

Monthly Chartbook

April 2004

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Executive Summary

From “recovery” to “expansion”

- Last month, we described the “W” recovery as the economy bottomed in October of 2001, rose in the intermediate period, and bottomed again in April of 2003.
- This double bottom explains some of the jobs lag against robust GDP growth.
- Although the economic news is generally good, this month the market has been wrestling with the anticipated increase in interest rates associated with that good news.

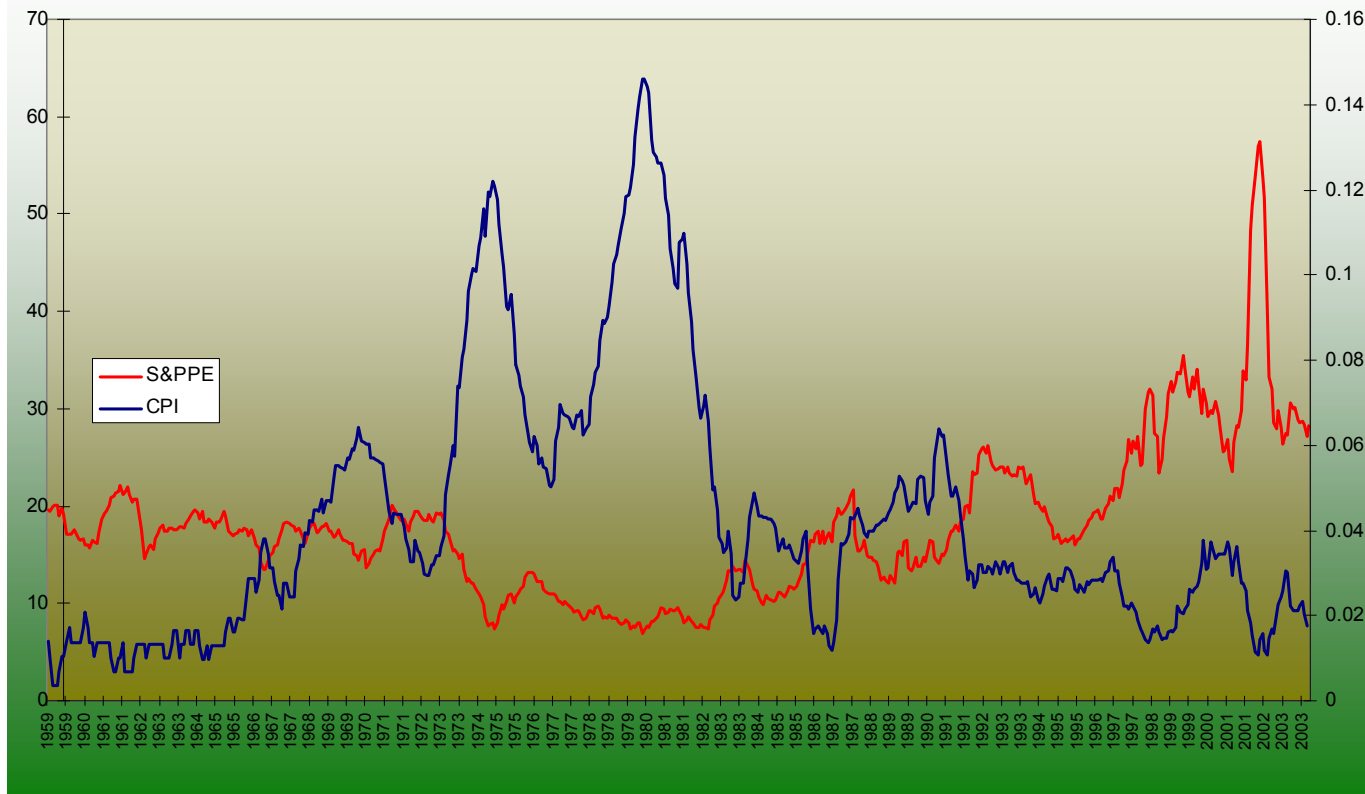
Executive Summary

However, we believe an increase in rates would be the signal the Federal Reserve believes the economy is making its transition from recovery to expansion.

This is supported by...

- Continuing strong company earnings reports and comparisons
- More positive jobs market data (perhaps the most critical piece since it has been missing for so long)
- Implicit increases in interest rates by the marketplace itself

S&P 500 P/E versus Inflation



Any contraction in the PE of the S & P 500 will be due to the inflation component of interest rates, rather than the rise in interest rates alone based on the inverse relationship.

Macro-economic Research

- **The market does not like uncertainty**
- Contraction in overall Price / Earnings has the markets concerned.
- However, when inflation is low market PE tends to be higher.

Over the past 40 years, if inflation is ...

less than 5%, market PE averages 19.46

less than 3%, market PE averages 20.82

greater than 5%, market PE averages 11.28

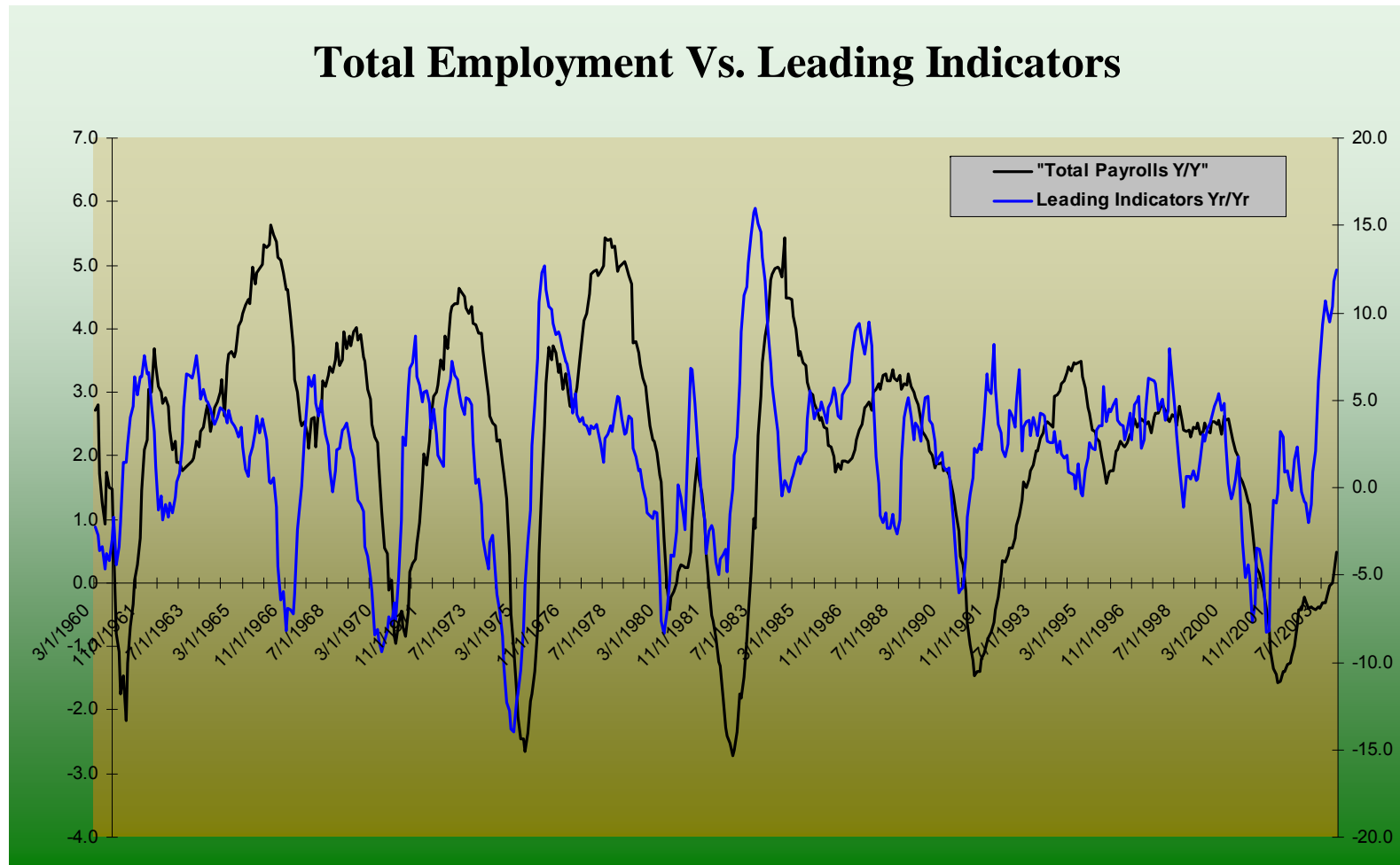
- We are bullish near term because, although inflation is growing, it appears contained. Also, company earnings are increasing.

S&P 500 SCORECARD

- **Companies reporting:** **390**
- **Beat expectations:** **295**
- **Met expectations:** **43**
- **Short expectations:** **51**

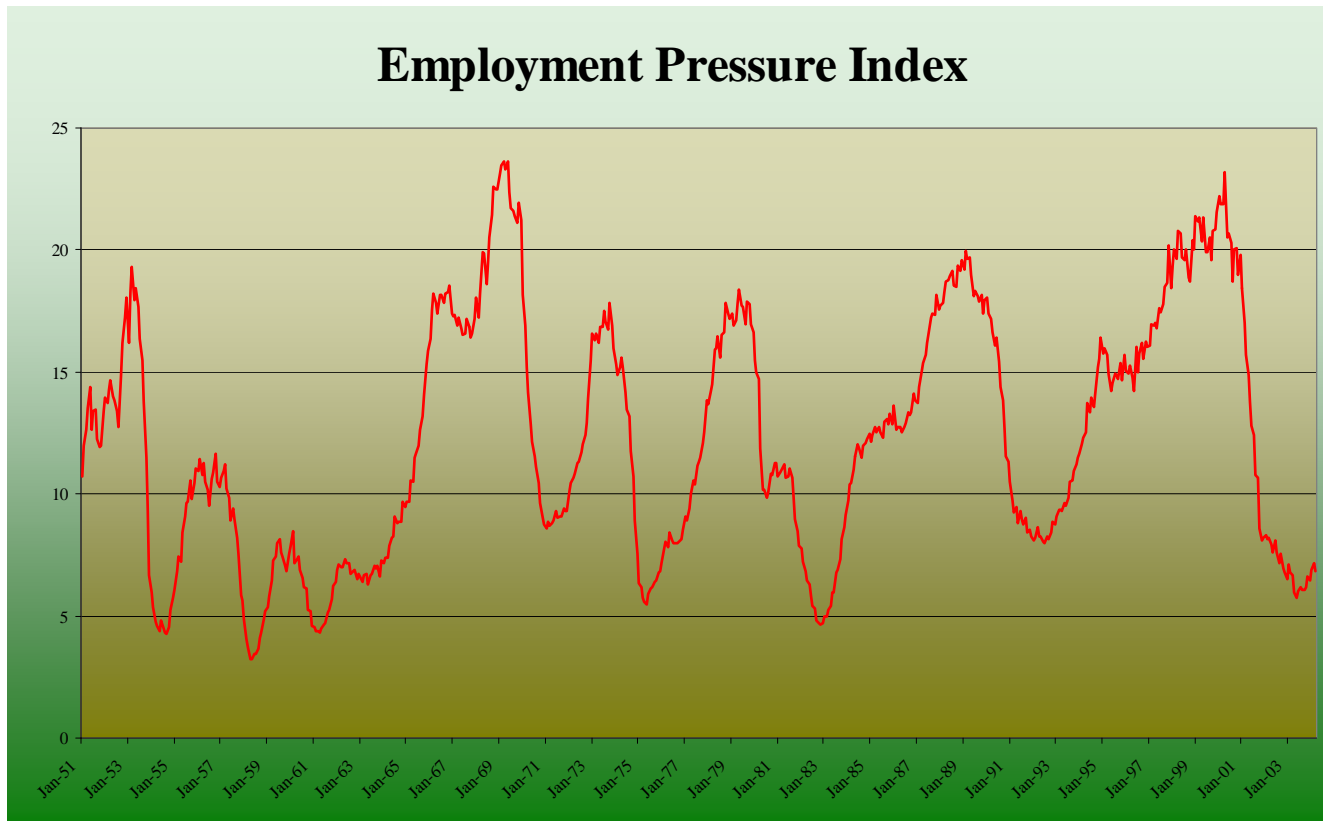
Data from First Call

Company earnings have been strong, and this will counter any contraction in the PE multiple; estimated earnings growth for the S & P 500 is 18% for the year.



Employment lags leading indicators 6 – 12 months on average and is following the broader economy higher.

Macro-economic Research



The employment pressure index continues to expand from its lowest point as the number of unemployed declines, due in part to the outstanding job creation last month.

A higher measure indicates more pressure is on employers as employees have more options.



Persistent joblessness has been stubborn and has only improved to levels consistent with job growth in the last three months.

Index levels above 1 are consistent with improving labor market conditions.



The marketplace is anticipating a rate increase and is doing the work for the Fed at the short term end of the curve, as 1 year Treasuries have leapt 43 basis points (37%) in the last 30 days and 2 year Treasuries have climbed 79 bp (53%).

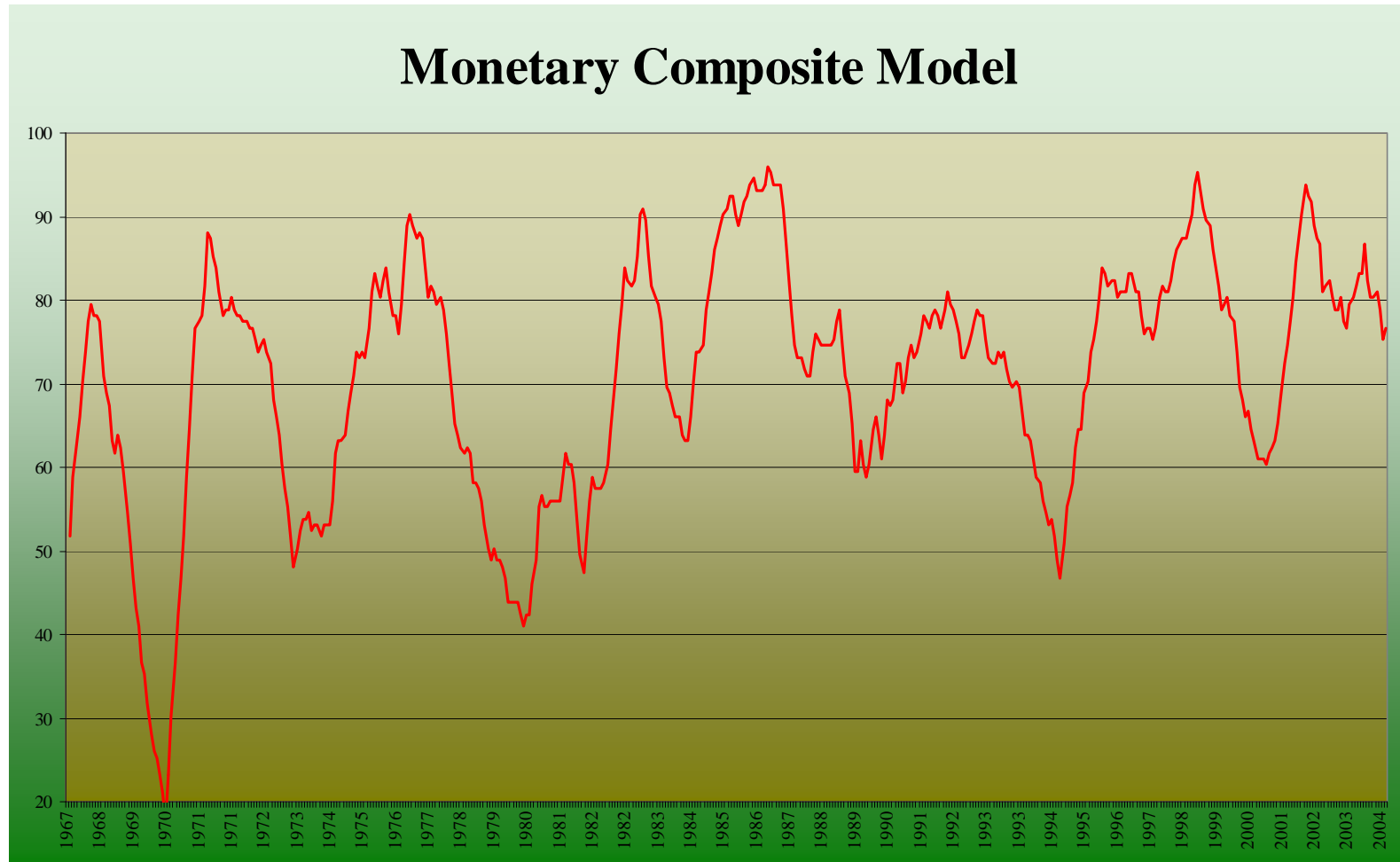
Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1113.89	Trading range	↔	1050-1250	10-12 Months
Ten Year Treasury	4.48%	4.50%	↑	4.25%-4.875%	10-12 Months
Inflation (all Urban)	1.79%	2.25%	↑	1.75%-2.75%	12-18 months
Fed Funds	1.00%	1.25%-1.50%	↑	1.25%-1.75%	6-10 months
S&P 500 Earnings	\$49.19	\$53.37	↑	\$51-55	2q2004
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

Federal Reserve Watch

- Is a rate increase inevitable? The market believes so.
- Interest rates for near-term Treasuries have priced in a rate increase in either June or August—notable also because it is before the election.
- We view an increase as “the mother of all bull signals” as the Federal Reserve interprets economic data positively and determines the market does not need “super” cheap money any longer.
- However, monetary policy is still accommodative as the three month growth rate of money supply has become considerably stronger; but, look for marginal tightening going forward.

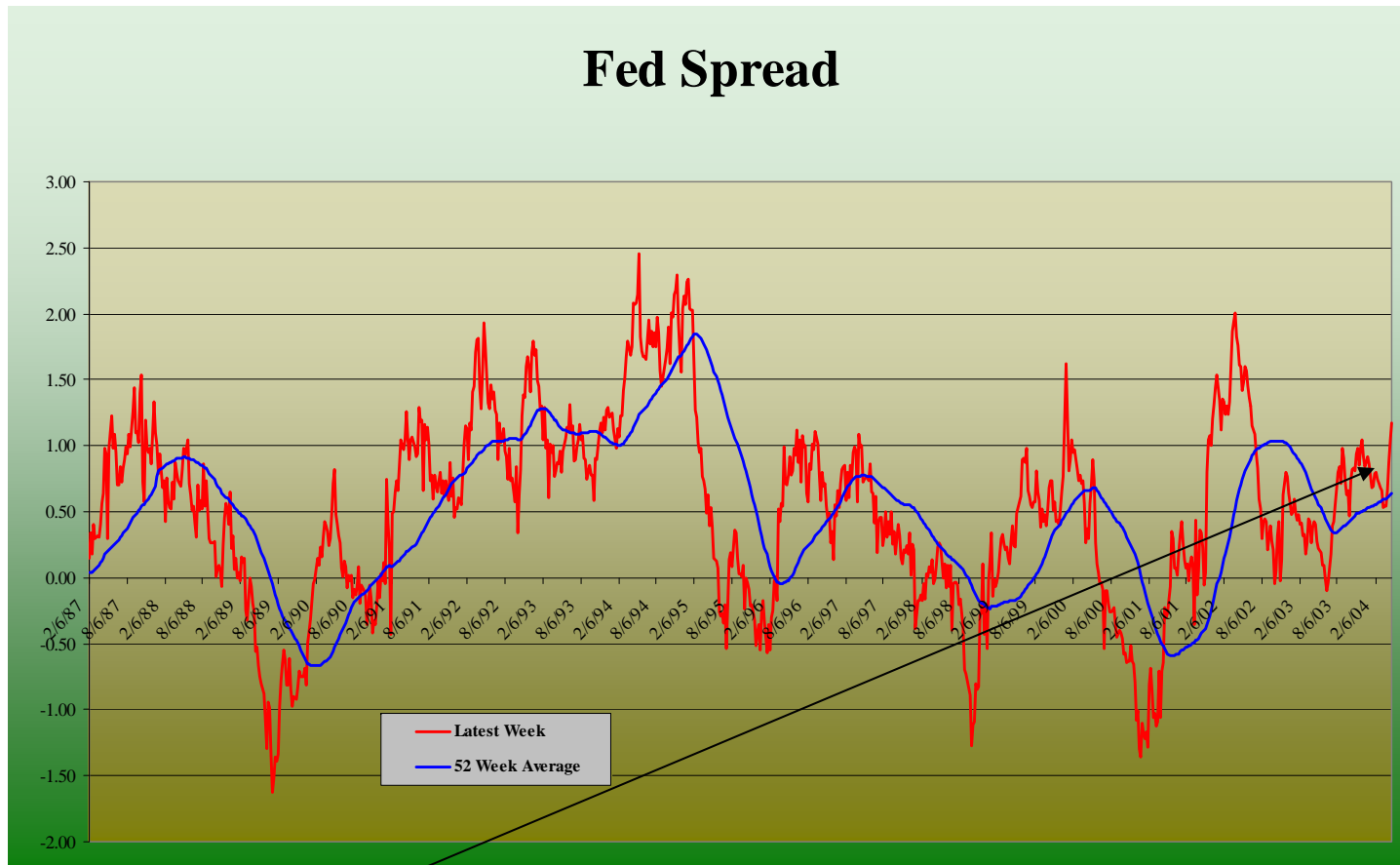
Federal Reserve Watch



The direction of trend in this series is as important as the level. A score above 50 indicates the Fed's monetary policy is accommodative.

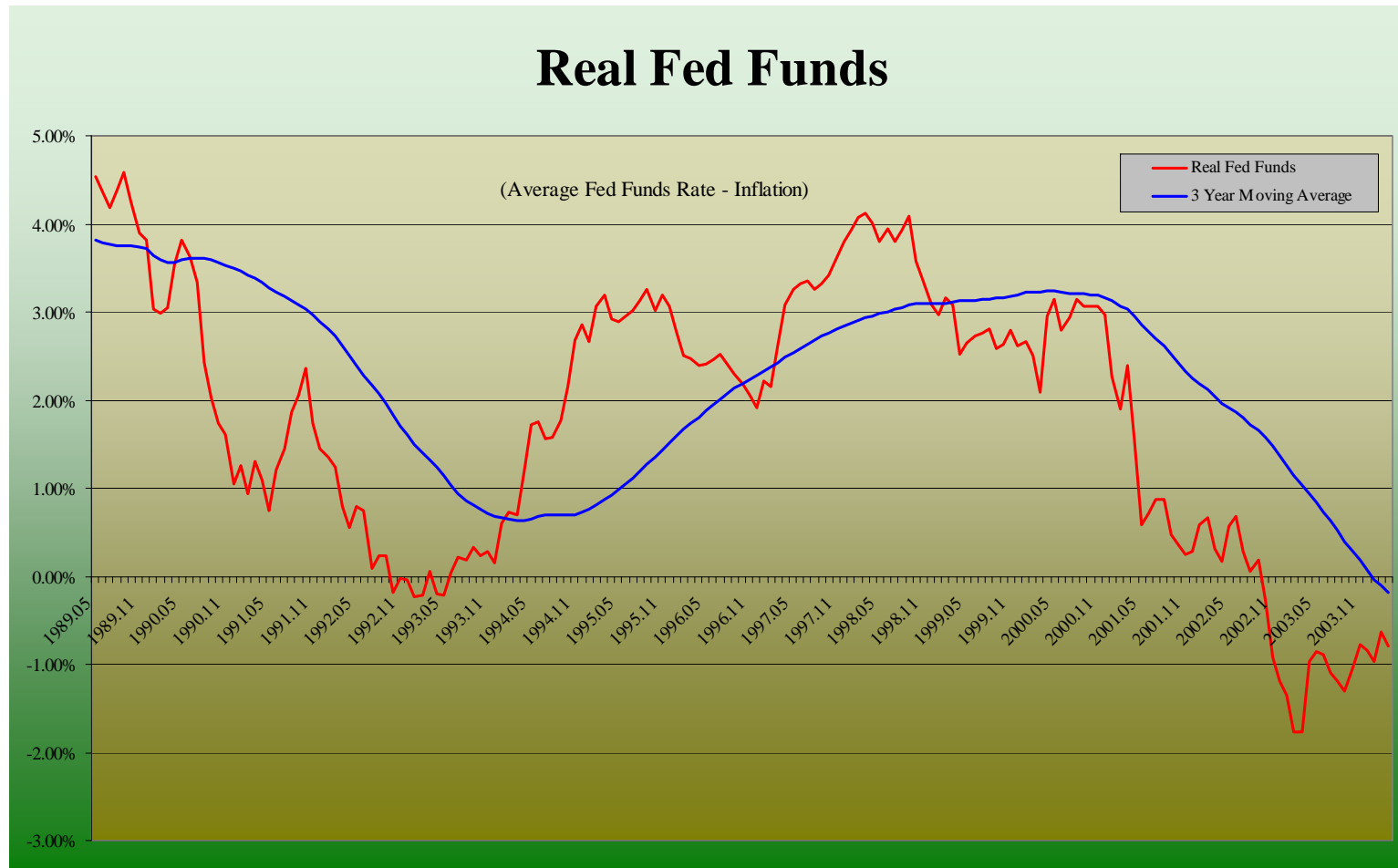
Monetary composite model shows monetary policy is not as positive as it has recently been.

Federal Reserve Watch



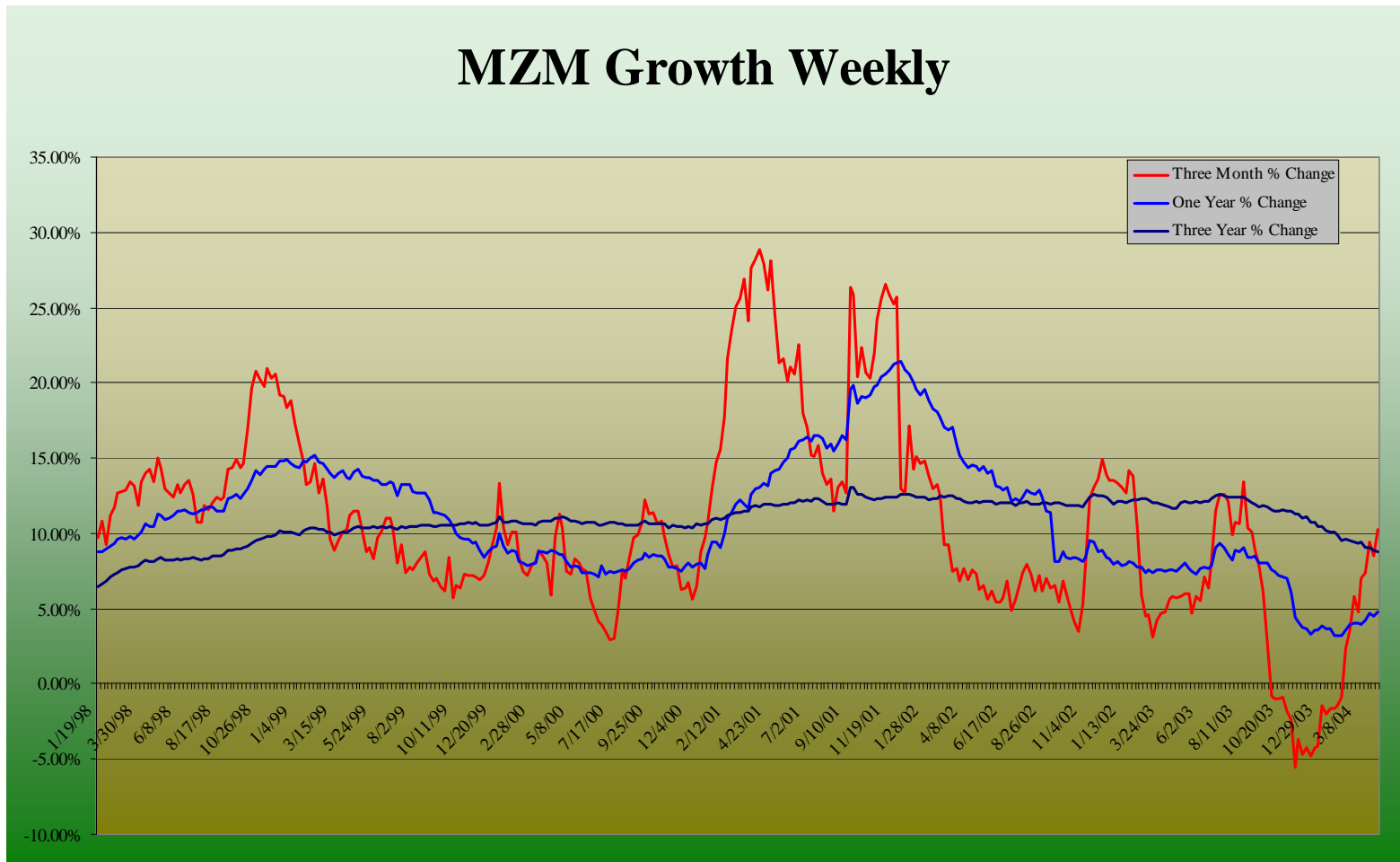
Significant recent increase in near term interest rates while effective Fed funds has remained flat.

Federal Reserve Watch



The negative Fed Funds Rate explains why Bank & Money Market Yields are so low—the 3 year moving average is now negative, the first time since early 1980!. We believe the Fed will have few reasons to keep real interest rates negative as employment and output improve. The 30 year average for Real Fed Funds is 2.72% - significantly above current levels.

Federal Reserve Watch



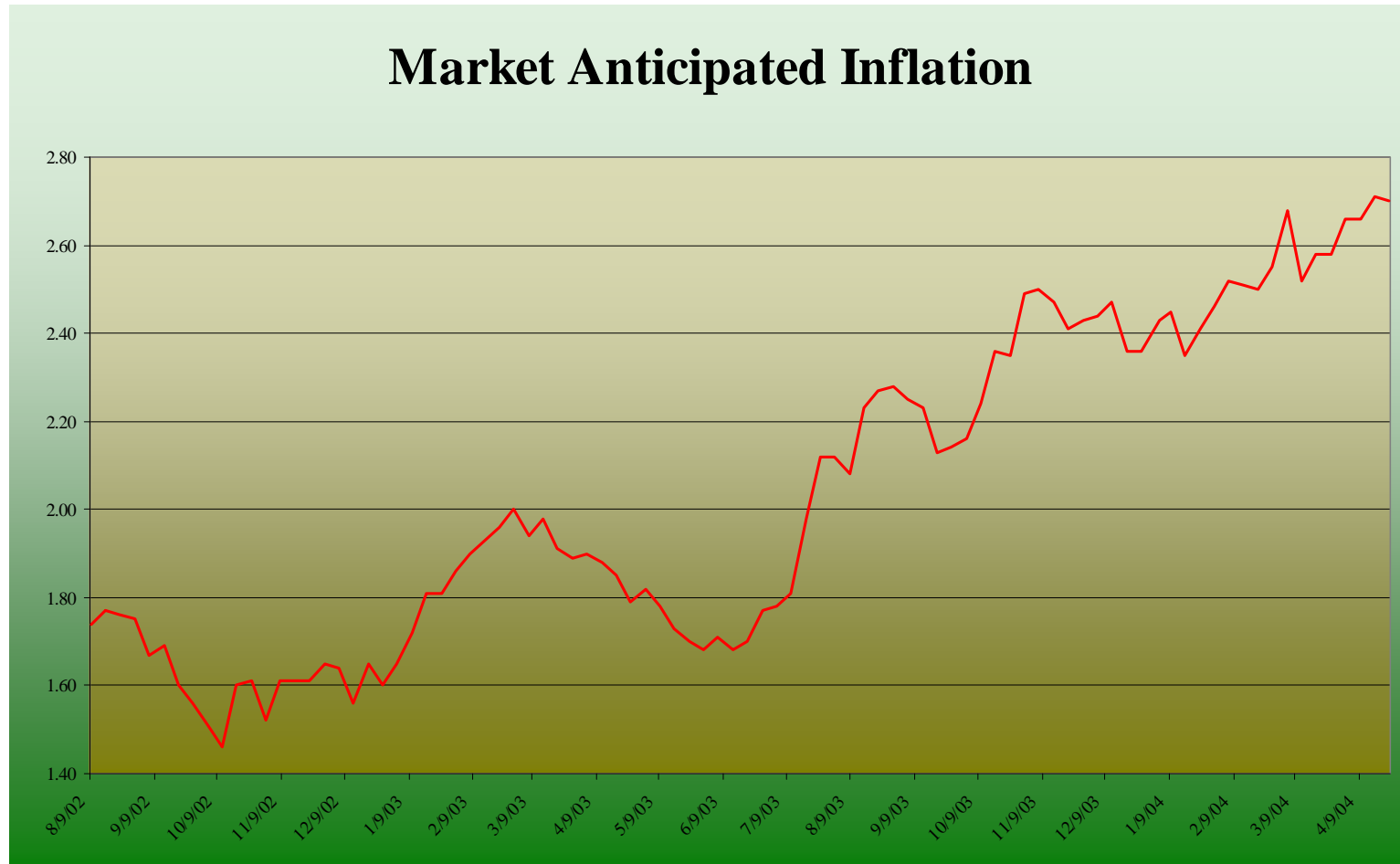
Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices.

The 3 month growth rate of money supply **continues** to improve considerably.

Inflation expectations

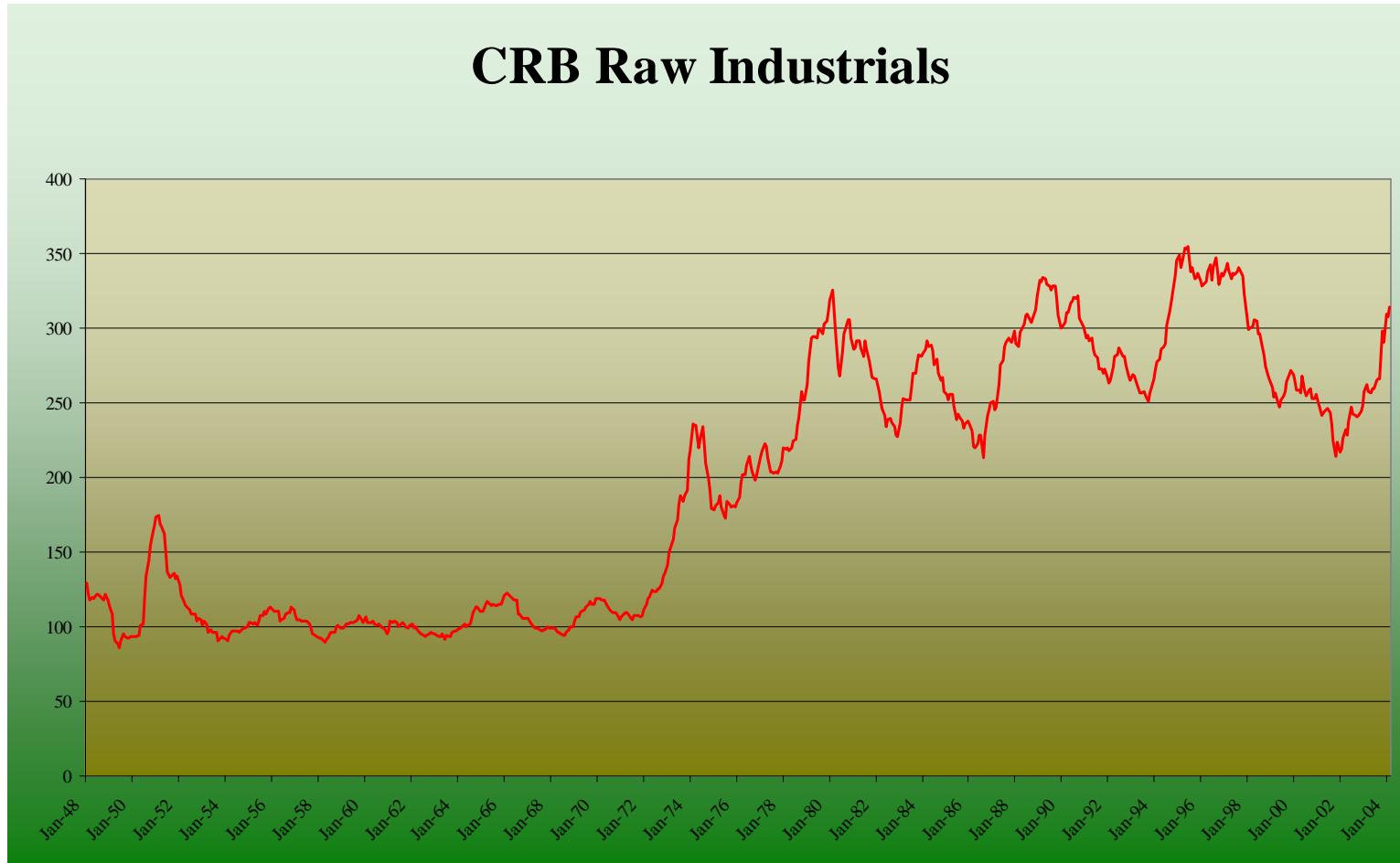
- The market anticipates higher inflation (2.70% expected versus 1.79% current) over the next cycle, as indicated by its pricing of inflation-protected Treasuries.
- Leading indicators on inflation continue to flash warning signs, and energy and materials prices cannot continue to move higher without affecting either profits or consumer prices. If energy prices remain stubbornly high, they will bleed over into the core rate of inflation.
- During March inflation increased .5% while the core rate was up .4% as increases in commodity prices made their way through the supply chain.
- Year over year inflation was only 1.8%, though, compared with 3.0% in March of 2003 (also primarily due to energy).
- Remember that labor is the most expensive factor for products made in the US, so higher commodities prices by themselves will only have marginal impact on the final prices paid by American consumers.
- And, as of yet, there is very little increase in our Price Pressure index.

Inflation Expectations



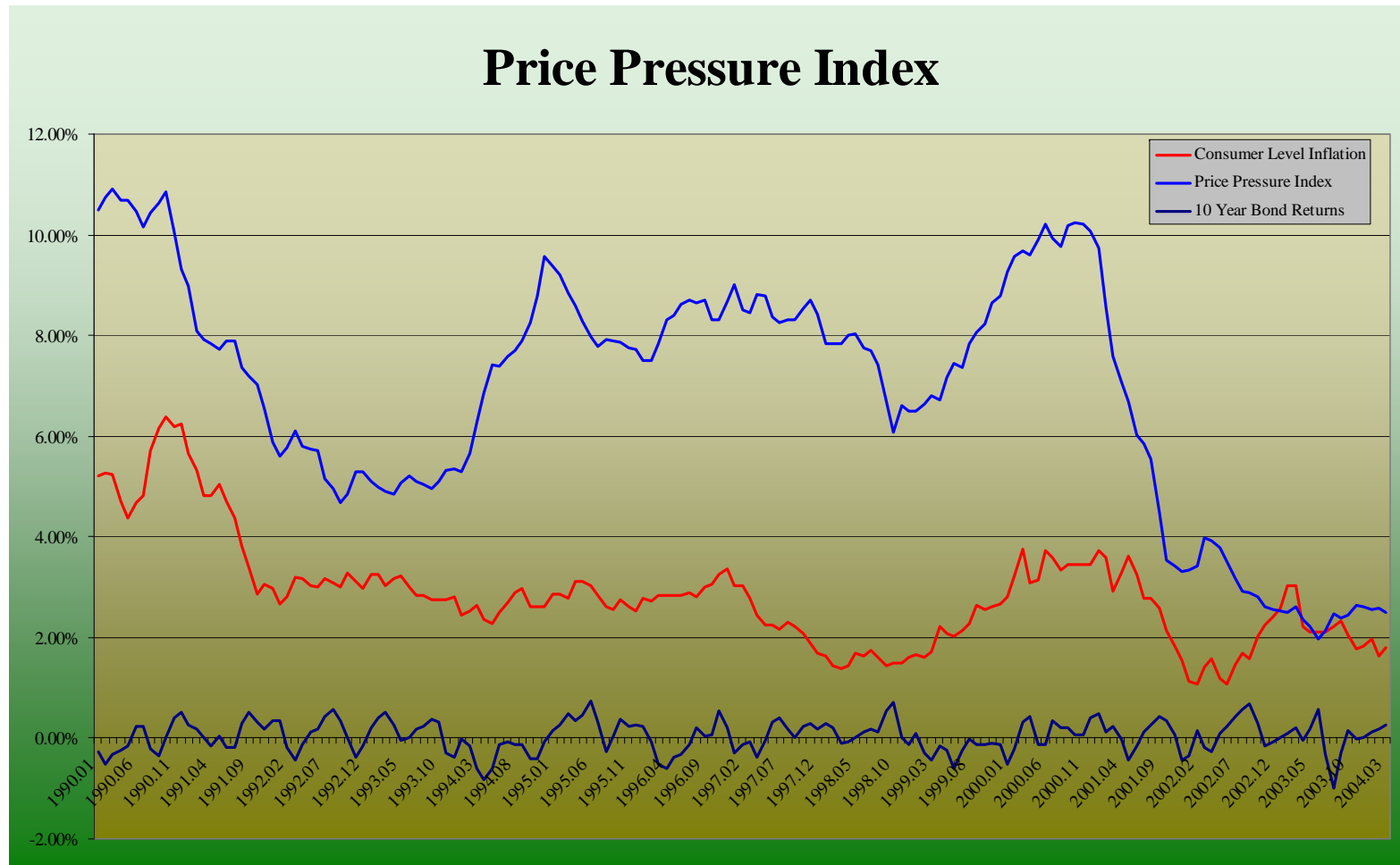
The market anticipates inflation (based on TIPS) to be about 2.7% over the next ten years. Inflation has averaged 1-3%, so that is right in line with experience but much higher than current levels.

Inflation Expectations



Materials prices continue to move and end users are seeing the results in the final prices of many manufactured products and building supplies.

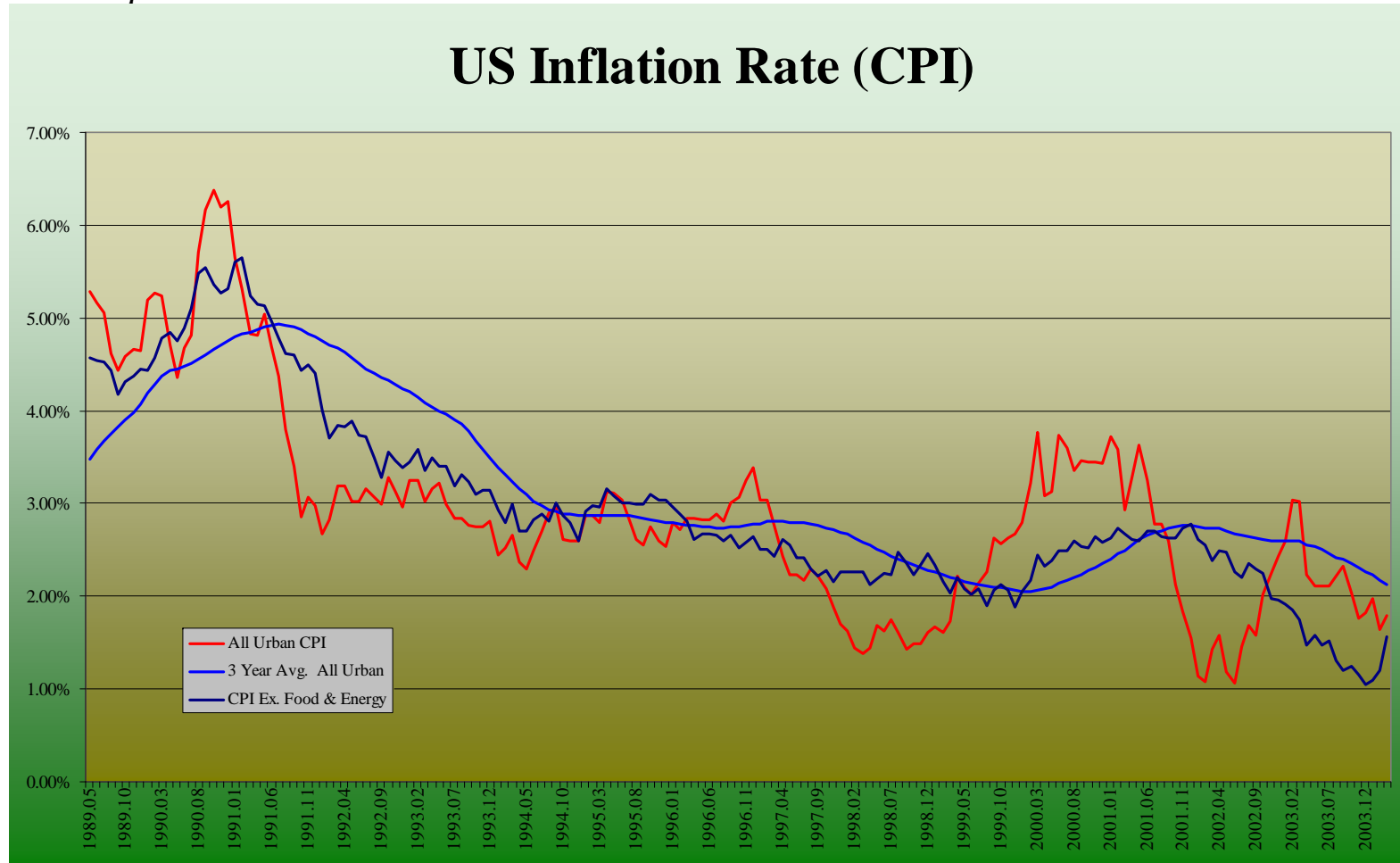
Inflation expectations



A declining index value indicates receding inflationary pressure within the economy, and a rising index value foretells higher consumer prices.

The Price Pressure Index bottomed June 2003.

Inflation Expectations

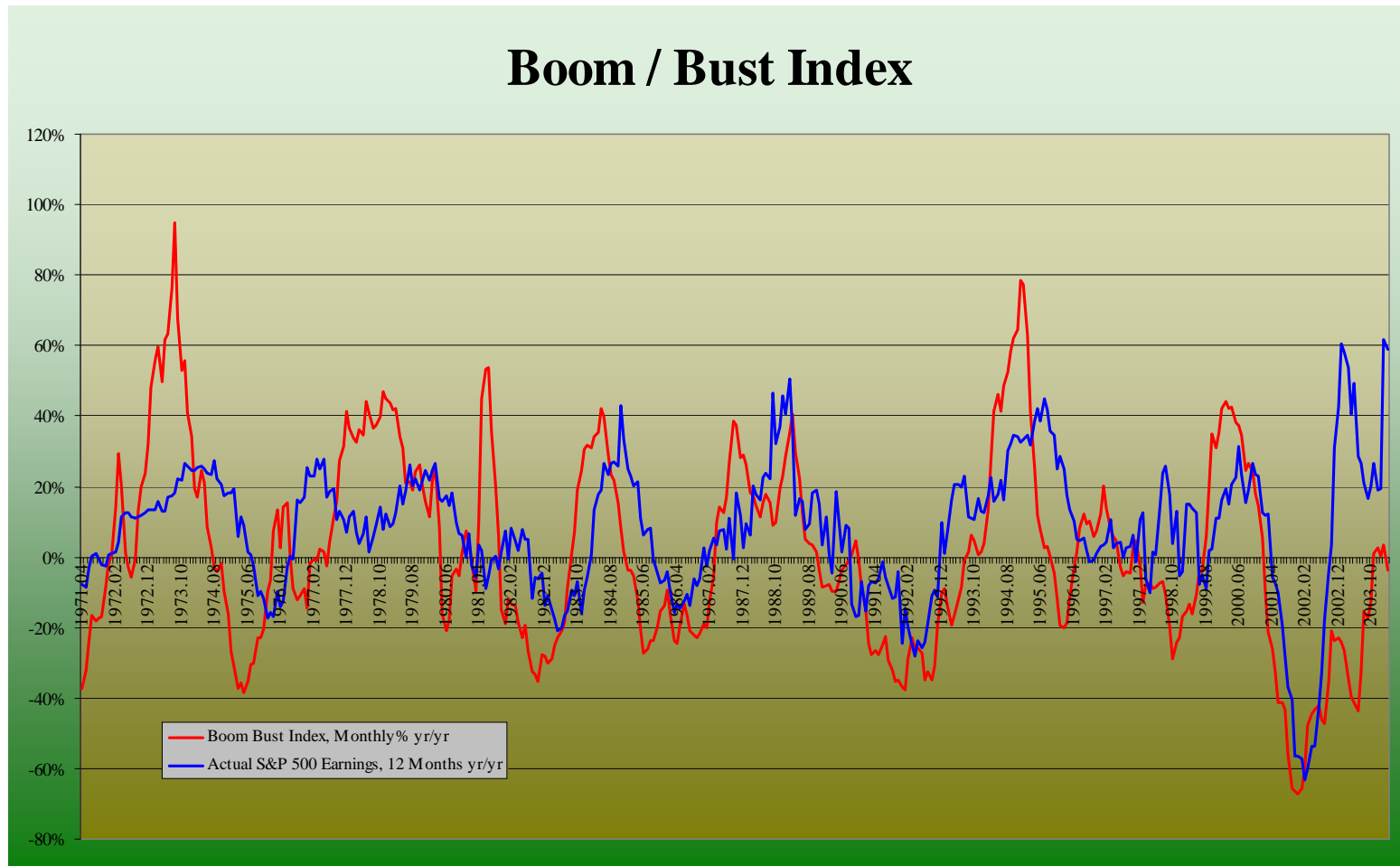


Inflation remains low at the consumer level even though there has been an sharp increase in the cost of raw materials. Also, there has been a significant increase in the core rate in recent months; this measures inflation increases ex food and (more importantly) energy.

Outlook & Forecast

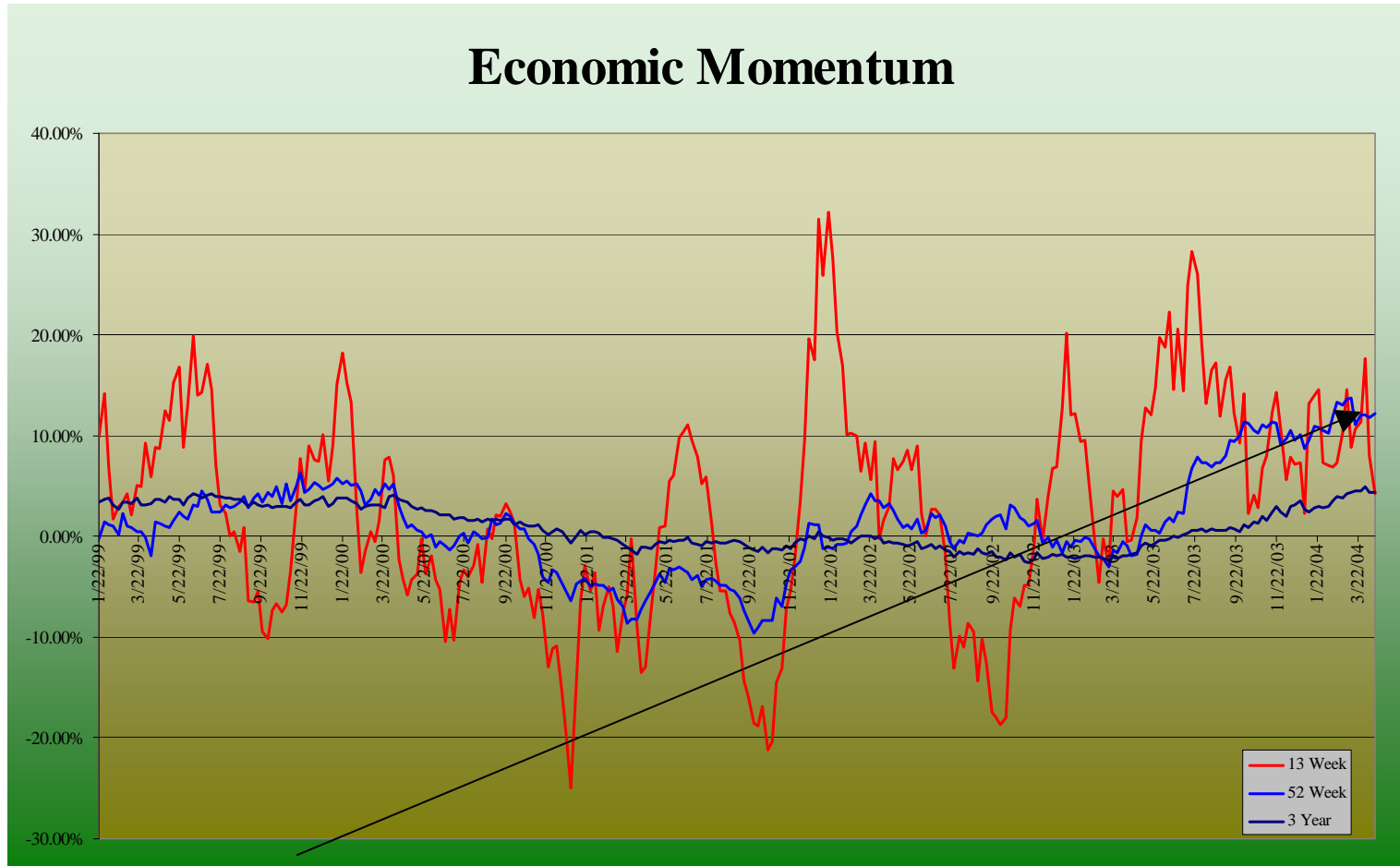
- The major issue affecting the pricing of the market in the intermediate term is inflation.
 - Inflation is expected to increase, but is anticipated to remain under 3%.
 - If inflation remains reasonable, there will be minimal contraction in the market's PE ratio.
 - As earnings improve, equity prices should increase.
- Improving jobs data is important for both the election and consumer spending and income.
- An interest rate hike has been priced into the rate structure by the marketplace and has reduced some of the steepness of the term structure curve.

Outlook & Forecast



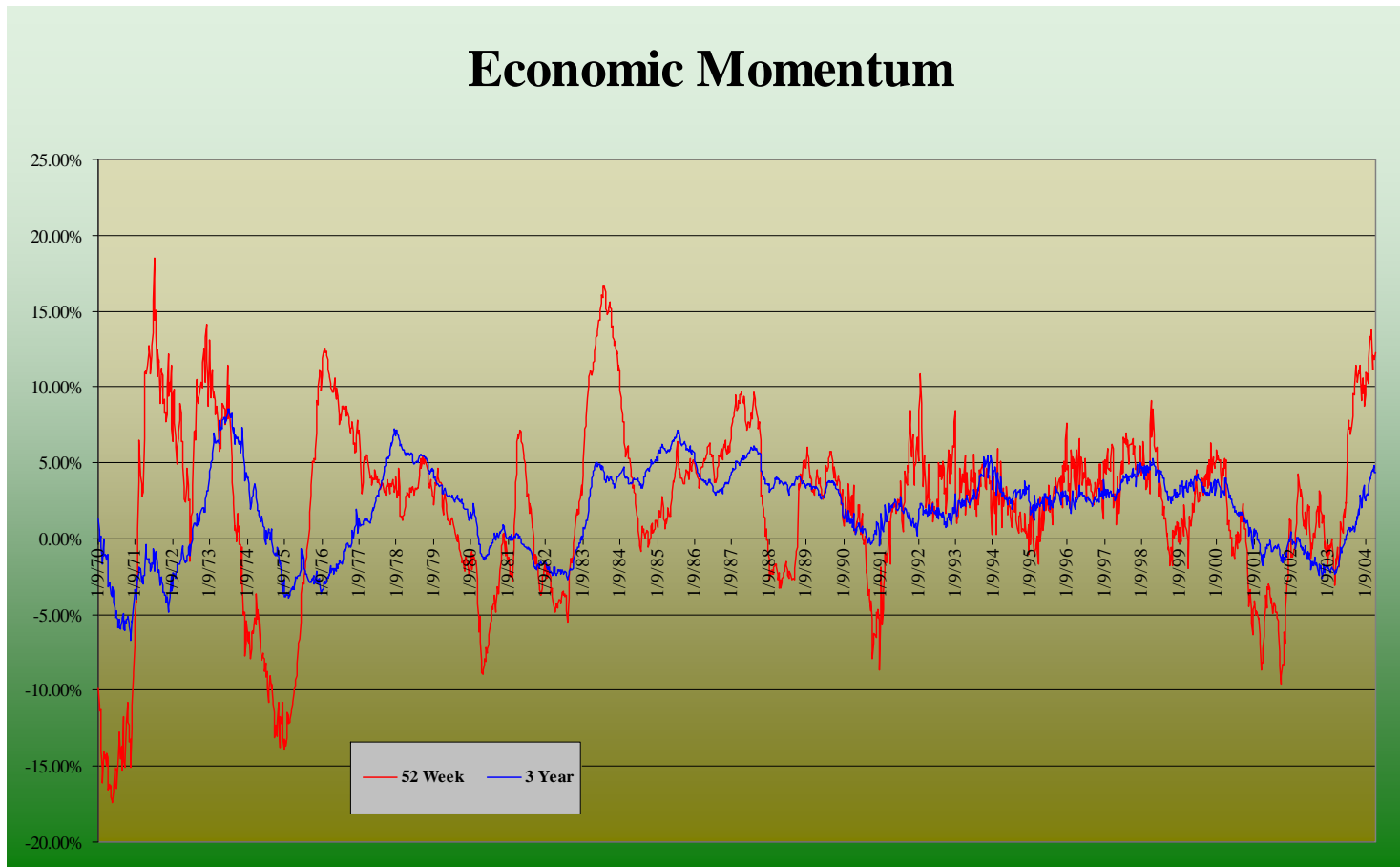
The Boom/Bust Index tracks several key variables within the economy that correlate with earnings. The red line is predicted S&P 500 earnings direction, indicating positive movement continuing.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).
Weekly momentum appears to be stalling, but...

Outlook & Forecast



... year over year levels continue to increase to the highest levels in a number of years.