

The Oarsman Outlook

First Quarter 2005

Skyrocketing energy prices and rising inflation worries overshadowed healthy economic growth and solid corporate profitability during the first quarter of 2005, resulting in disappointing three-month investment returns. Bond investors abandoned their complacent view of tightening Federal Reserve policy, pushing the yield on the benchmark 10-year Treasury Note up 60 basis points (0.60 percentage points) from early-February lows and resulting in negative returns from all but the shortest maturities. Stocks fared no better – a mid-quarter rally to four-year highs notwithstanding – with the S&P 500 Index providing a total return of -2.2%.

Within the U.S. equity market, only the Energy and Utilities sectors provided positive returns; Basic Materials, Consumer Staples and Health Care were areas of relative strength, however. The worst results were in the interest rate- and economically-sensitive Financial Services and Technology sectors; real estate securities also bowed under the pressure of rising bond yields. Non-U.S. markets performed somewhat better, benefiting from greater exposure to Energy and Materials, as well as generally more conducive inflation and interest-rate environments.

Benchmark Performance – Equities

	<u>First Quarter 2005</u>	<u>Last Twelve Months</u>
S&P 500 Index	-2.2%	+6.7%
Dow Jones Industrial Avg.	-2.1%	+3.6%
NASDAQ Composite	-8.1%	+0.3%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-2.4%	+3.4%
Small-Cap Stocks (Russell 2000)	-5.6%	+4.2%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+0.4%	+15.2%

Benchmark Performance – Fixed Income

	<u>First Quarter 2005</u>	<u>Last Twelve Months</u>
Lehman Aggregate Bond Index (taxable)	-0.5%	+1.1%
Lehman Municipal Bond Index (tax-exempt)	-0.0%	+2.7%

Three developments dominated the financial markets during the first three months of 2005: a renewed surge in the price of oil; a subtle but important shift in investors' perceptions of inflation risks and Federal Reserve policy; and a bombshell negative earnings announcement from General Motors, prompting fears that a huge volume of auto industry bonds could be downgraded to "junk" status. In combination, these events caused a distinct change in investor sentiment, with widespread complacency replaced by aversion to nearly all types of investment risk.

Perhaps buoyed by the underlying health of the economy and corporate finances, the decline of the U.S. equity market was fairly modest, particularly considering the strong advance (+9%) in the last quarter of 2004. Faced with less daunting monetary and bond-market conditions, nearly all major overseas markets managed gains for the quarter (although returns to U.S. investors were reduced by a late-period rebound in the foreign-exchange value of the dollar). Despite the seeming rise in uncertainty, stock market volatility remained subdued during the quarter: the S&P 500's 62-point trading range (1163–1225) was the narrowest in more than eight years.



Looking ahead, the U.S. economy seems set to continue expanding at roughly the 3.8% rate registered in the final three months of 2004. To date, consumers seem unfazed by high energy prices and rising interest rates: measures of confidence are meaningfully above year-ago levels; gasoline consumption is up 2%; housing activity remains robust (though this bears close watching); and job creation is running at a healthy average of 180,000 per month, with unemployment gradually declining. After a slow start during the first two years of the current expansion, corporate investment has become a bright spot, advancing at an 18% clip in the fourth quarter of 2004. Lean inventories, hyper-competitive markets and healthy cash flows should sustain this spending for some time.

Nevertheless, few would be surprised to see the pace of growth moderate somewhat as the year progresses, particularly if energy prices and interest rates continue to rise. But it is important to keep in mind that, while rising, interest rates remain low by historical standards, and energy prices *adjusted for inflation* remain far below levels reached in the early 1980s. Accordingly, we expect any slowdown to be modest, barring a major “dislocation” in, say, the residential real estate market, or a major surprise in the geopolitical arena.

After expanding at a 20% pace in 2004, corporate profits will do well to rise at half that rate in 2005. Although energy-sector earnings are obviously burgeoning, and many industrial companies are increasingly able to raise prices (and sustain high profits), rising interest rates will hit financial-service firms, which account for nearly 30% of the total profits of publicly-traded U.S. companies. Still, we expect earnings to be up 7% to 8%, on average; continued productivity improvements – along with more widespread price increases – could yield an upside surprise in this area.

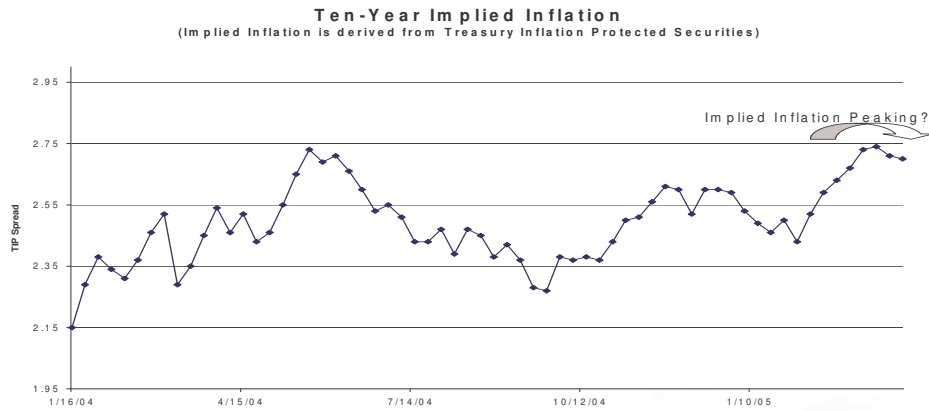
The recent shift in investor sentiment and the market's failure to build upon its fourth-quarter advance suggest the above developments are recognized and largely discounted.

Accordingly, investment performance in the months ahead will be most influenced by the ebb and flow of inflation expectations, and the response of Fed policy and, by extension, bond yields. In its recent pronouncements, the Fed has clearly signaled that it is carefully attuned to inflationary currents in the economy. At the same time, the consensus view of future Fed actions has become substantially more negative: late last year, most investors believed the Fed would raise short-term rates (currently set at 2.75%) no higher than 3.0% or 3.5% in 2005; today, most think rates will need to reach at least 4.0%, with some calling for substantially higher levels in 2006.

Rising prices for oil and other industrial commodities have been an important component of the recent up-tick in inflation fears. In addition to the well publicized spike in the price of crude oil, a widely watched index of 17 industrial and agricultural commodities reached a 24-year high during March. The key investment issue is whether this price surge accurately reflects a mismatch of supply and demand that could persist for years, or is being greatly magnified by the speculative activities of hedge-funds and other leveraged investors. The investment-analytical consensus seems to lean toward the former view, but a number of influential analysts are convinced that speculative activity is playing an important role. The supply/demand argument asserts that global demand, particularly from China, will continue to outstrip increases in supply for years to come, resulting in persistently high if not rising prices (one analyst has suggested oil could reach \$105 per barrel). The speculation argument predicts that as the deceleration of global growth becomes more apparent and commodity prices stop increasing, the "unwinding" of leveraged positions could cause prices to drop dramatically later this year – analysts in this camp have oil price targets around \$30.

We believe stock prices, bond yields and investor sentiment currently are more reflective of the supply/demand argument, incorporating a rising inflation outlook. If the consensus view shifts even marginally toward the speculation argument, investors may return to the belief that, due to the perceived fragility of the current expansion and a strong desire to avoid an "accident" in either the financial or real-estate markets, the Fed will be inclined to leave rates somewhat lower than might otherwise be expected. This would create a more conducive environment for both bonds and stocks.

We are optimistic that inflation fears will peak soon (if they haven't already): global economic growth has been gradually *decelerating* since the middle of 2004; a proprietary measure of "pipeline inflation," developed by the *Bank Credit Analyst (BCA)*, is declining; and the inflation outlook implied by the yield spread between "regular" and inflation-indexed



Treasury securities (TIPS) has stopped rising. Moreover, *BCA* analysis of yield differentials between shorter- and longer-term TIPS indicates the recent rise in inflation expectations is concentrated at the “front-end” of the yield curve: expectations beyond five years are actually *lower* than they were 18 month ago. This is important from an investment perspective, as a few years of higher inflation would be much less damaging than a more persistent rise.

Until the inflation outlook is more settled, giving investors a better sense of the Fed’s course and the likely range for bond yields, stocks will continue to face a headwind. However, valuation is reasonable – the S&P 500 is trading at less than 16 times expected 2005 earnings – and profit growth should be respectable, suggesting risk is limited. Moreover, history suggests we have reached the point in the economic cycle where the stocks of high-quality companies with proven records of earnings and dividend growth will be favored. Finally, as the inflation-fear/monetary-policy “headwind” is generally absent outside the U.S., and most overseas markets sport even lower valuations, investments in non-U.S. stocks remain relatively attractive.