"Shifting From Defense To Offense"

Market Commentary – November 2004

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The U.S. economy, as measured by Gross Domestic Product (GDP), grew a solid annualized 3.7% in the third quarter. While this was not as fast as economists' consensus forecast of 4.3%, it was better than the second quarter's 3.3% growth. The economy continues to experience moderate growth:

- Consumer spending accelerated to a 4.6% pace in the third quarter, up from a three-year low of 1.6% in the second quarter of 2004.
- The National Association of Purchasing Management – Chicago reported its measure of Midwest manufacturing was 68.5 in October, the highest since January 1988. Readings above 50 indicate growth in the manufacturing sector.
- Core inflation, which factors out the volatile food and energy sectors, rose 2.0%, the highest in nearly two years.
- Unemployment remained stable at 5.4% in September, the lowest since October 2001.
- Volatility in the price of oil adds uncertainty to future economic growth. Oil topped $55 per barrel earlier in October as damage from Hurricane Ivan cut oil production in the Gulf of Mexico by 25%. Crude oil closed October at $51.76 per barrel.

The Federal Reserve is expected to raise their benchmark Fed Funds rate 0.25% to 2.0% at their meeting on November 10. Federal Reserve Chairman Alan Greenspan indicated that he is not too worried about $55-a-barrel oil, saying that oil has added a "tax" costing the U.S. economy 0.75% of GDP. Some economists believe that once the Fed Funds rate gets to 2.0%, the Fed will become less aggressive in hiking rates. Wall Street may react negatively to the end of rate hikes since it would fear a slowdown in economic growth. We expect the Fed to carefully word its position to try to prevent this interpretation.

Futures contracts still forecast that President Bush will win the Presidential election, but with only a 55% probability. As for Congress, futures contracts predict a 92% chance that the Republicans will retain control of the House of Representatives and a 73% chance that they will also keep control of the Senate. Perhaps the most negative scenario for the stock market regarding the election, aside from the remote possibility of a terrorist event, would be an inconclusive outcome the evening of the election.

Earnings for companies in the S&P 500 are expected to grow 16.5% in the third quarter of 2004, more than double the historical average. Still, the third quarter will end a series of four consecutive quarters of earnings growth above 20%. Comparisons to last year are becoming more difficult, especially as economic growth has leveled off. This trend is expected to continue into 2005.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. Fundamentally, the average stock is not cheap when valued on a price-to-earnings (P/E) ratio basis. Intrinsic values, calculated using discounted free cash flow analysis, have benefited from the recent weakness in bond yields. However, as long-term interest rates rise, valuations will appear even more stretched. Technically, the market moved up on higher volume the last week of October. As well, our proprietary market breadth and sector analysis indicators have both turned bullish. These factors suggest the market may be poised to break the intermediate-term downtrend that has characterized the major indexes throughout 2004.

Barring a high volume decline following the election, we are incrementally shifting to offense in our portfolios. Consistent with our investment philosophy, we have identified several stocks that we estimate to be undervalued and to have bullish technical chart patterns. Of course, we never ignore our defense. We stand ready to stop out of a stock position should it turn against us, remembering that our number one priority is to protect capital. Our cash position buffers our portfolios from potential downside.