

Monthly Chartbook

October 2005

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Our investment thesis for the next month...

Risk is under-priced.

We think that the stock and bond markets in the US are reasonably priced based on current fundamentals. But they are not priced to reflect some of the potential threats to our current economic stability that we can foresee (but do not necessarily predict).

In our opinion, the markets should reflect some of this uncertainty.

Macro-economic Research

Risk is under-priced – Stocks

We have mentioned that we anticipate 5% - 7% annualized returns in the US through the end of the decade for several reasons...

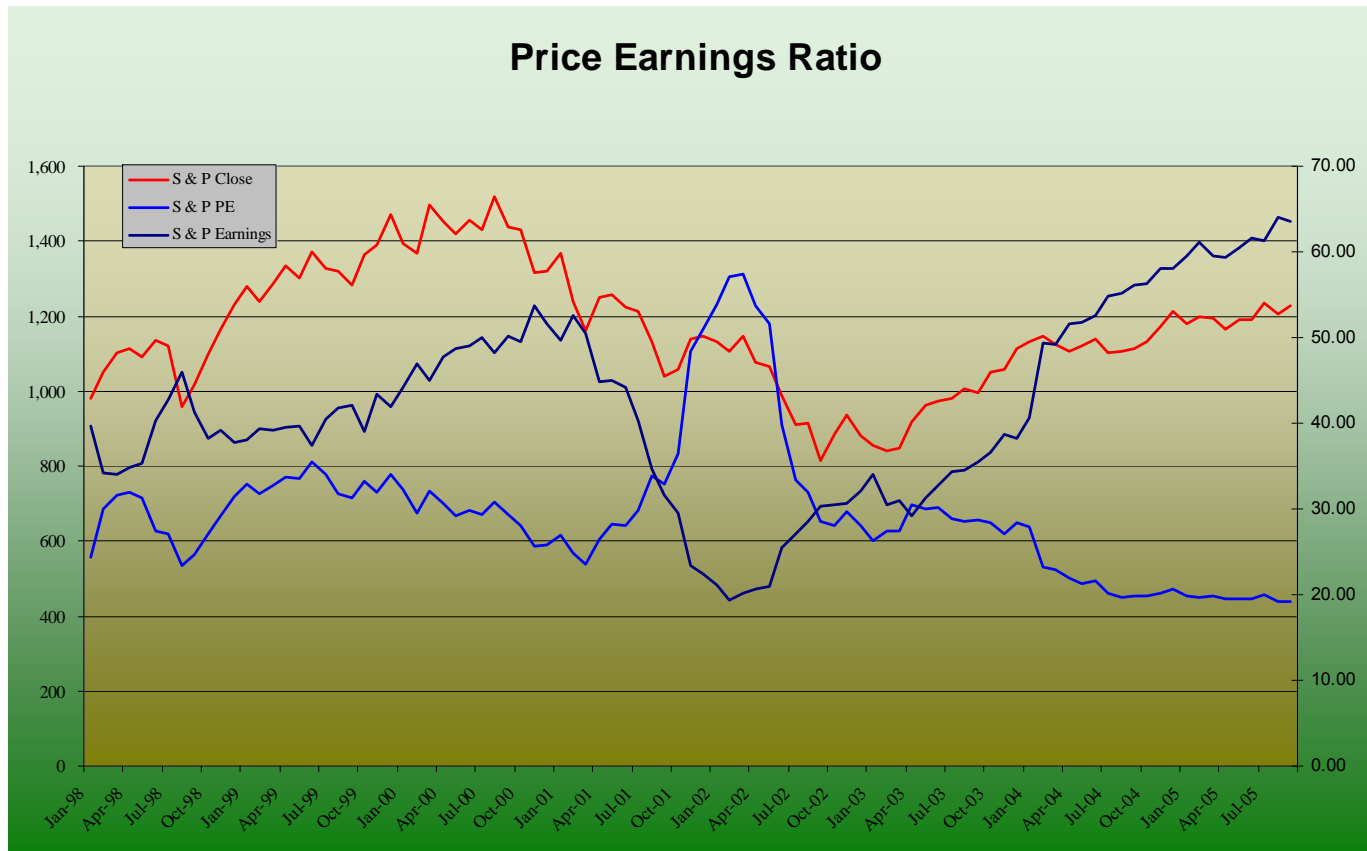
- in the near-term, energy-related commodity prices may decrease consumer spending for discretionary items
- inflation -- the market PE will likely remain range-bound until it is demonstrated that both price inflation and wage inflation are under control
- monetary growth is likely to be moderate over the coming periods as the Federal Reserve seeks to put itself in a stronger position with respect to its policy tools
- other global complexities, including the following
 - 1) recovering economies in other parts of the world
 - 2) the impact of short-term trading (hedge funds) on capital markets
 - 3) the American consumer continuing to borrow from the world, not for investment but to finance lifestyle

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The chart provides information on the price of natural gas, based on the futures market; this is anticipated to be above \$12 through March of 2006 and above \$10 through March of 2007. Contrast these prices with the winters of 2003 & 2004. Those who use heating oil face a similar issue with prices having increased from \$1 per gallon to \$2 a gallon this winter. Consumers, especially those of modest means, will have much less discretionary income over the coming months.

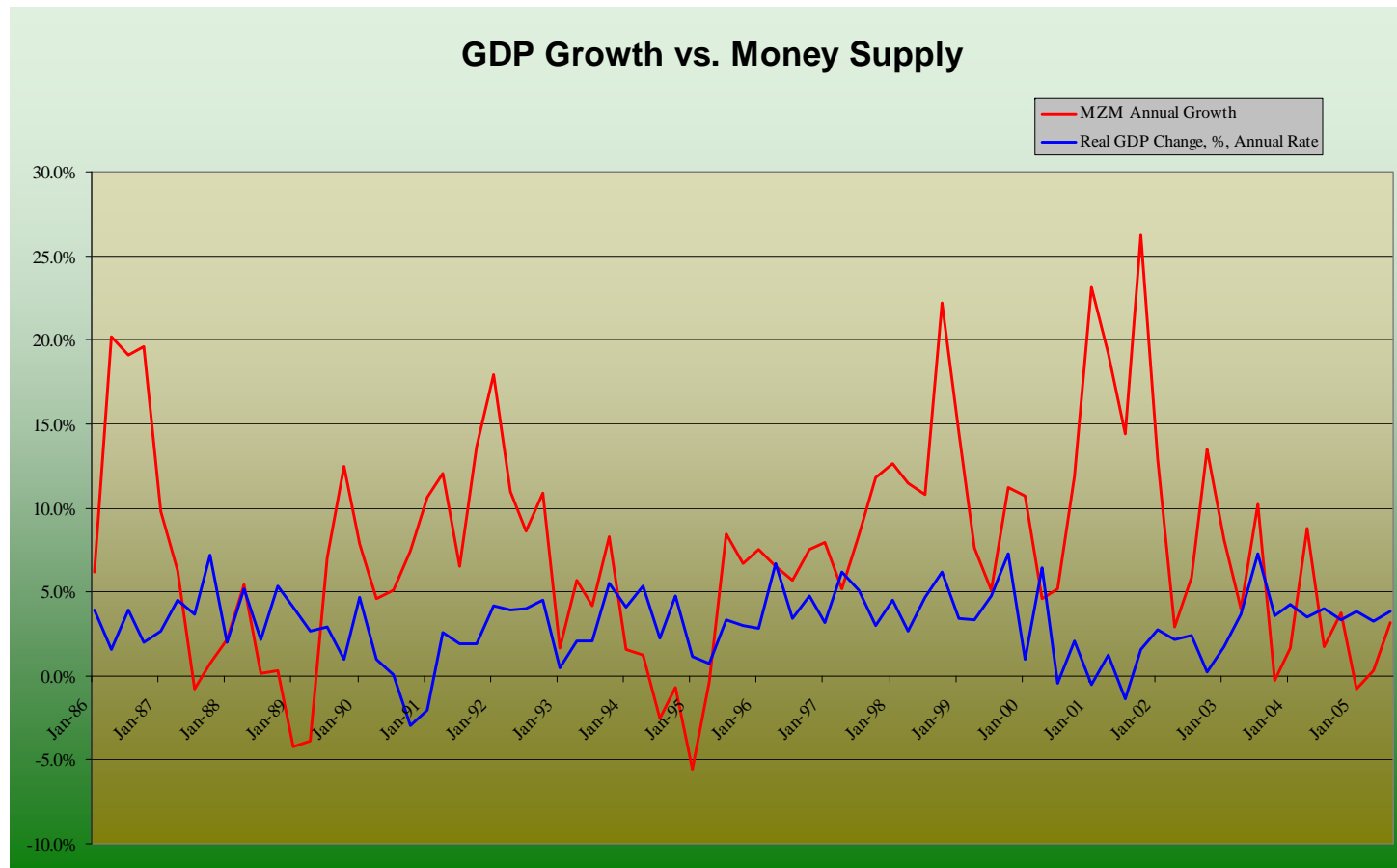
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Earnings growth has been strong since early 2002, but there has been minimal price movement as the market PE remains below 20x.

This PE will not likely move above this threshold without evidence that inflation is under control. This evidence has been lacking as of late, and any move upwards in the S & P 500 has been based on earnings rather than an expanding multiple.

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The Federal Reserve supplied considerable liquidity to the marketplace in the late 1990's to prevent a money crisis during the Y2K change-over and after the terrorist attacks of 2001 to serve as a needed economic stimulus. However, recent rates of growth in money supply have been considerably lower as the Fed has slowed growth in an effort to retain one of its primary policy tools.

Risk is under-priced – Bonds

For quite some time, we (along with many others) have been anticipating higher longer-term interest rates, and this is beginning to come to fruition.

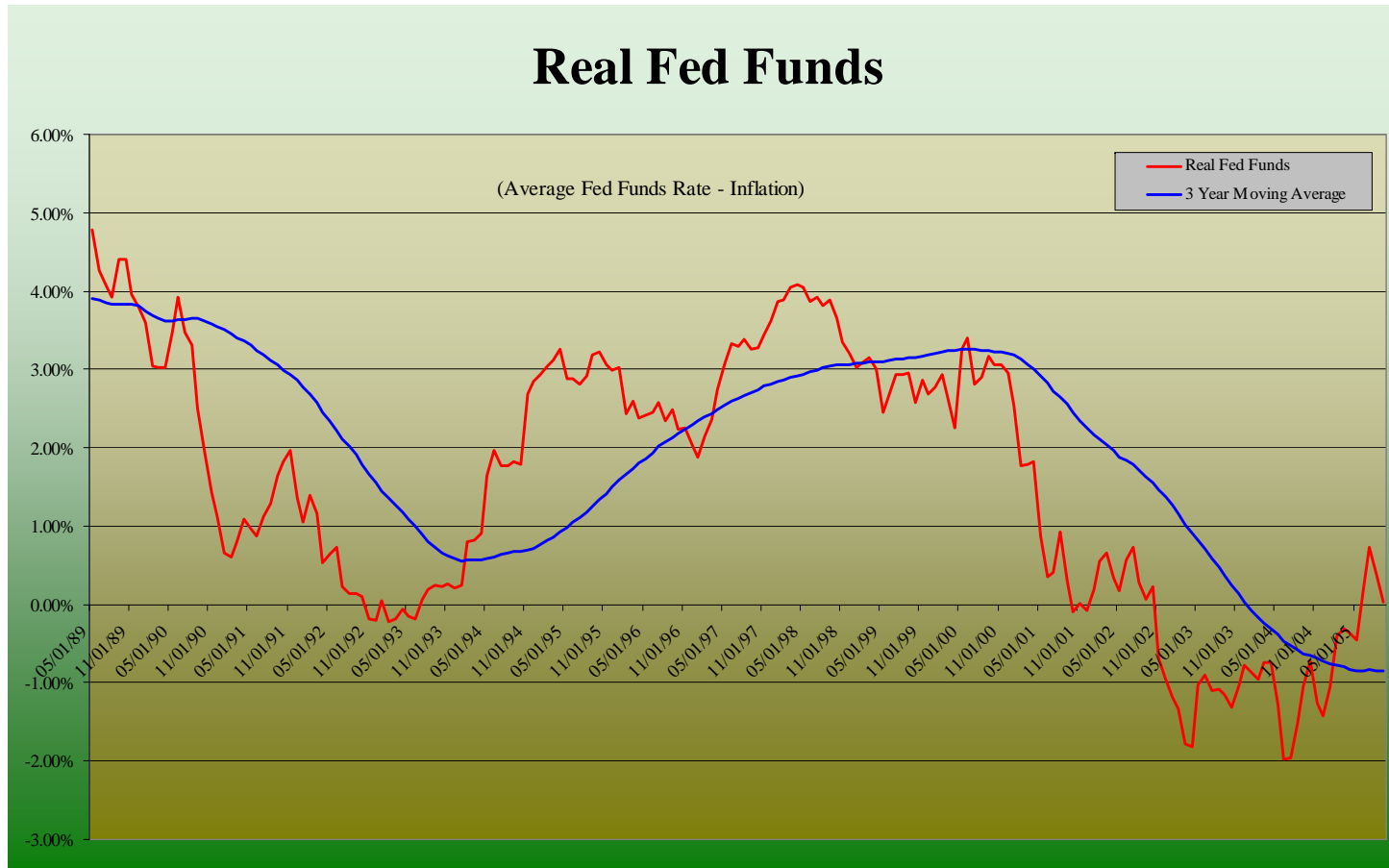
However, risk may still be under-priced in this sector due to...

Inflation – with higher inflation, interest rates have to rise to offer a real rate of return to investors

Foreign participation – there is still a considerable amount of foreign investment in US Treasuries

Aggressive uses of debt by consumers – some is rational, and some is scary

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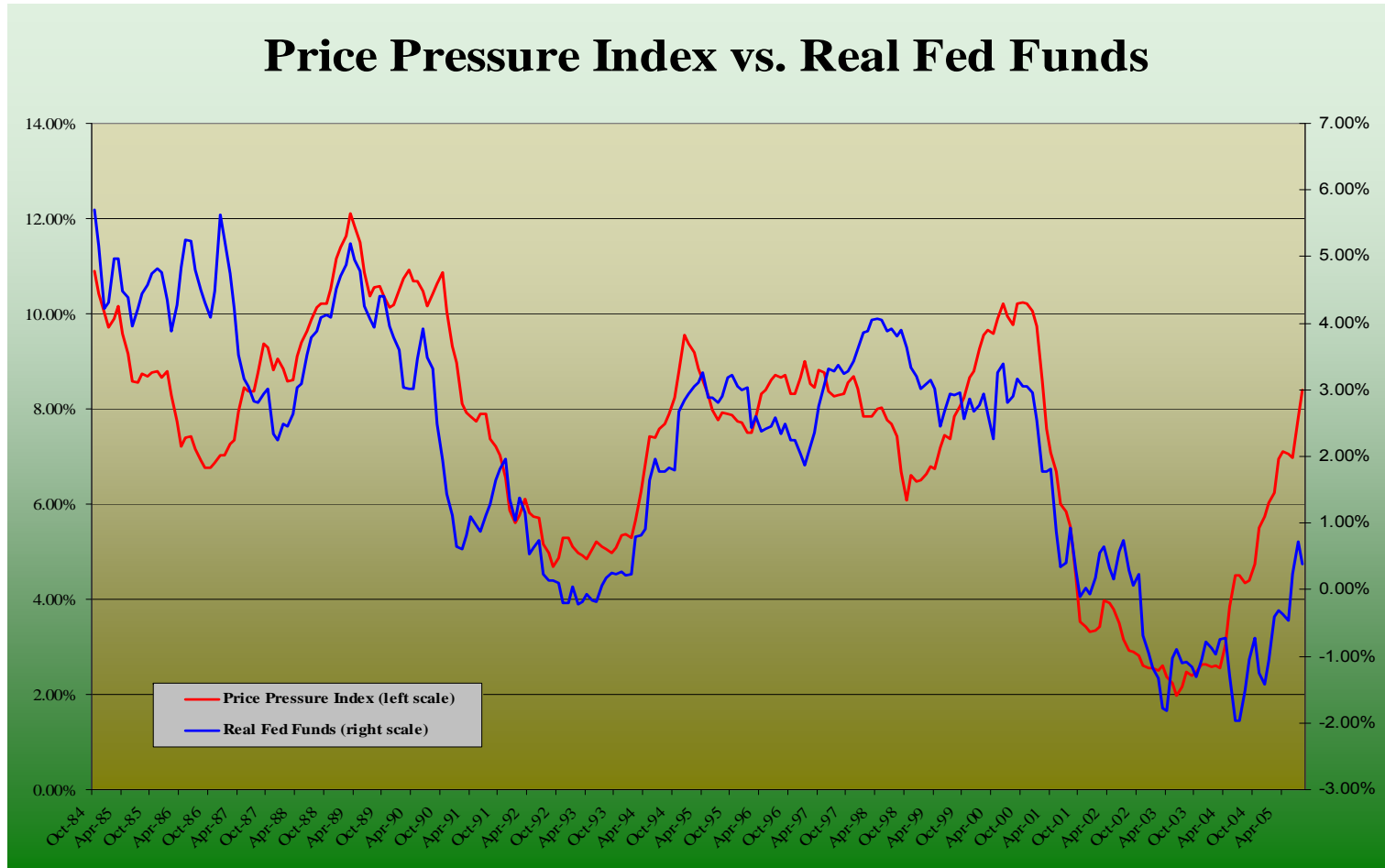


The real Federal funds rate is just barely providing a positive return when compared to CPI on a year-over-year basis. Either inflation has to decline or interest rates will have to increase to rectify this situation.

The energy costs associated with the higher inflation rate are likely temporary, but that is likely only part of the story behind the inflation number as all of the impacts of these cost increases have not filtered down to consumer goods.

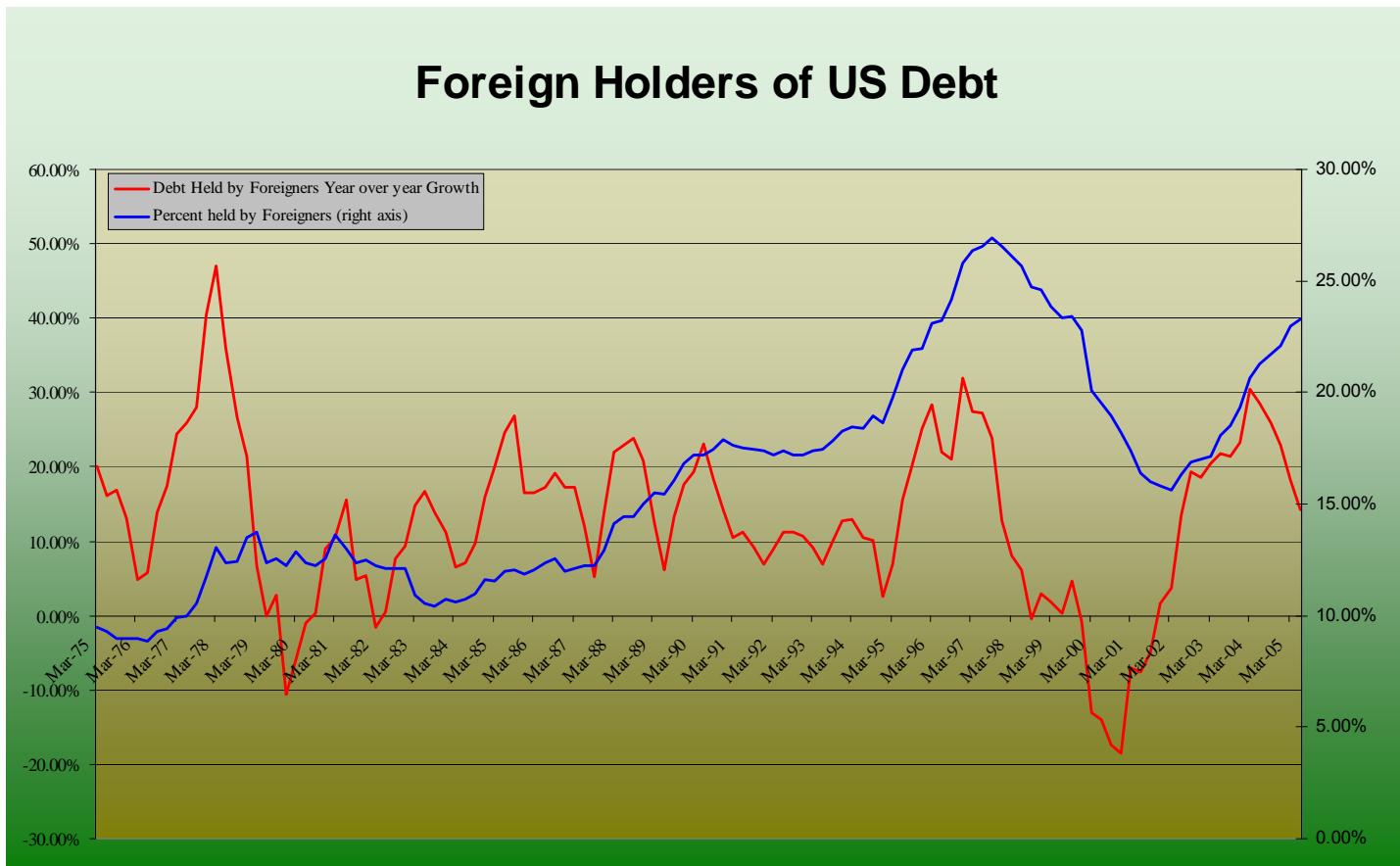
Therefore, it is likely to be both lower inflation and higher rates that bring this into balance.

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The real interest rate is very consistently correlated to our proprietary Price Pressure Index in both magnitude and direction. It appears the Federal Reserve is behind the curve with respect to the potential price increases indicating the likelihood of a continued increase in interest rates.

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Foreign entities still hold a considerable allocation of US debt, and this has potential (not necessarily likely) negative implications (i.e., longer rates would rise) if there were to be a lack of interest in subsequent purchases or a change in governmental / economic policy.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1207.01	Trading range	↔	1100-1275	Next 6 months
Ten Year Treasury	4.55%	4.45%	↓	4.25 - 5.00%	6 months
Inflation (all Urban)	4.69%	3.35%	↑	3.00 – 4.00%	6 months
Fed Funds	3.75%	4.25%	↑	3.75 – 4.50%	6 months
S&P 500 Earnings	\$63.62	\$67.50	↑	\$66 - \$70	1Q 2006
	Legend:	↑ Higher	↓ Lower	↔ Indifferent	

Inflation expectations

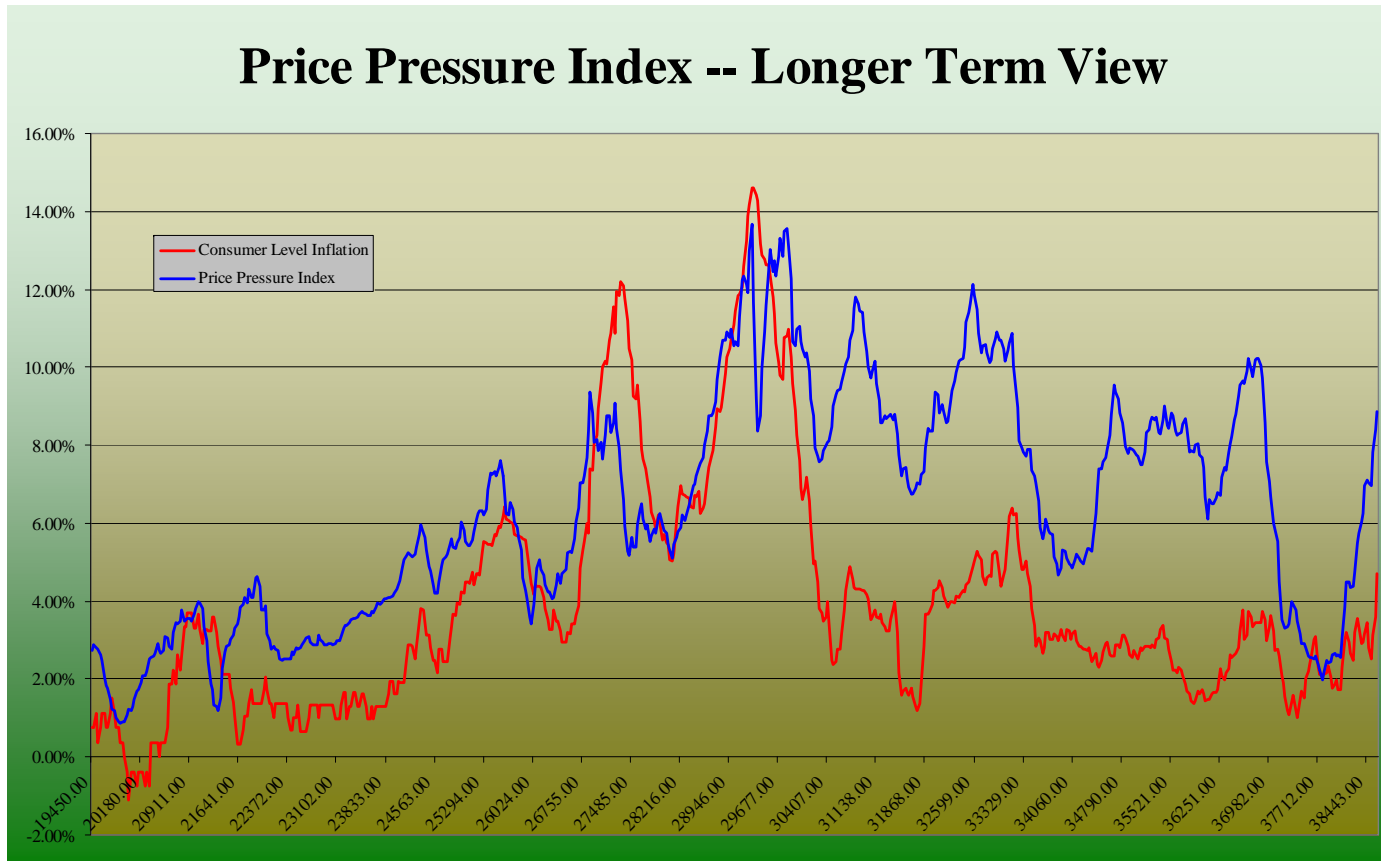
Our expectations for near-term inflation have increased as a result of the continued rise in the prices of energy-related commodities.

We believe inflation will likely remain in a range between 3% and 3.5% over the intermediate period due to the effects of these costs as they move through the supply chain.

Over the longer-term, inflation will be higher than it has been in the recent past but not high enough to de-rail economic recovery and incur stifling measures from the Federal Reserve.

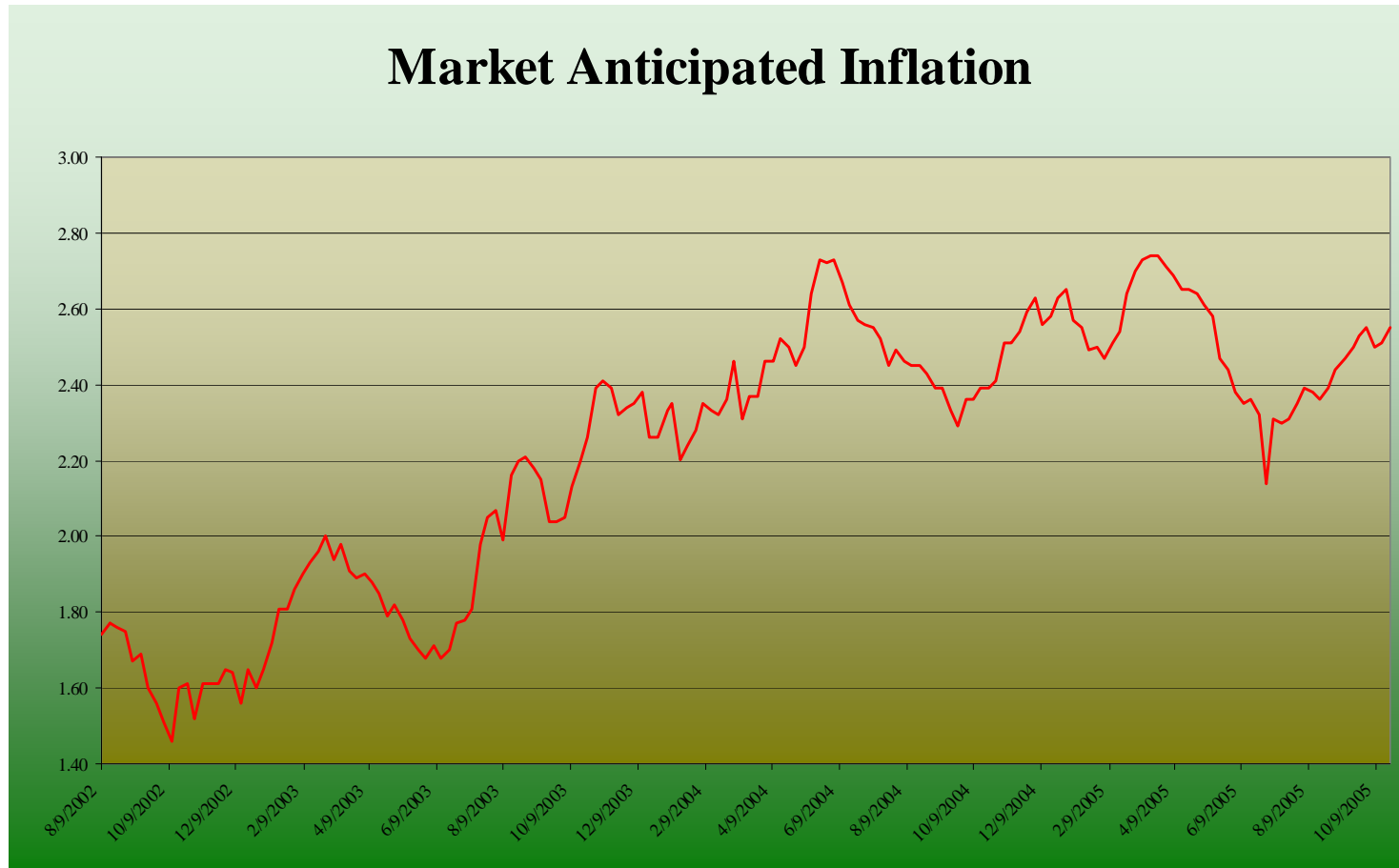
In the meantime, though, expect increases in the Federal funds rate.

Inflation Expectations



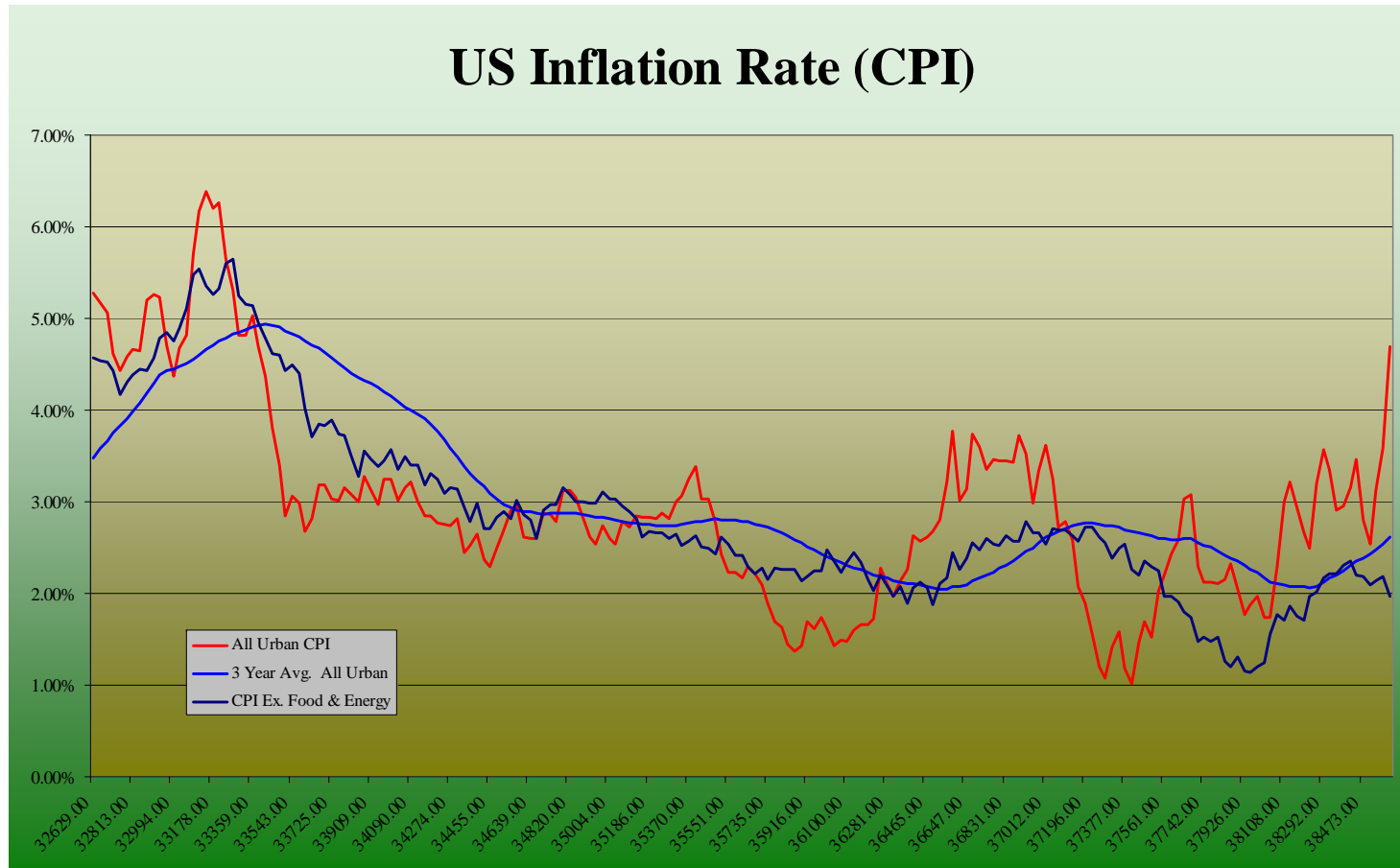
The Price Pressure Index has moved higher yet again as inflation spiked last month due to the cost of energy. Although we feel some of these effects are going to be short-lived, we also believe that some of the costs will filter down through the economy to consumer goods.

Inflation Expectations



Over the coming ten years, the market is anticipating inflation of approximately 2.5% per year. This is significantly lower than the current year-over-year rate, but it reflects the fact that the markets are predicting an inflation rate that is higher than recent history.

Inflation Expectations



Due to significantly higher energy costs as a result of hurricanes along the Gulf Coast, inflation on a year-over-year basis has increased to a recent high of 4.69%

Federal Reserve Watch

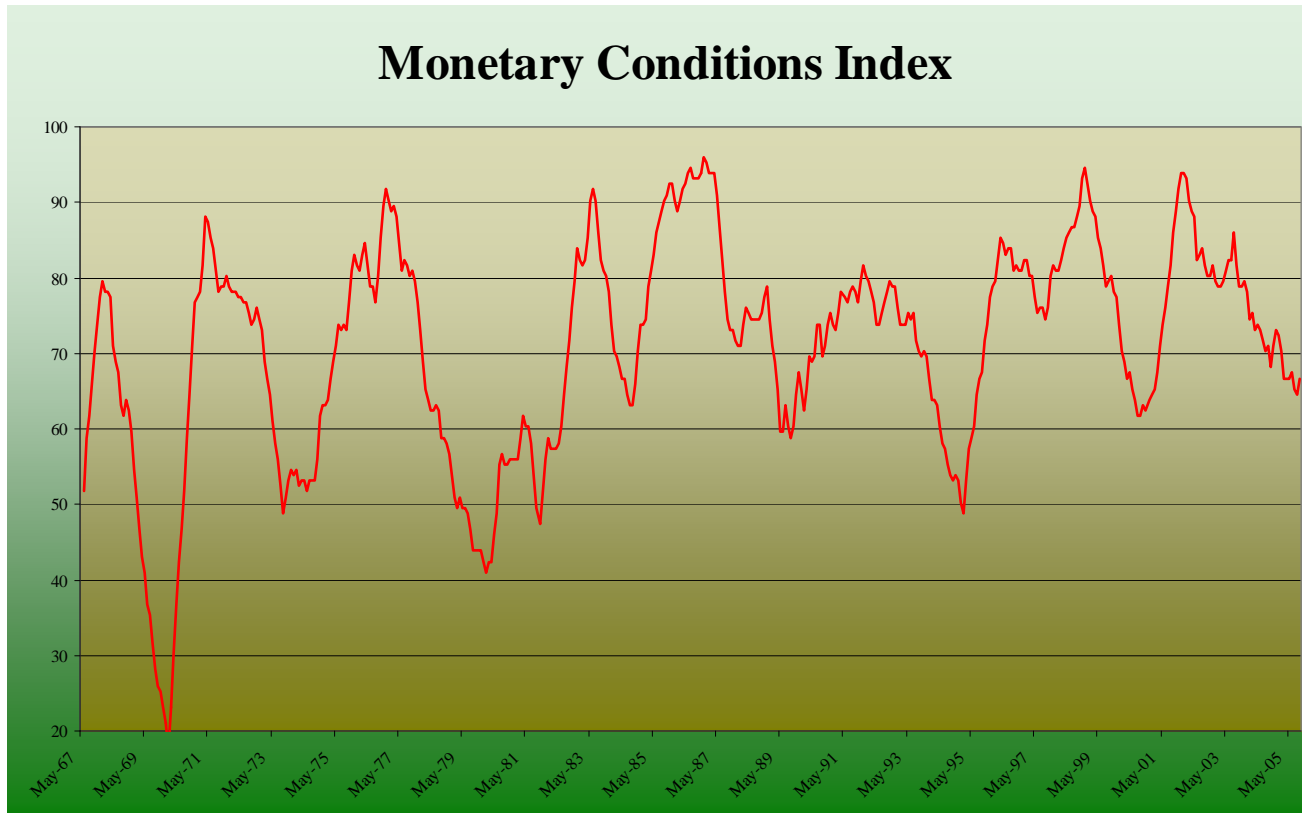
The Fed is working to gain control over their primary tools for economic stimulus – monetary growth and interest rate changes.

When the Federal funds rate was hovering around 1%, the central bank could not use this as a tool to stimulate the economy should there be need to do so. In addition to a wariness about inflation due to commodity demand as a result of the globally synchronized recovery, part of their strategy to increase short-term rates was an effort to provide this flexibility in future periods. Unfortunately, long rates have not increased commensurately to reflect the risk inherent in the bond market partially due to foreign demand.

At the same time interest rates have been increased, we think there has been a desire to reduce the rate of monetary growth to temper the expansive monetary policy of the late 1990's and the early part of this decade.

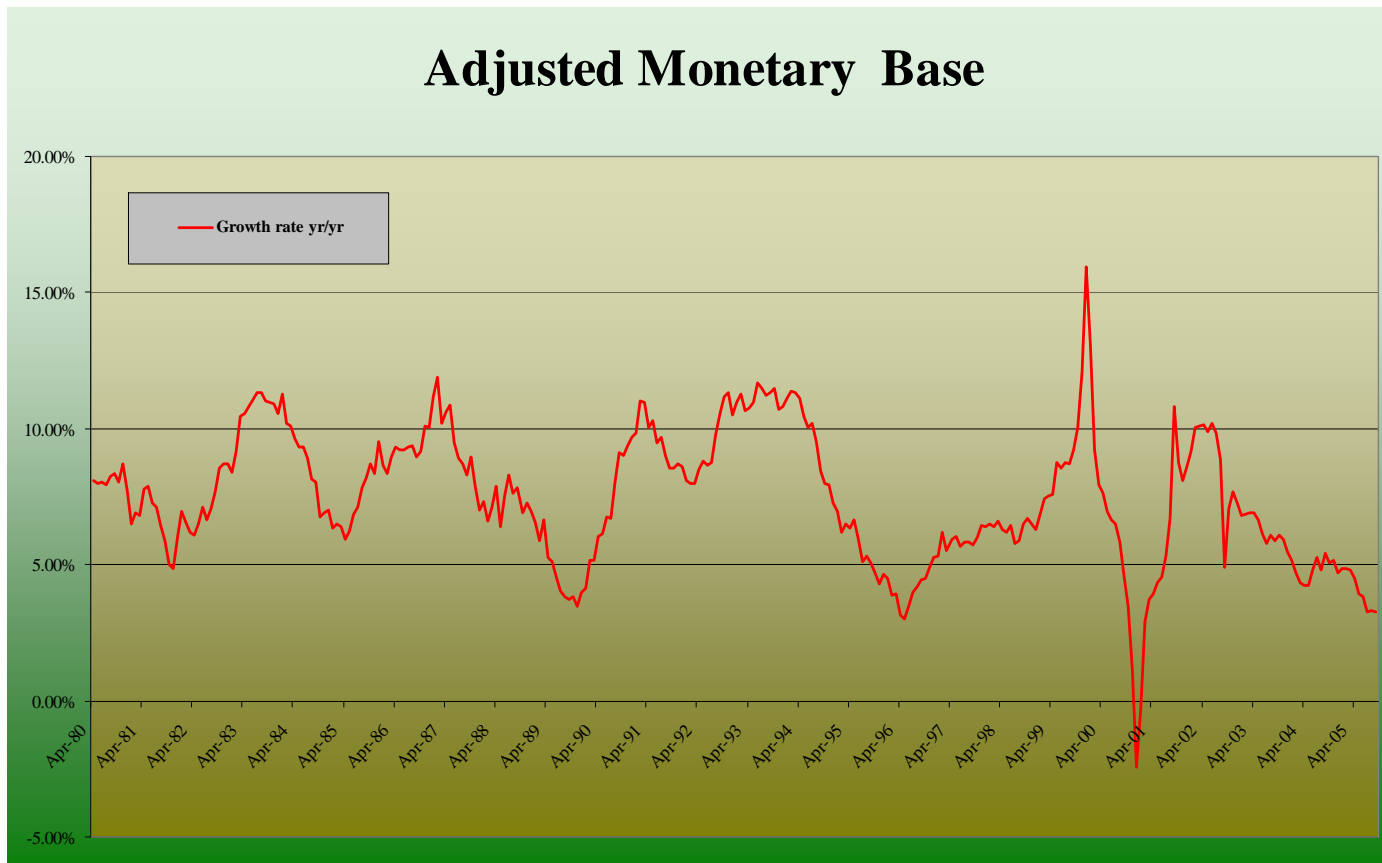
There will also be a new Fed chair at the end of January, and this economy is walking a very narrow line between inflationary pressures, slowing monetary growth and sustained economic growth. I'm glad I'm not in charge...

Federal Reserve Watch



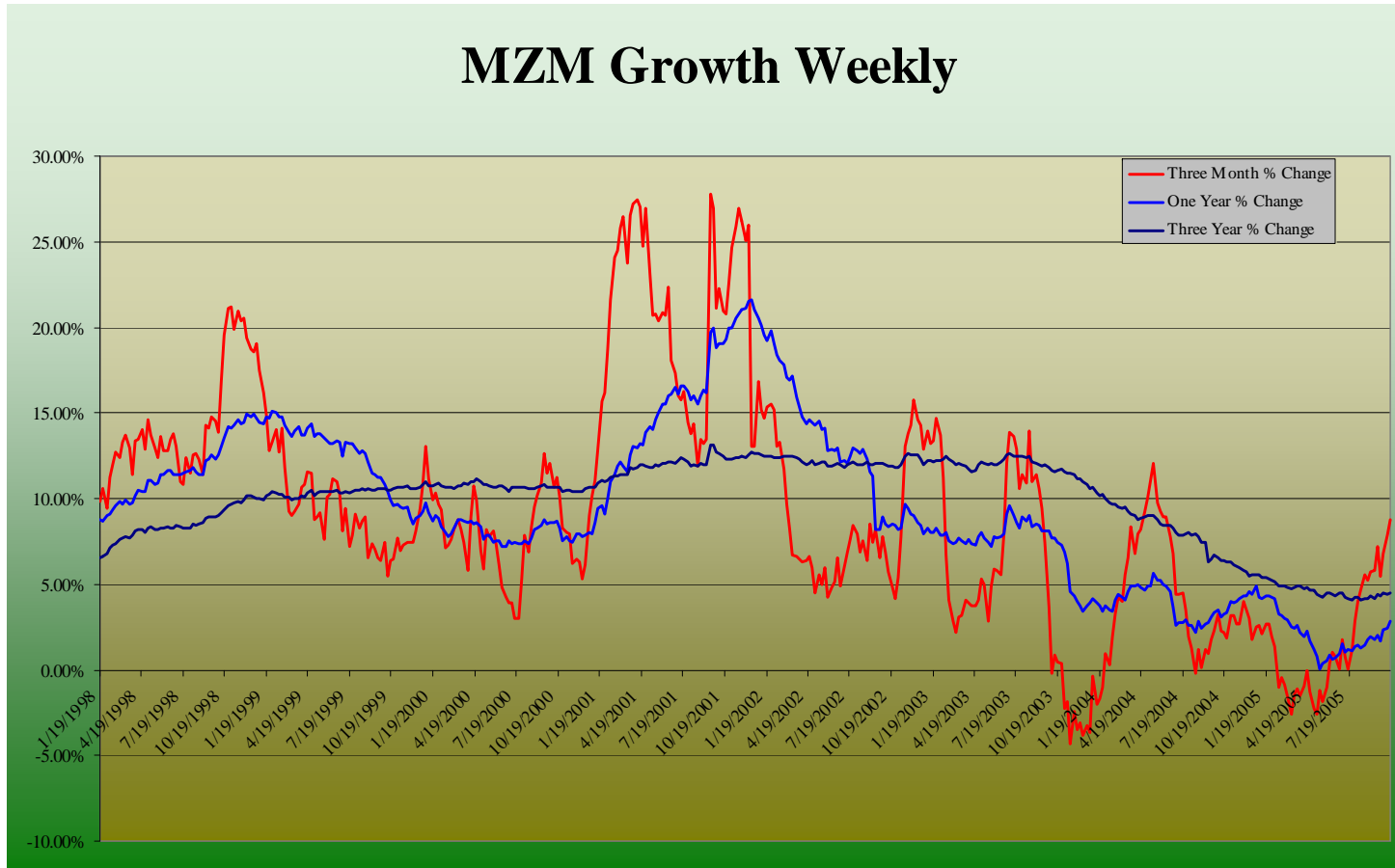
The monetary conditions index reflects these policy decisions and the delicate balance the Reserve bank attempts to mediate between re-gaining control over its policy tools, serving as the reserve currency for the world and safe-guarding the US economy.

Federal Reserve Watch



The growth rate for the monetary base is extremely low relative to historical standards.

Federal Reserve Watch



But, it is much higher on a short-term basis.

Outlook

US financial markets are not for the faint-hearted...

Even though there have not been many corrections or retracements in the past year and a half, there is a lot of risk inherent in the market that is not being reflected in current prices for either stocks or bonds.

This is not a prediction for “imminent doom”; we are not perpetual bears on the markets and we continue to see select opportunities within the marketplace in both sectors and individual securities. However, there are risks to the market we feel are not priced into other assets and asset classes.

These ideas are merely a cautionary reminder that investors should consider as they determine where to allocate their capital.