

The Oarsman Outlook

Second Quarter 2005

The second quarter of 2005 was uneventful, as most financial assets provided positive, but subdued, returns. As inflation fears eased and evidence of a mid-cycle economic “soft patch” gathered, bond yields fell, causing prices – especially of longer-maturity issues – to rise. As for stocks, solid corporate profitability and healthy – even if slowing – economic growth were sufficient to offset worries about Federal Reserve interest-rate hikes and sky-high energy prices. Of note, smaller-company and higher-risk issues outperformed high-quality, “blue chip” stocks, suggesting investors were optimistic despite the seemingly uncertain environment. Non-U.S. stock markets also produced superior results, although a rally in the foreign-exchange value of the dollar muted returns to dollar-based investors. Finally, fully reversing a first-quarter sell-off, real estate securities provided double-digit returns.

Benchmark Performance – Equities

	<u>Second Quarter 2005</u>	<u>Last Twelve Months</u>
S&P 500 Index	+1.4%	+6.3%
Dow Jones Industrial Avg.	-1.6%	+0.7%
NASDAQ Composite	+3.0%	+0.9%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+1.2%	+4.4%
Small-Cap Stocks (Russell 2000)	+4.3%	+9.5%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-0.4%	+15.8%

Benchmark Performance – Fixed Income

	<u>Second Quarter 2005</u>	<u>Last Twelve Months</u>
Intermediate-Term Taxable Fund Avg. (Lipper)	+2.4%	+6.4%
Intermediate-Term Muni Fund Avg. (Lipper)	+2.3%	+5.0%

The U.S. economy continued on a path of solid growth in the spring, although the pace appeared to slacken somewhat in the second quarter. Overall growth was a healthy 3.8% in the first quarter, equaling the pace achieved in the last period of 2004. Economic growth has averaged 3.9% over the past seven quarters, with unemployment falling from 6% to just over 5%. Corporate profitability continued at near-record levels, with S&P 500 earnings up a solid 13% (year-over-year) in the first quarter.

Beneath the headline numbers were some indications of decelerating growth: consumer spending, business investment and real final sales (which exclude changes in inventories) all expanded more slowly in the first quarter than in late 2004. Moreover, both the ISM purchasing managers’ index and the Conference Board’s index of leading economic indicators have fallen consistently over the past several months (although the June ISM reading was a significant positive surprise); both still indicate an expanding economy, however.

Other important developments during the second quarter included a roller-coaster ride for the price of oil, which fell more than 15% in April and May, and then rose 25% to new highs in June. Meanwhile, the credit markets spent much of the quarter digesting the troubles of the American auto industry – including the downgrading of General Motors and Ford bonds to “junk” status. By the end of June, this episode seemed to have been resolved positively, with credit spreads (a measure of risk) narrowing and the *Bank Credit Analyst’s* “Financial Stress Index” falling from a recent peak. Finally, the Federal Reserve held steady on its course of “measured” increases in short-term interest rates, with its eighth and ninth quarter-percentage-point hikes raising the overnight Fed Funds rate to 3.25%.

The American economy stands on a firm foundation for continued growth, with a healthy corporate sector, rising personal incomes, and strong consumer-sector balance sheets, thanks in no small part to burgeoning house prices. Nevertheless, persistently high energy prices and gradually rising interest rates seem likely to act as a drag, so we expect growth to slow modestly in the months ahead. Most leading barometers of inflation suggest that price-increases have peaked, but – due primarily to high energy prices – inflation may remain high enough (in the area of 2.5%) to be of concern to Fed policymakers. Slowing growth and stable or falling inflation already seem to be reflected in the drop in longer-term interest rates seen during the second quarter.

The outlook for corporate profits is similar. Both American companies and their foreign counterparts still seem bent on maximizing efficiency/productivity in the face of global hyper-competition, and we believe this will drive a continued expansion of earnings at least into 2006. However, profit growth seems set to decelerate, coming under increasing pressure from rising costs for both labor and commodity inputs (including but not limited to energy). Standard & Poor’s analysts expect earnings growth for the companies that make up the S&P 500 to slow to just under 10% in the second quarter – still a healthy pace (the long-term average is closer to 7%), but below the rate seen over the past two and a half years.

Despite solid underpinnings, two issues weighing on investors’ minds in recent months have prevented U.S. stocks from advancing: tightening Federal Reserve monetary policy and skyrocketing energy prices. Historically, periods of Fed tightening have rarely been good for stocks, as investors struggle to divine the eventual level of interest rates and fret that the Fed will either fail to contain inflation or “succeed” in quashing economic growth. So far, the current episode is not much different: most of the past 18 months has been about as exciting as watching paint dry, although an election-induced late-2004 rally has stocks up a bit since the Fed began tightening early last year.

Similarly, although investors have debated whether sharply higher energy prices are more likely to ignite inflation or to act as a “tax” that slows growth, either outcome would be negative for stocks (outside the energy sector, that is). To date, falling bond yields and shrinking inflation-premia on inflation-protected Treasury Notes suggest the slower-growth scenario is unfolding.

We believe both these issues stand a good chance of being resolved positively in the months ahead. Although most economists expect the Fed to continue raising short-term rates, many believe the end of the current tightening phase will be at or below 4.0%, a level we could see

before yearend. Paradoxically, the apparent economy-slowness (as opposed to inflation-inducing) impact of higher energy prices probably means that, all else equal, the Fed can stop raising rates sooner than might be expected. As for energy prices, slackening growth in the developed economies compared to last year's robust pace will remove some demand-side pressure. Moreover, demand from China seems to be abating; while economic growth there may or may not slow, much of last year's surge in oil demand was apparently related to shortages of coal-fired electric-generation capacity (which forced factories to run diesel generators), most of which have been alleviated. Meanwhile, fears of supply disruptions in the Middle East, Russia and Venezuela have so far gone unfulfilled, while every month of high prices spurs incremental investment aimed at increasing future supply. A highly respected consulting firm, Cambridge Energy Research Associates, has predicted that these factors will combine to produce a substantial drop in oil prices sometime after 2006.

The stock market could react quite positively to a growing sense that the Fed is nearly finished raising rates and/or that energy prices are more likely to stabilize or fall than to continue rising. With average valuations improving (thanks to rising earnings), such a reaction could result in a healthy short-term rally: the S&P 500 currently trades at less than 16 times reasonable estimates of 2005 earnings, and around 14.5 times admittedly less certain projections for 2006; if Fed and oil worries subside while 2006 earnings come into better focus, the market could rise to bring valuation up to between 16 and 17 times 2006 earnings, yielding a gain of 10% to 17% from June 30th levels.

Even if current worries about monetary policy and energy prices recede, however, two more intractable, albeit less immediate, concerns may keep a damper on investor enthusiasm. First is a growing concern about an unsustainable "bubble" in residential real estate that could end as badly as the late-1990s technology-stock version. Second are worries that chronic over-consumption/under-saving in the American economy is creating unprecedented global financial imbalances that are inherently unstable. (Both problems have received a good deal of media attention: a particularly good real estate story ran in the June 20th issue of *Barron's*, while the current (July/August) *Atlantic Monthly* has articles on both issues; please let us know if you would like us to send you a copy of either piece.) These are both very real concerns – a bad ending to either of these situations could precipitate in an economic downturn. Although we attach a low probability to any kind of "meltdown," we are devoting considerable attention to studying these problems with an eye toward "inoculating" our clients' portfolios to the greatest extent possible; we will keep you posted as our thinking on these topics develops.