

## Commentary - 3rd Quarter 2004

As we enter the final quarter of 2004, the presidential election and energy prices seem to be the dominant issues concerning the markets. The stock market can be directly affected by the outcome of the election because of the candidates' approach to tax policy. President Bush's move to lower capital gains taxes and the tax rate on dividend income made equities more attractive to investors in 2003. If those lower tax rates are allowed to expire under a Kerry administration, the expected after tax returns on stocks will decline. In order to boost the after tax returns on stocks back to what investors require for taking on the higher risk, either stock prices would have to fall commensurate with the higher tax rates or corporate earnings would have to grow enough to offset the higher tax rates. Unfortunately, higher energy prices are having a restraining effect on earnings growth for two reasons: companies have a hard time passing through higher costs because of competition, and consumers have less disposable income to spend on discretionary items after covering their basic food, shelter, and transportation expenses. The economy will gradually adjust to higher energy prices as consumers focus on conservation and producers are incentivized to find more supplies of energy. Given the "headwinds" the economy has experienced this year, the stock market has performed tolerably with most major market indices showing slight gains or slight losses. The fourth quarter is shaping up to be the "make or break" quarter for 2004.

Our outlook is similar to the position we stated last quarter. We anticipate the economy to continue growing at a moderate pace and for interest rates to continue climbing. Corporate earnings should be positive, though they may not expand as rapidly as last year, and eventually higher earnings should lead to higher stock prices. Even though small cap stocks have slightly outperformed large cap stocks so far this year, we still expect large cap stocks to provide better returns over the next couple of years as the dollar weakens and global growth picks up. The emerging economies of India and China continue to boost the global economy, contributing in no small way to the run-up in energy prices. A few statistics that we found interesting: China used 40% of the world's cement last year. In 1989 China had 168 miles of expressways, last year it had completed 18,500 on its way to a planned 51,000 miles

by 2008. (The United States' Interstate highway system totals 46,500 miles.) China has just 7.4 million cars on the road for a population that exceeds one billion. The U.S. has 230 million vehicles. India's situation is similar but their economic reforms have not been as successful ...yet. In other words, strong demand for basic materials should persist as long as China, India, and other developing countries remain on the path of economic liberalization. Rising commodity prices will keep the Federal Reserve vigilant for a revival in inflation. Bonds should struggle to provide positive returns as the Federal Reserve continues on its measured pace of interest rate increases to offset higher price pressures.

The economy's soft patch in the second quarter turned out to not be too soft. In the final GDP report, growth was estimated at a 3.3% annual rate. Recent economic reports point to a stronger third quarter even in the face of high energy prices. Interest rates are still near historic lows and personal income is growing. The increase in real estate values is having some wealth-effect as homeowners trade up to larger homes, take out home equity loans, or sell their homes to realize gains. The refinancing boom may be over, but the housing sector remains relatively strong. Much as the ever-rising stock market of the late nineties led to stronger personal consumption, higher home values are supporting stronger consumption. The ever-resourceful U.S. consumer usually finds some way to support his/her profligate lifestyle. Is this a great country or what?!