Commentary - 4th Quarter 2004

The fourth quarter of 2004 turned out as we had anticipated. The post-election rally boosted the market and the strength continued into year-end. The equity markets currently suffer from some profit taking, but our outlook is still optimistic. The economy remains on a vibrant growth track as the manufacturing sector is recovering with the weakened dollar. Oil prices have moderated from their fourth quarter highs, lowering that burden on individual consumption. Holiday sales appear to have come in better than expected after Wal-Mart's poor showing in late November and early December. Home sales remain robust as the rise in short term interest rates has not induced a similar rise in long term interest rates, from which mortgage rates are derived. (In fact, the housing sector is one of our major sources of worry, more about that below.) Personal incomes are rising, and the powerful financial market rally in the 4th quarter enhanced the ability of consumers to keep on spending.

Oil prices retreated from their recent highs of around $56 per barrel. As expected, higher prices lead to more conservation, higher output, and substitution. These reactions combined to bring oil prices back down to the low to mid-40's per barrel. We remain positive on our outlook for the energy sector since the emerging economies of China and India will persist in their growing demand for energy products and it is becoming harder to find new sources of cheap energy. One energy analyst was recently quoted in a publication we receive as saying oil prices could increase by a factor of three to five times over the next decade. We may not agree with the magnitude of his forecast, but we agree with the trend. Unless there is a global recession, which we do not expect in 2005, energy demand will keep on growing, along with the demand for many other basic commodities. Commodity price pressures will sustain the need for the Federal Reserve to be vigilant for inflation.

Which brings us to the monetary policy situation. If there has ever been a luckier person than Alan Greenspan, the Chairman of the Federal Reserve, we would like to join them on a trip to Las Vegas. Mr. Greenspan has been primarily responsible for the longest running bull market in bonds that we know of. His answer to any financial turbulence has been to lower

rates. This was the correct move after the stock market crash in 1987, but it has become his tool of choice. The stock market bubble of the late 1990's was primarily his responsibility because money was cheaply available and every time there was a financial "crisis" his response supported the market instead of letting market forces eliminate the inefficiencies or excesses. The main reasons that we have not had a tremendous amount of inflation resulting from his moves are because of the competitive price pressures on labor from emerging economies, especially Southeast Asia, China, and India, and the technology innovation boom. The emerging economies may begin to cause Mr. Greenspan a little indigestion as their demand for commodities keeps upward price pressure on the basic ingredients of production, while their competitive labor costs keep a lid on the prices companies can charge for their final products. Industries that have to compete with China and India for basic commodities will see their costs increase, which they may be able to pass along to the consumer, but industries that compete with China and India in final output like automobiles, electronics, furniture, and appliances will see limited ability to pass along price increases. This sequence of events indicates corporations will have a difficult time maintaining their profit margins, but hey, Mr. Greenspan has an answer to that problem… Our concern is that Greenspan's maintenance of lower than necessary interest rates will lead to another bubble. It may not be in equity markets this time, but in the housing market. Easy money has led to bigger and more extravagant homes being in demand across the country. Maybe higher individual wealth and two income families explains most of the surge, but it is the marginal home buyer that has us worried. At some point the music stops playing, and how many borrowers will be overextended? The increase in home values is not sustainable on an economic basis. Eventually, more builders will enter the market and supply will increase. When higher interest rates have the expected diminishing effect on demand, there will be a drop in home values, like any other financial asset. The higher prices go in the meantime, the more they will have to fall to become rational. Just like the stock market bubble of 2000, it will be a painful correction. If this cycle comes to pass, Mr. Greenspan's legacy might not be as appealing as most historians expect. We believe one of our main responsibilities is to try to identify risk. The risk of a housing bubble is one that we think is apparent.

One thing that has us perplexed is the ability of long term interest rates to remain low as

short term rates are regularly increased by the Fed. With strong economic growth, strong credit demand, and higher inflation, long term rates should be going up. In fact, the ten year Treasury ended the year with a yield similar to where it started the year, even though the Fed raised the Federal Funds rate by 1.25% in 2004. There may be a few explanations for this anomaly. First, most bond fund managers were not around the last time there was a strong bout of inflation in the late seventies and early eighties. (Most of them probably think Paul Volcker is an ex-athlete.) All they know is falling interest rates, which means you have to be invested in long term securities. Second, there is now a proliferation of hedge funds and by borrowing at short term rates and investing at long term rates; they have been able to make lots of money. At some point, the higher short term rates will squeeze their profitability and it will be like a herd of elephants trying to get out a single door, similar to the bond market sell-off we experienced last April/May when ten-year Treasuries increased in yield by one percent in a matter of six weeks. Third, and a more rational explanation, is that the market is telling us that higher interest rates pose a severe risk to the economy because of the extreme leveraging of the consumer. Some time soon, higher short term rates will restrict the consumer's ability to shop and the resulting economic slowdown will make long term bonds attractive. Reality is probably a combination of all of the above.