

MARKET NEWS

Keeping our Clients Informed

Second Quarter 2005



July 12, 2005

Half Way to Nowhere

As the second quarter of the year concluded, almost all of the major equity market indices were in the red when measured from the beginning of the year. The Dow Industrial average and the NASDAQ composite fared the worst with 4.77% and 5.47% declines, respectively. The S&P 500 and Russell 2000 indices finished better, but still with losses of 1.73% and 1.84% respectively.

Fortunately, the days following the end of the second quarter have been kind to investors. Recent gains have now brought all of these indices to near break even. Thus we've now spent half the year essentially trading water.

The notable exception to this trend is the Mid Cap sector, the only segment of the market that closed out the quarter on a positive note year to date. The mid caps, as measured by the S&P Mid Cap 400, returned 3.32%. This continues a trend of superior performance that has now gone on for two and a half years. During that time the mid cap sector has increased in value by 59%, far surpassing the large cap segment of the market.

Many of our clients have seen firsthand the performance of mid caps through their shares in the symbol MDY, an exchange traded fund which mimics the S&P 400, and to some extent the Schwab 1000 fund. The MDY position in particular has been one of the best examples of the importance of long-term diversification across different segments of the equity market. During much of the bull market of the late 1990's, MDY significantly lagged the large cap segment of the equity market.

Then, as we all know, the large caps collapsed over a three and a half year period, from which they have still not fully recovered. The mid caps, however, are now the only group of stocks that have a positive return during that same time period. In fact, if it were not for MDY many of our equity portfolios would still not have had positive returns since the middle of 2000. The lesson is that you never know when or how sharply these trends will change.

Interest Rates

Since June of 2004, The Federal Reserve Bank has raised rates in nine quarter point increments. That increase has taken the Fed Funds target rate from 1% to 3.25% and has caused the Prime rate to rise from 4.00% to 6.25%. Normally, when the Federal Reserve decides to start increasing short term interest rates you would begin to see all other interest rates rise, including mortgages. This time has been different, however, and long-term rates have not increased at all. In fact, long-term rates are lower than they were last year.

What is different this time? While the Federal Reserve controls short term rates, market forces control longer term rates. It is these market forces that have seemingly negated the increases by the Fed and have held long-term rates low.

Despite the Fed, long-term rates are a function of supply and demand. As money flows into the Treasury bond markets, yields on those securities decline. Because Treasury bonds are viewed as risk-free securities, their yields are the foundation for all other interest rates in the economy (i.e. mortgages, auto loans, etc.). The primary inflow of money recently has been from China. China continues to maintain a huge trade

surplus with the U.S. In turn, these dollars being spent on their goods are being repatriated via China's appetite for United States Treasury bonds.

How does this impact me? At this point in the interest rate cycle, we would not have believed that bond yields would have remained as low as they are. Normally when the Fed is tightening the money supply, we would have been actively adding new bond positions to take advantage of higher long term yields. Since longer term yields have failed to increase we have chosen to stay very conservative with our fixed income investments.

For the most part, our largest bond position is a short term fund called Schwab Yield Plus. This is our favorite alternative for bonds in this rate environment. The fund has a very short duration and therefore its yield is greatly influenced by the Fed rates increases. Our plans are to continue using this fund as the primary fixed income investment until the Fed stops raising rates or longer term bond yields become more appropriate.

We suspect that we will have to wait until next year before the Fed finishes its work or before longer term rates are attractive. At that point we will be in a great position to take advantage of higher rates offered by longer term bonds.

Another hedge for our bond positions that we put in place this quarter is the ProFund Rising Rate Opportunity Investment (symbol: RRPIX). This security is designed to change in value with the yield in the 30-year Treasury bond. Thus, when long-term rates increase the value of this fund will, too. While the fund is currently down from where we bought it due to the drop in the 30-year yield, over the coming months its gains will offset our fixed income positions that are interest rate-sensitive. In addition, the fund is leveraged in such a way that a modest position in RRPIX will insulate a relatively large fixed income position.

The Energy Factor

Three months ago an oil analyst suggested that the price of oil could reach \$80 per barrel by year end. At that time, oil prices were coming off their highs (approximately \$48) and headed

towards \$40. This widely reported prediction was almost universally dismissed by the financial markets as it would have represented a near doubling of the price at that time.

This week prices blew through the \$60 mark and peaked at \$62. At this point \$80 doesn't seem so far fetched. In addition to oil, natural gas and coal have sharply risen in price, as many industrial consumers have switched to these alternative fuel sources. Of all the economic news affecting the financial markets these days, energy costs are clearly one of the most influential and we see no change in this for the near future.

So what is really driving this run-up in energy costs – specifically oil? Has the world-wide demand really increased that much in such a short period of time? There is little doubt that the long-term outlook for oil consumption has changed with the emergence of surging economic growth in places like China and India. Nevertheless, that shift reasonably shouldn't have caused the current price of crude to rise this fast. This is evidenced by the fact that prices have become almost totally unhinged from the level of oil inventories.

Based on historical supply and demand relationships, the current U.S. oil inventory levels would place West Texas Intermediate crude prices around \$25 a barrel. Obviously, there are a number of issues and concerns about OPEC capacity and demand growth that would place an additional risk premium on that price, but the point is that the natural price is probably closer to \$40 than \$60. There is no doubt that speculation has played a major role in this run-up.

The impact of these higher prices has been to add 0.6 percentage points to the 2.8 percent increase in the U.S. consumer price index in the 12 months ended in May, the Labor Department reported. Furthermore, even though the U.S. economy has continued to expand at a healthy pace, many economists believe higher oil prices have been a drag on growth. That is, the economy would have grown faster if oil prices hadn't surged. And that growth might well have been tolerated by the Federal Reserve because it would have been accompanied by lower inflation pressures.