	39.15	37.70	37.91	—	.86	22,655
38.67	16.09	Dec 04	38.67	37.15	37.39	—	.84	65,563
37.96	22.84	Jan 05	37.96	36.50	36.82	—	.78	19,166
37.45	22.88	Feb 05	37.45	36.15	36.28	—	.79	11,941
37.00	22.93	Mar 05	37.00	35.60	35.84	—	.76	11,399
36.33	23.08	Apr 05	36.33	35.75	35.45	—	.71	6,761
35.98	23.04	May 05	35.98	35.19	35.07	—	.66	3,472
35.58	22.05	Jun 05	35.58	34.60	34.71	—	.62	21,018
35.30	23.38	Jul 05	35.30	34.54	34.45	—	.59	6,047
34.94	24.29	Aug 05	34.94	34.10	34.20	—	.58	3,363
34.67	23.58	Sep 05	34.67	33.95	33.95	—	.57	6,129
34.32	16.75	Dec 05	34.32	33.20	33.29	—	.50	42,157
32.40	24.78	Jan 06	...	...	33.06	—	.49	3,815
32.82	23.75	Jun 06	32.82	32.15	32.18	—	.36	8,072
32.05	18.03	Dec 06	32.05	31.23	31.27	—	.27	27,927
30.85	19.08	Dec 07	30.85	30.16	30.17	—	.17	14,513
30.05	19.56	Dec 08	30.05	29.36	29.37	—	.12	11,274
29.12	22.43	Dec 09	29.12	28.76	28.72	—	.12	9,435

Fri to Thu sales 1,206,123 Open Int 706,793

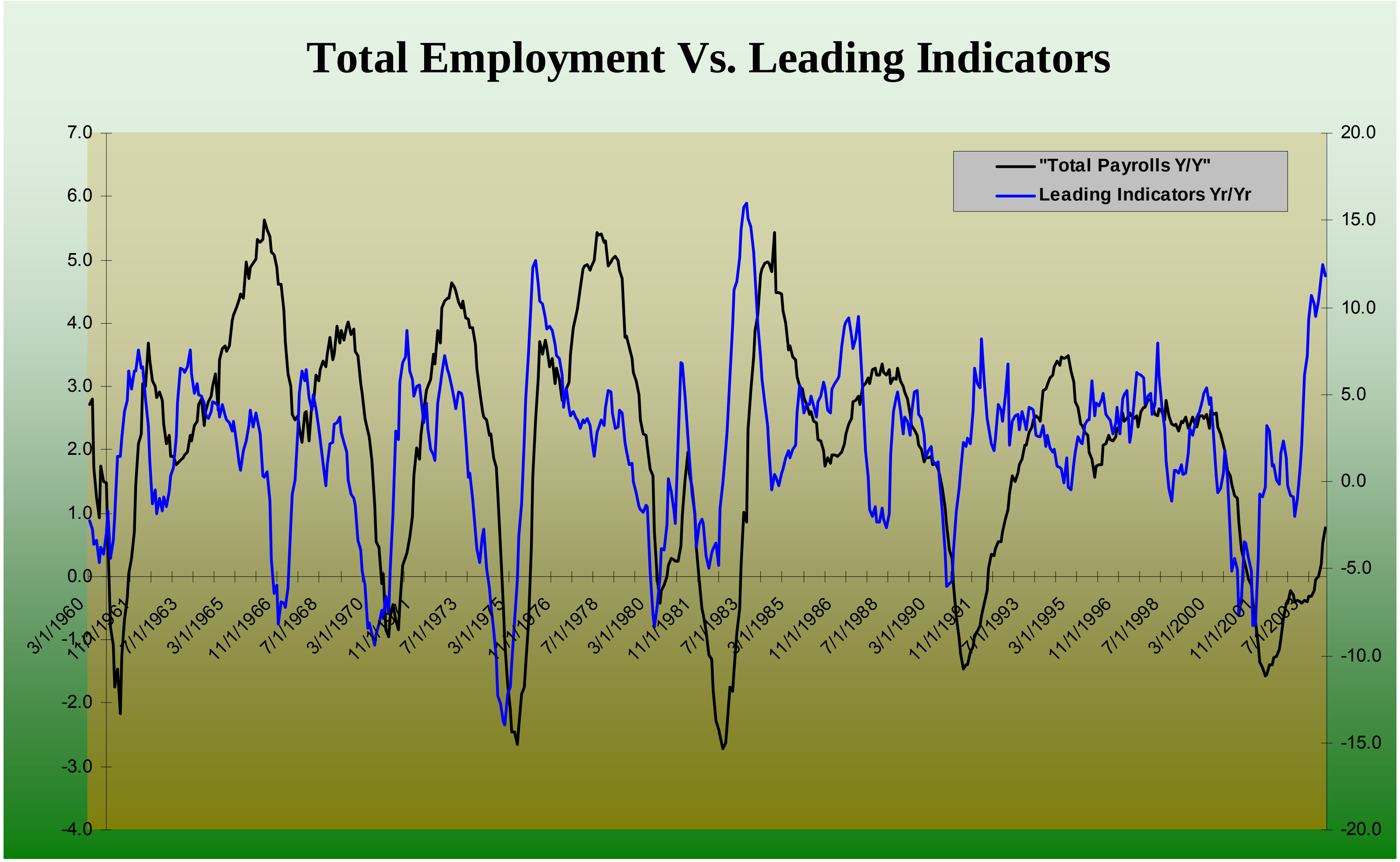
Lower prices
in future periods

The futures market anticipates a reversion to more normal prices over the coming months and years.

Its high price now is partially due to speculation priced into the market for potential terror threats, but there is significant incentive for oil-producing nations to restrain the market price through supply if need be.

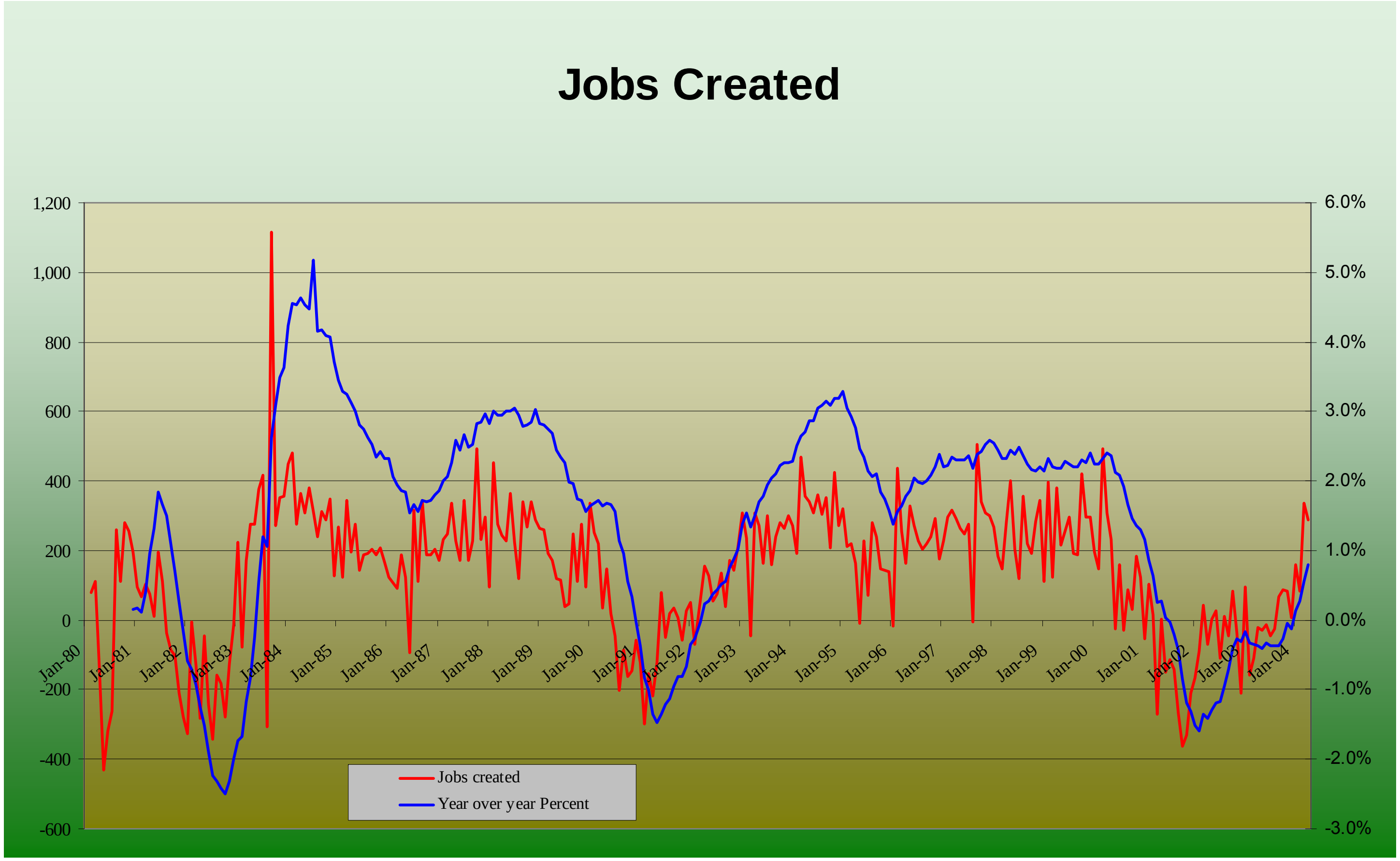
- The other politically important economic indicator we are watching closely is employment, where a large number of jobs have been created in the previous two months.
- This is a lagging indicator and has been the final lynchpin in the economic recovery.
- As people are employed, incomes are higher (providing additional funds to spend or save).
- Given that consumer spending is the preponderance of our economy, higher employment will be able to supplant lower interest rates as the main source of funds for consumer spending.

Macro-economic Research



Employment lags leading indicators 6 – 12 months on average and is following the broader economy higher.
There is continued upward movement in payrolls confirming the economy is on more solid footing.

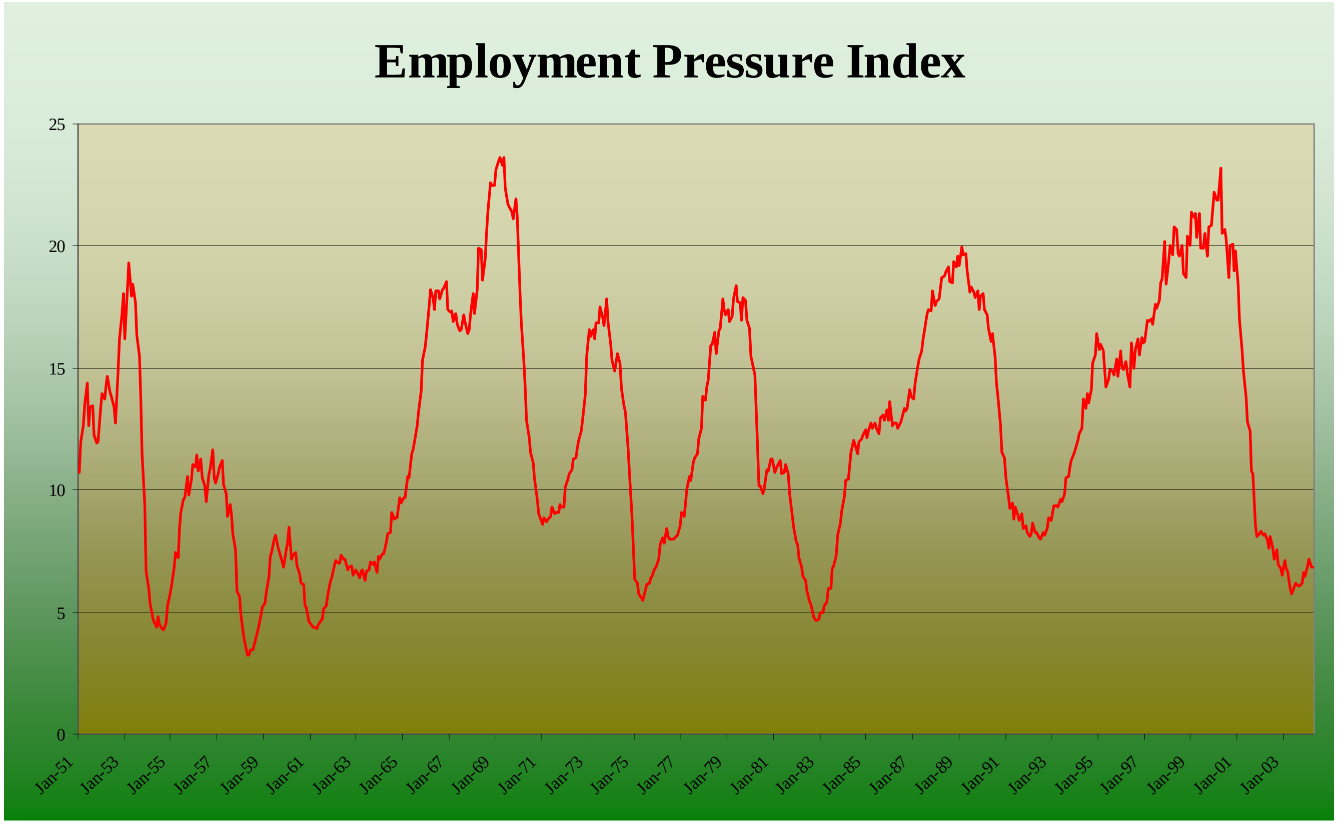
Macro-economic Research



Recent months have shown strong job creation, with over 280,000 new jobs each month (almost 600,000 total).

Between June ’01 and December ’03, there was no job creation in a weak economy, but the year over year change bottomed at the end of 2002.

Macro-economic Research



The employment pressure index continues to expand from its lowest point as the number of unemployed declines, but the index is still not sharply off its lows.

A higher measure indicates more pressure is on employers as employees have more options.

Macro-economic Research

Persistent joblessness has been stubborn and has only improved to levels consistent with job growth in the last three months.

Index levels above 1 are consistent with improving labor market conditions.

CORNERSTONE
Investment Management and Consulting

5/28/2004

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	**1120.64**	**At low end of trading range**	↑	**1075-1250**	**9 months**
Ten Year Treasury	**4.64%**	**4.65%**	↔	**4.35%-4.875%**	**9 months**
Inflation (all Urban)	**2.35%**	**2.50%**	↔	**2.0%-2.75%**	**12 months**
Fed Funds	**1.00%**	**1.25%-1.50%**	↑	**1.25%-1.75%**	**6-10 months**
S&P 500 Earnings	**$51.66**	**$56.00**	↑	**$53-58**	**3q2004**
	Legend:	↑ "Good"	↓"Bad"	↔"Indifferent"	

CORNERSTONE
Investment Management and Consulting

Inflation expectations

The anticipated increase in inflation has arrived.

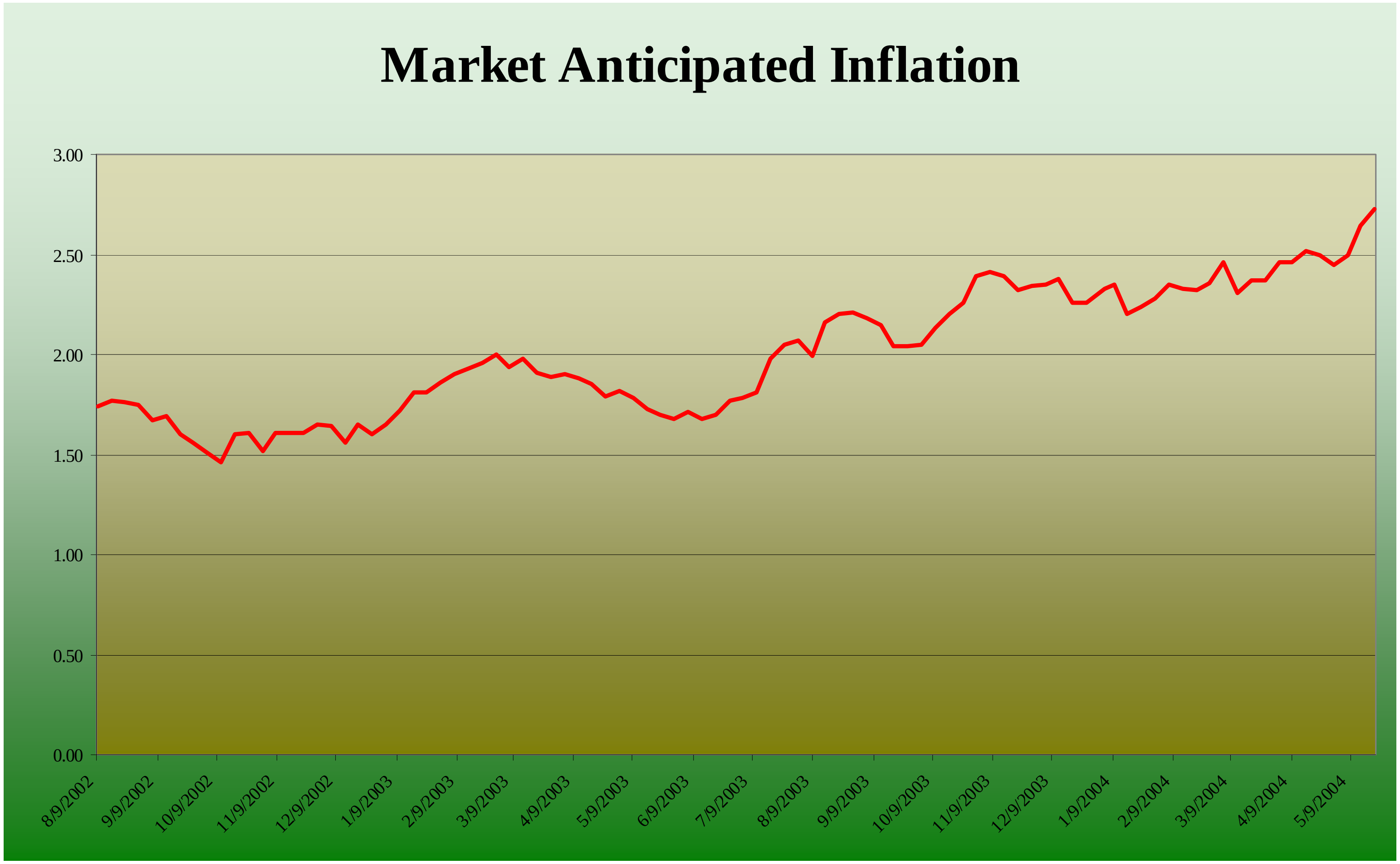
The market is expecting still higher inflation (2.73% expected versus 2.35% current) over the next cycle, as indicated by its pricing of inflation-protected Treasuries.

- Year over year readings had previously been much lower (1.8%), but there was a significant increase in the inflation measure for both "all urban" and "ex food and energy" this month.

However, this measure is still within the range of acceptable numbers.

- Last month we illustrated inflation was one of the chief issues in the pricing of the market through the Price / Earnings ratio for the S & P 500. When inflation is above 5%, the contraction in the market's PE is significant due to the high cost of uncertainty.

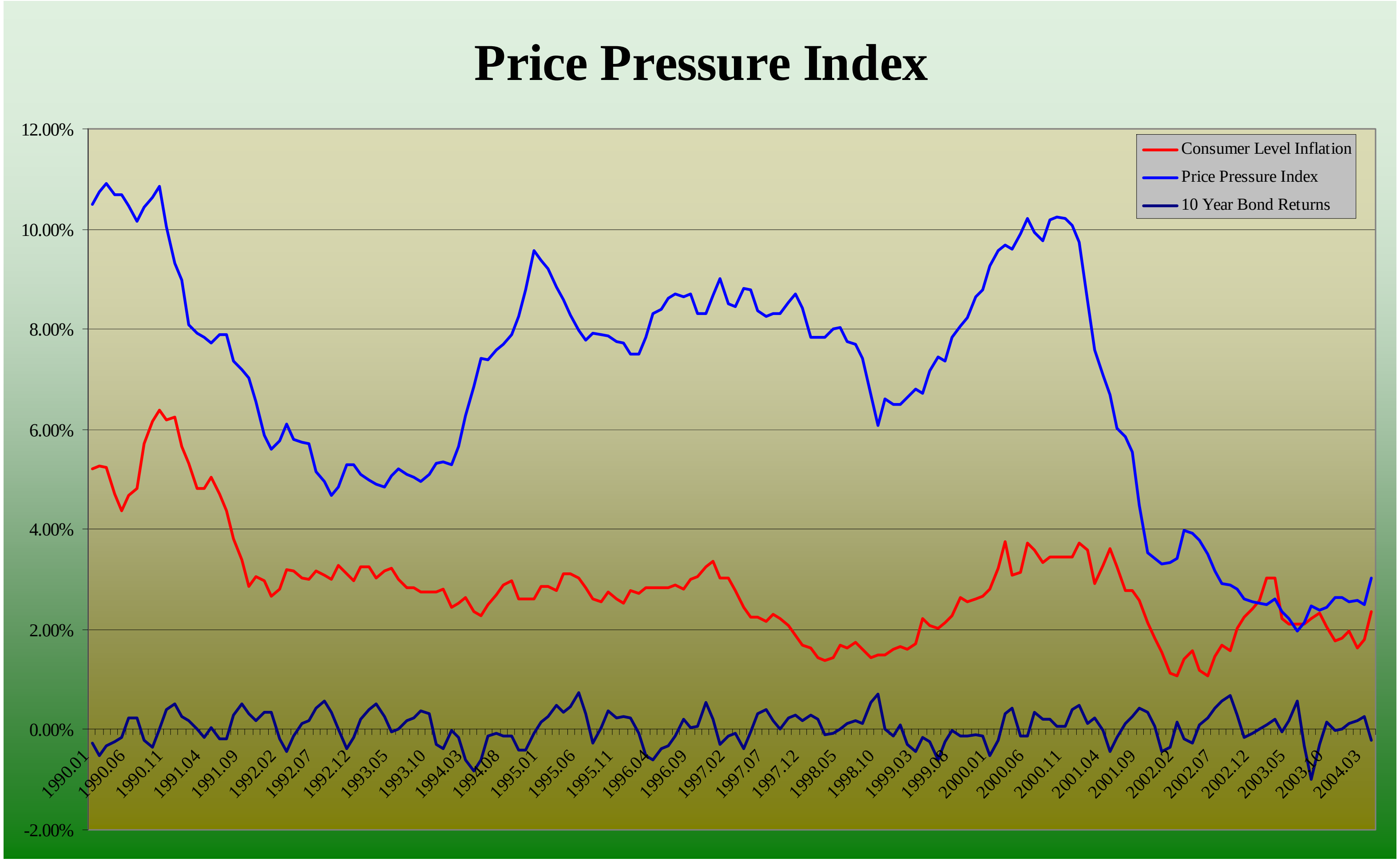
Inflation Expectations



The market anticipates inflation (based on TIPS) to be about 2.7% over the next ten years.
Inflation has averaged 1-3%, which is in line with experience but higher than current levels.

CORNERSTONE
Investment Management and Consulting

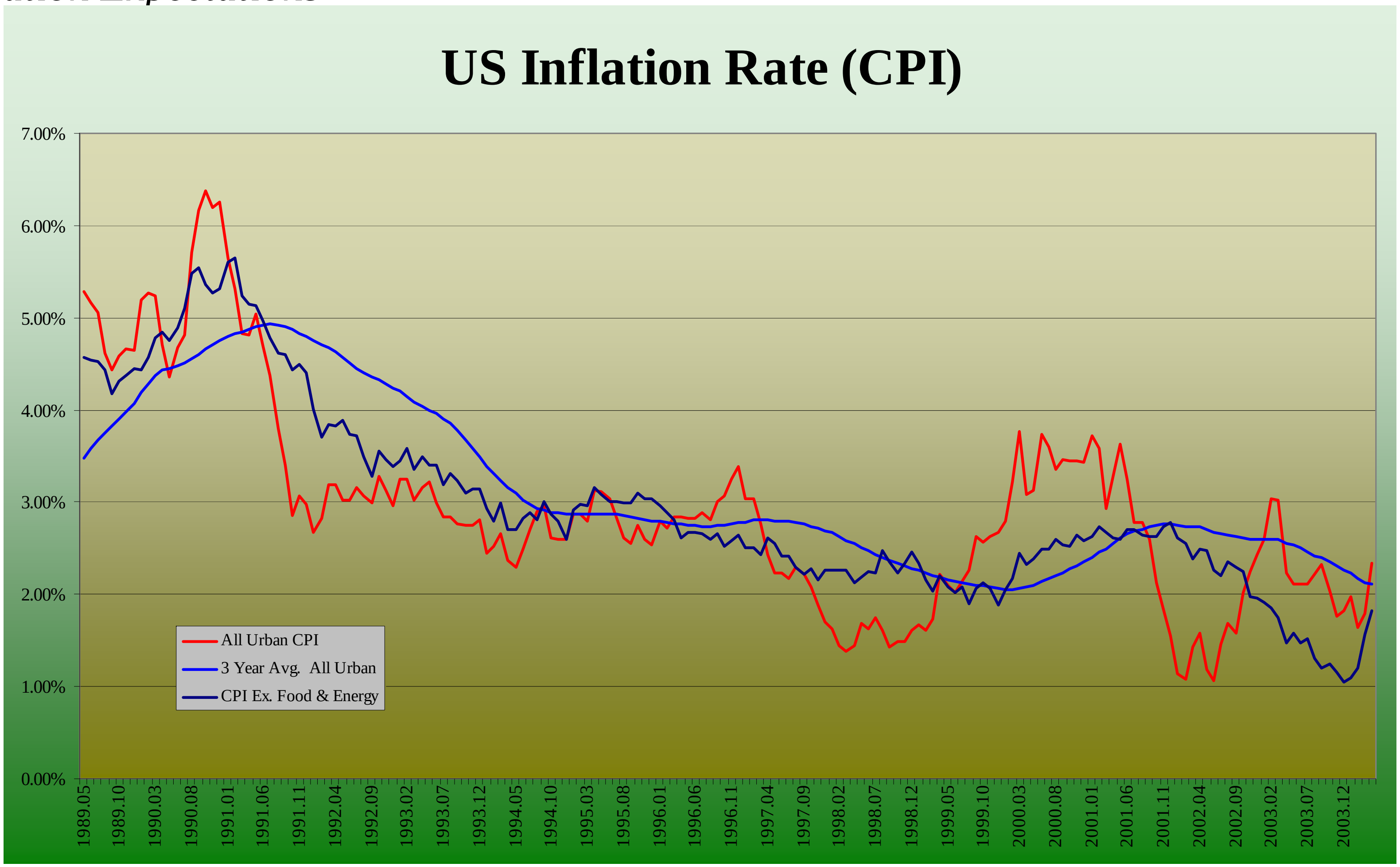
Inflation expectations



A declining index value indicates receding inflationary pressure within the economy, and a rising index value foretells higher consumer prices.

The Price Pressure index has increased within the last month; correspondingly, the value of the ten year Treasuries declined as market rates moved higher.

Inflation Expectations



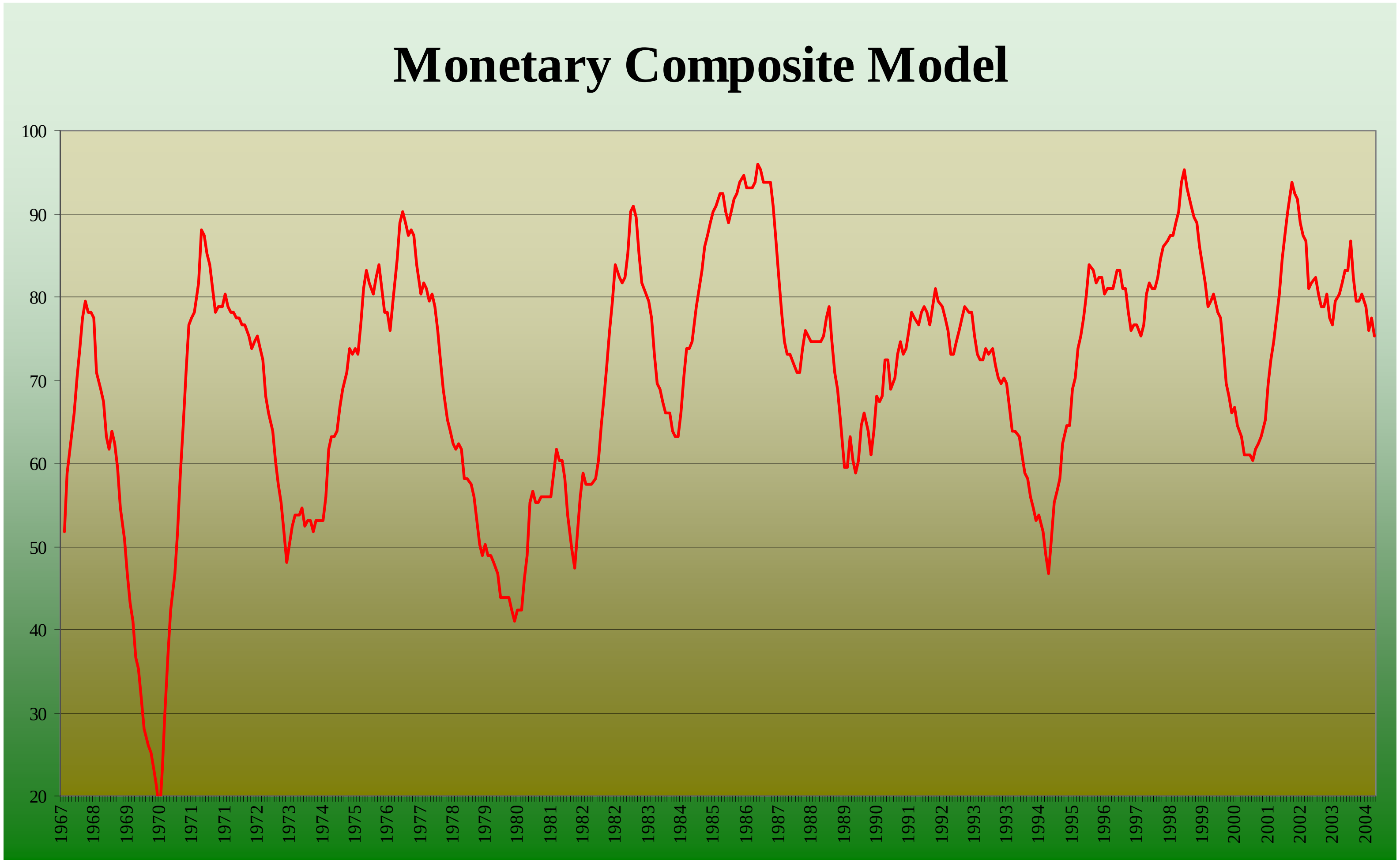
There has been a significant increase in inflation year over year this past month, on both an overall basis, as well as when food and energy are excluded from the calculations.

Federal Reserve Watch

There have been repeated insinuations / implications by the Fed that interest rates are to be raised, and the marketplace has essentially priced this increase into current yields. Will there be any effect when the rate hike actually occurs, or could there be disappointment if changes are not implemented strongly or quickly?

The eventual increase in the Federal funds rate has put pressure on monetary conditions, but near-term money supply growth has increased in recent weeks helping to offset this effect somewhat.

Federal Reserve Watch



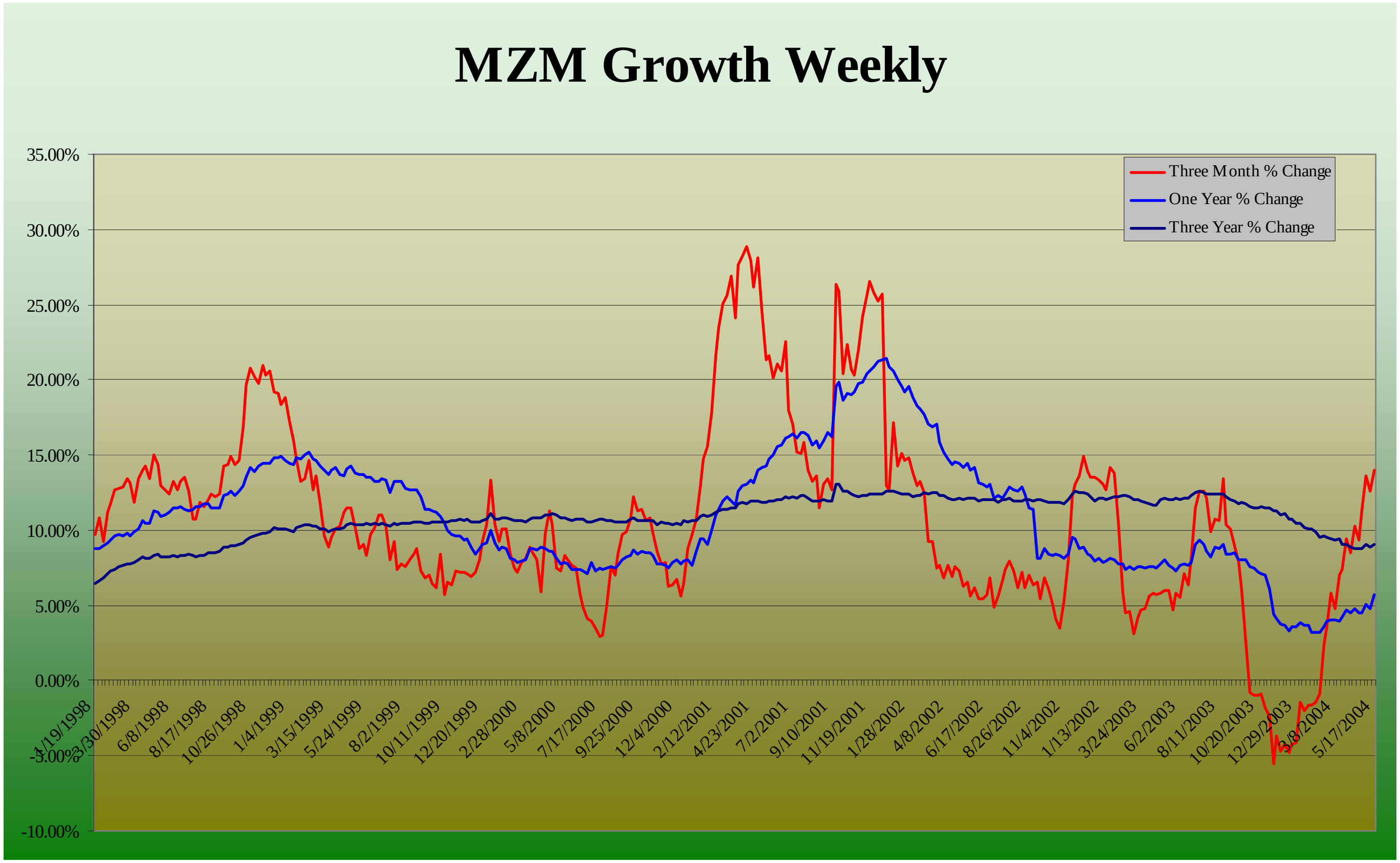
The direction of trend in this series is as important as the level. A score above 50 indicates the Fed’s monetary policy is accommodative.

The increase in market yields has put pressure on monetary conditions, and money is not as cheap as it has recently been.

CORNERSTONE
Investment Management and Consulting

5/28/2004

Federal Reserve Watch



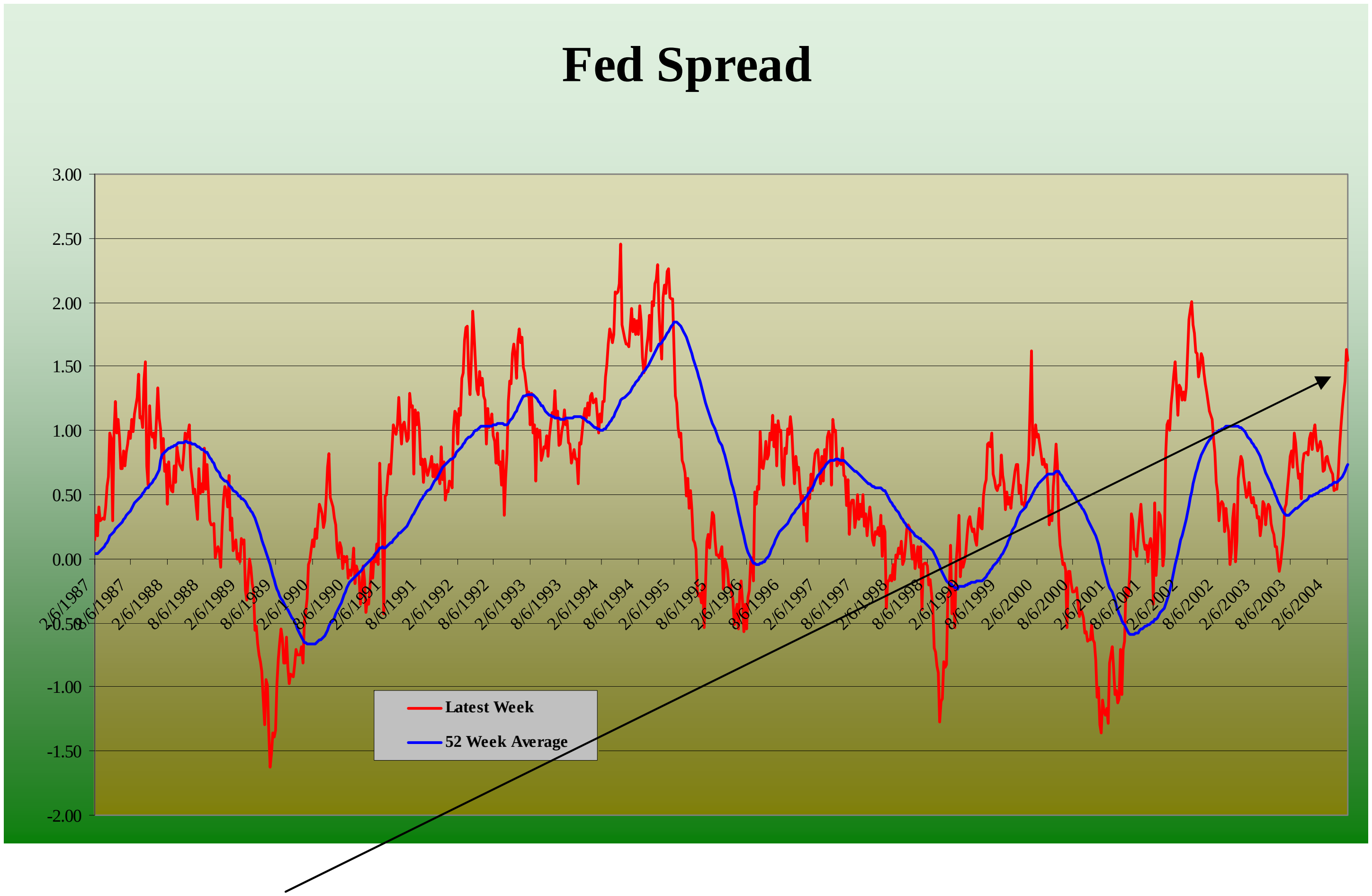
Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices.

The 3 month growth rate of money supply has been very rapid since the beginning of the year.

CORNERSTONE
Investment Management and Consulting

5/28/2004

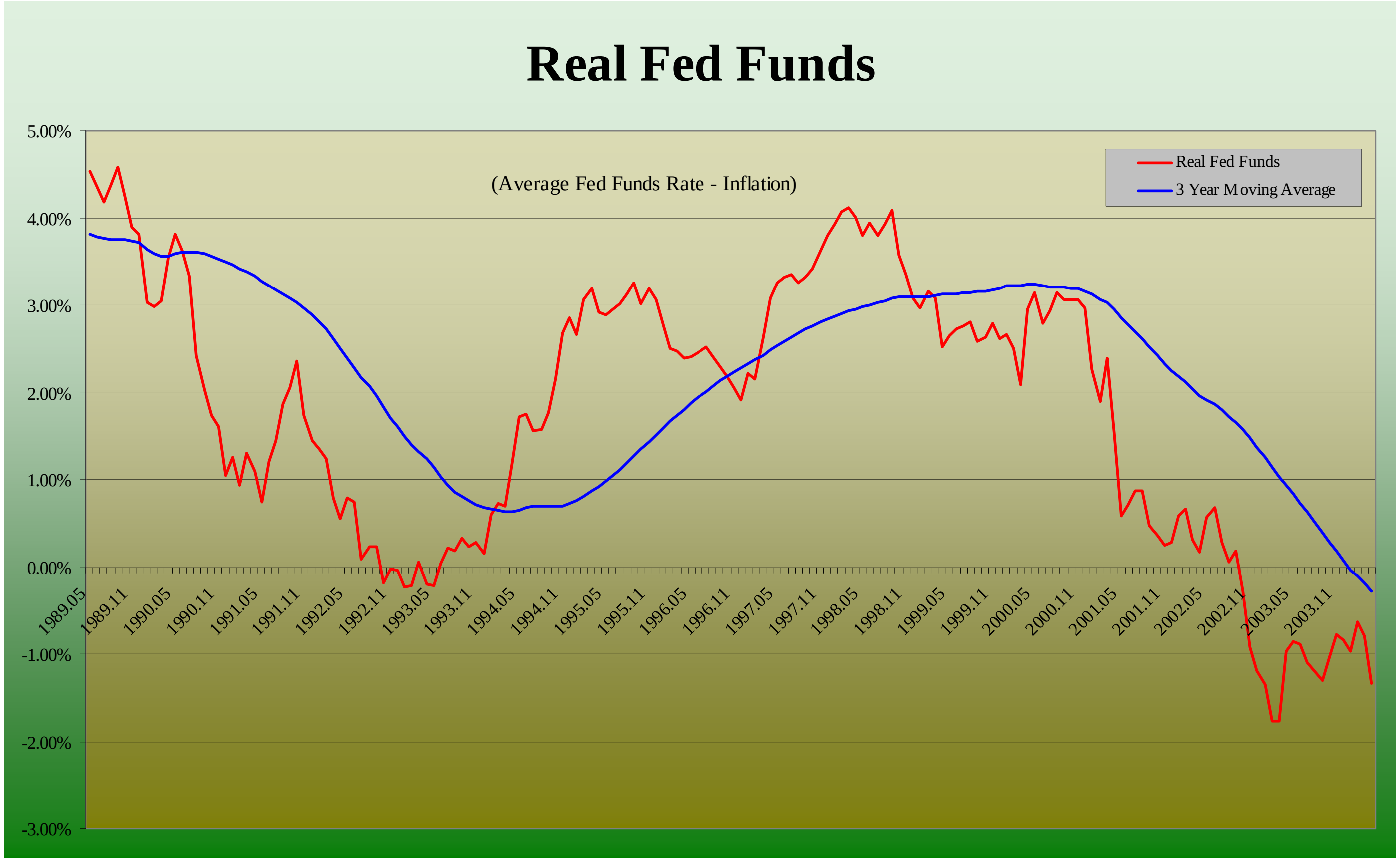
Federal Reserve Watch



Significant recent increase in near term interest rates while effective Fed funds has remained flat.

The market has already priced the rate hike into yields…

Federal Reserve Watch



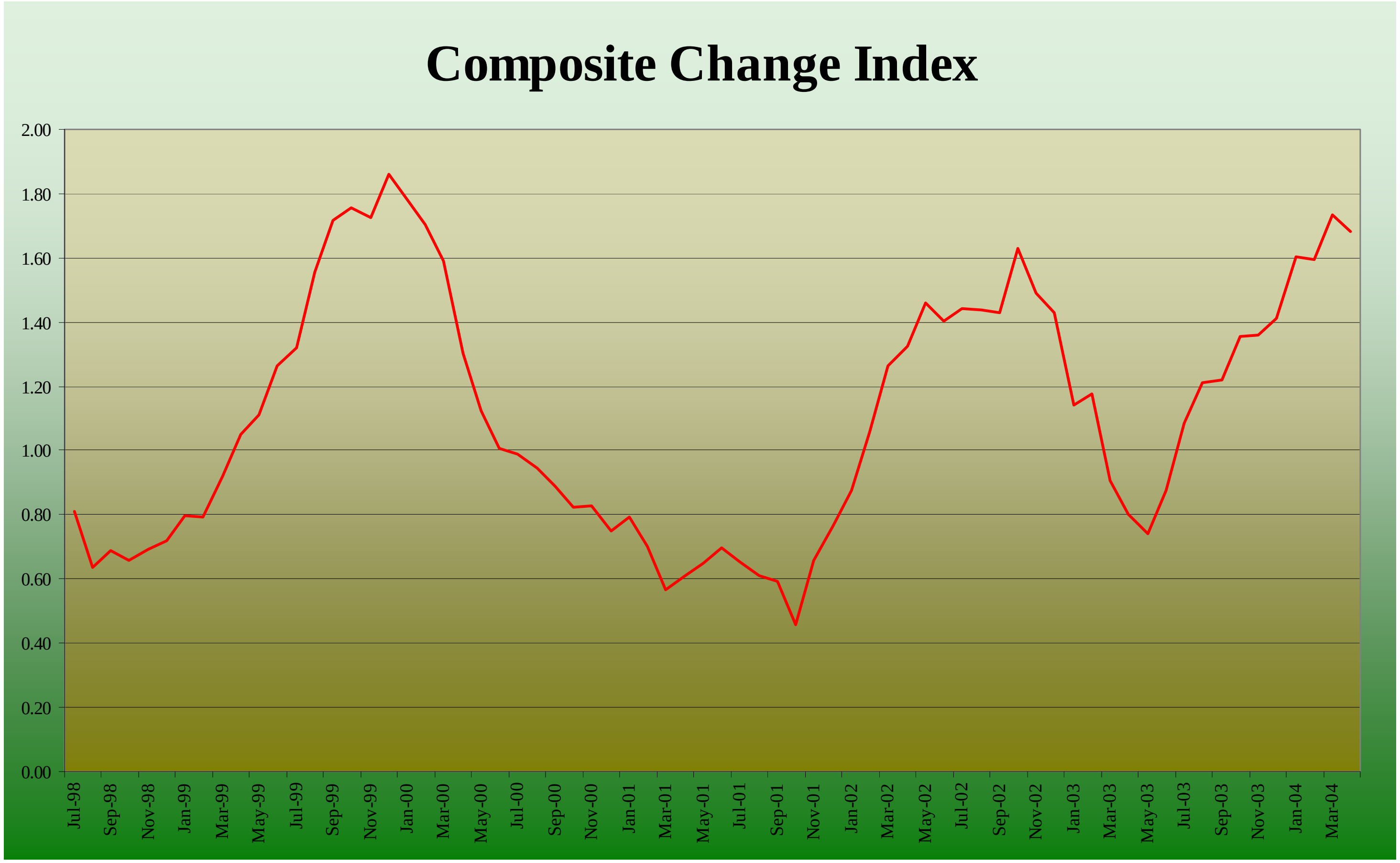
We believe the Fed will have few reasons to keep real interest rates negative as employment and output improve, and the increase in inflation has made real rates even more negative.

Outlook & Forecast

- The market does not like uncertainty, and there are several concerns that currently discount security valuation:
  - Interest rates
  - Inflation
  - Oil prices
  - Presidential election

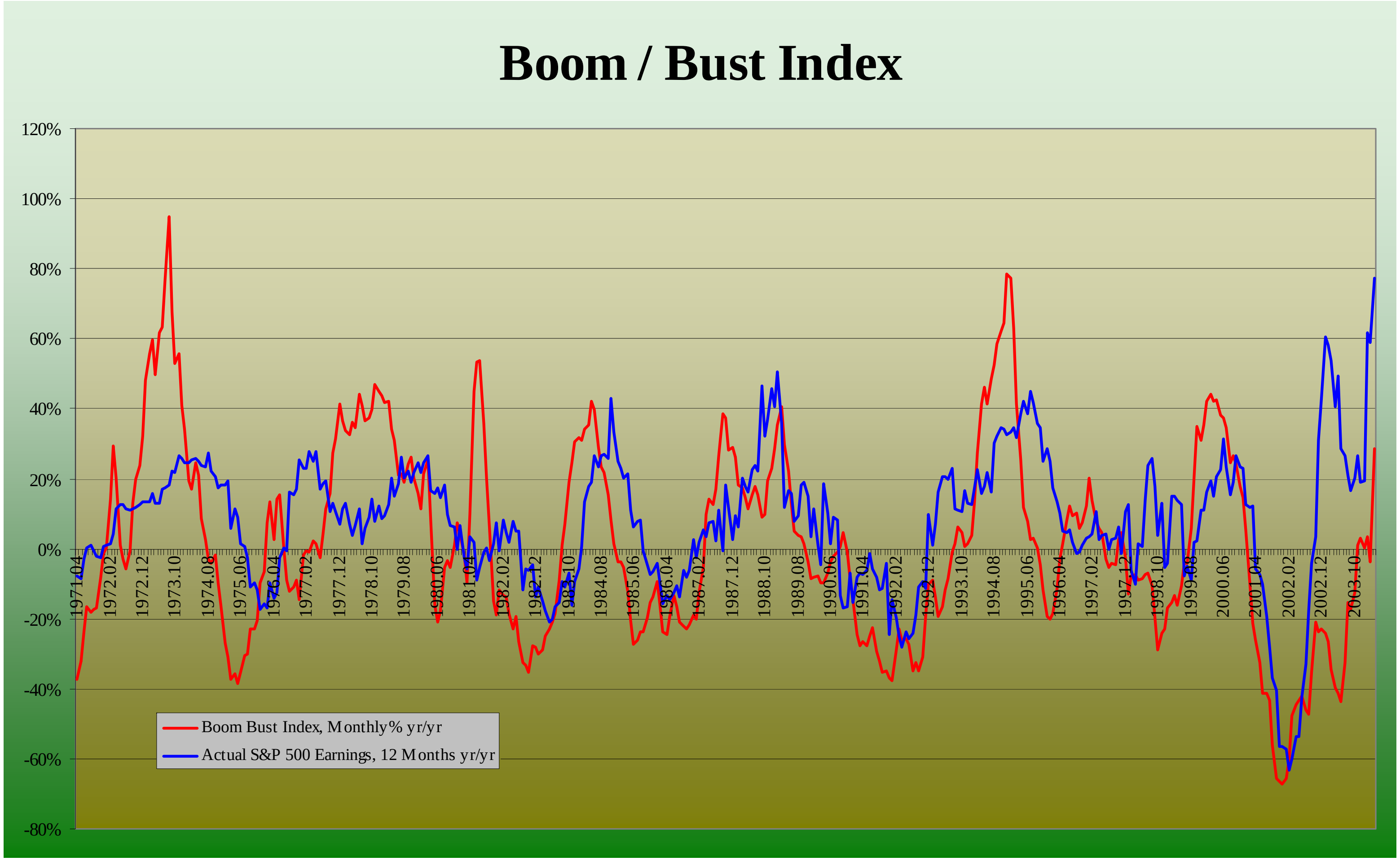
- We think each of these points of uncertainty could be resolved positively in the coming months, and this period may have been a "buying opportunity" as the market was discounted too much:
  - Interest rate increases have been priced into the market, but the Fed will not move too quickly to stifle the economic recovery.
  - Inflation will remain between 2 – 3% over the coming market cycle, which will not provide undue pressure on the market multiple. All the while, company earnings continue to grow at a healthy pace.
  - The "terror" / "unknown" premium priced into world oil markets will gradually recede, and oil-producing nations will continue to meet demand in an attempt to keep oil prices within a reasonable range.
  - The most uncertain of all the unknowns… if the above settle as described and economic growth translates into jobs, the current administration will be better poised to retain its position in the White House.

Outlook & Forecast



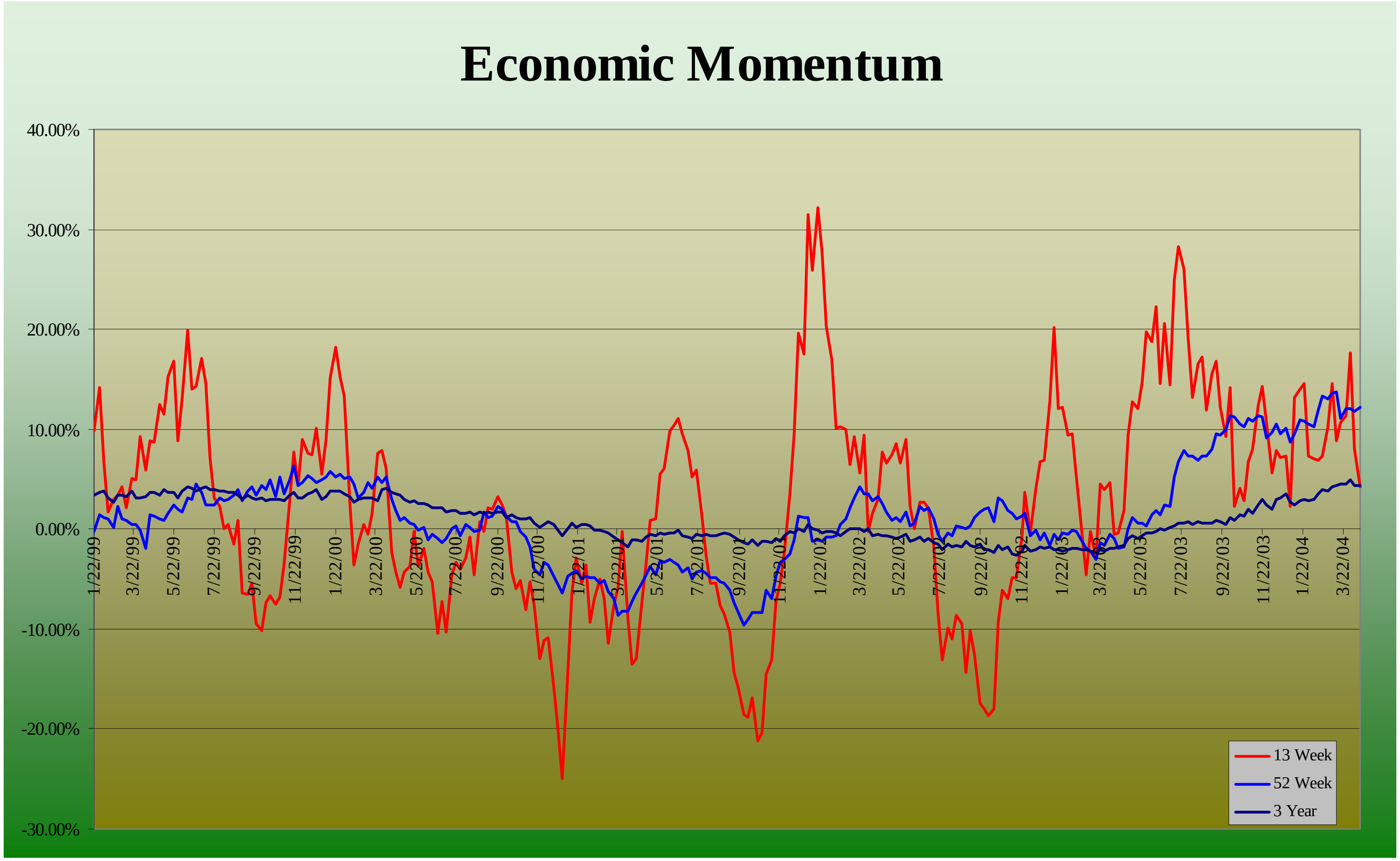
The composite change tends to lead earnings, and values over 1.00 are considered bullish. Earnings and earnings comparisons have been positive thus far in 2004.

Outlook & Forecast



The Boom/Bust Index tracks several key variables within the economy that correlate with earnings.
The red line is predicted S&P 500 earnings direction, indicating positive movement continuing.

Outlook & Forecast



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

Weekly momentum appears to be stalling, but the 52 week growth rate is still strong. The economy is just not "white hot" anymore.

CORNERSTONE
Investment Management and Consulting

www.investwithcornerstone.com

5/28/2004