“A Slow Start To The New Year”
Market Commentary – February 2005

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In January, the financial markets treaded cautiously as the Iraqi elections approached. Headlines of violence associated with the elections caused some investors to sit on the sidelines. While the markets have grown more desensitized to political uncertainty over the past several years, they are not immune.

Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew 3.1% in the fourth quarter, slowing from 3.9% growth in the third quarter. While the fourth quarter growth rate is the slowest in seven quarters, it is still comfortably greater than zero. The domestic economy, characterized by consumer and business spending, continues to be strong:

- Consumer spending rose at a 4.6% annual rate, while business fixed investment grew 10%.
- The Conference Board’s consumer confidence index hit 103.4 in January, the best since July.
- Total 2004 retail sales jumped 8%, the largest annual increase since 1999.

Red flags are visible in some parts of the economy, however, tempering bullish economic views.

- While inflation, excluding the volatile food and energy sectors, rose a mild 2.2% in 2004, wholesale prices spiked 4.1% in 2004 – the biggest annual rise since wholesale prices jumped 5.7% in 1990. Inflation is on the horizon.
- Home prices appreciated an average of 8.1% in 2004. The high degree of leverage involved in real estate and the typical view that real estate is a “safe” investment give reason to be cautious.
- Benefit costs, including health care, increased 1.4% in the fourth quarter, the 11^{th} consecutive quarterly rise greater than 1%.
- Falling exports and rising imports grew the U.S. trade deficit to a record $60.3 billion in November. The rest of the world is relying on demand from the U.S. to fuel their economies.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 2.50% at their meeting on February 2. Aside from the rate hike, no big changes are forecast in the Fed’s view of the economy. So far, the Fed has said that it will continue to raise short-term interest rates at a “moderate pace”. When the Fed eventually stops raising rates, the market could get spooked that the Fed sees steeper slowdowns ahead in economic growth than have already occurred.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. While stocks have pulled back since their December highs, they are still pricey relative to earnings and free cash flow. Technically, market declines have generally been on higher volume than subsequent rallies.

Our proprietary market breadth indicator slipped into negative territory on January 11 and has been negative ever since. Our proprietary sector analysis shows that 80.4% of the 209 industries spanning the entire stock market are in “medium” uptrends. We have not yet seen a breakdown of these industries from “medium” to “weak” uptrends, suggesting that the current weakness in stocks is mild.

Our cash position has served our clients’ portfolios well, especially when the market did unexpectedly break to the downside in January. In addition to holding cash, we also strive to protect our clients’ capital by owning undervalued stocks with bullish technical chart patterns. While we do not necessarily believe the hypothesis that “as goes January, so goes the rest of the year”, we do believe that the stock market is in a secular bear market. Therefore, it is prudent to lock in some profits into strength throughout 2005. This approach should yield excellent returns in this low-return environment.