

Monthly Chartbook

August 2004

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Executive Summary

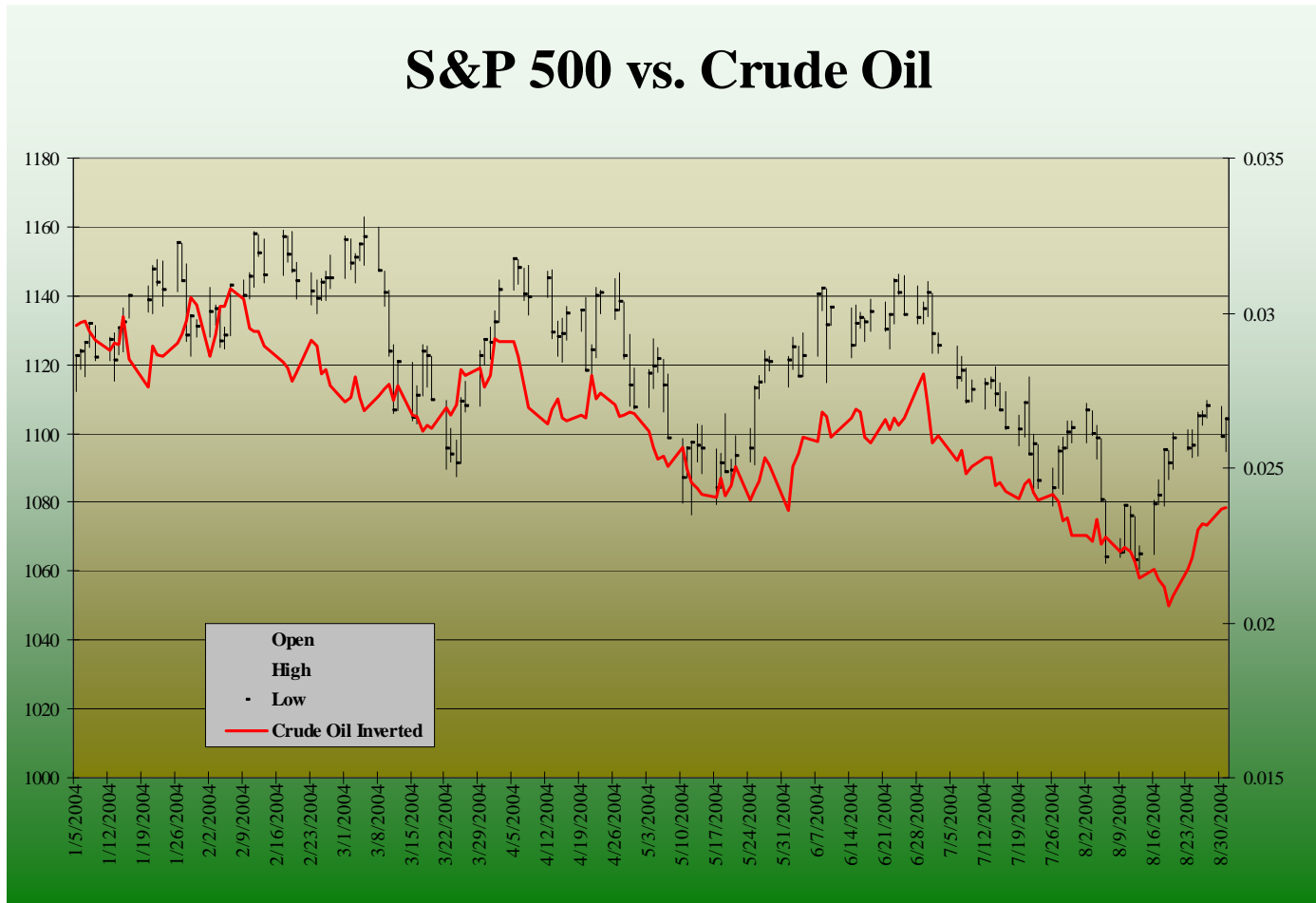
Number six in line for take off...

As we write, there are just 63 days that remain until the Presidential Election. Just like waiting on the taxiway at the airport, we know that we are going to take off and arrive at our destination, but the wait is grueling.

Politics aside, the Presidential race is neck and neck and will likely come down to the wire. The markets are watching the race, and the campaigns are watching the markets looking for strength or weakness to exploit.

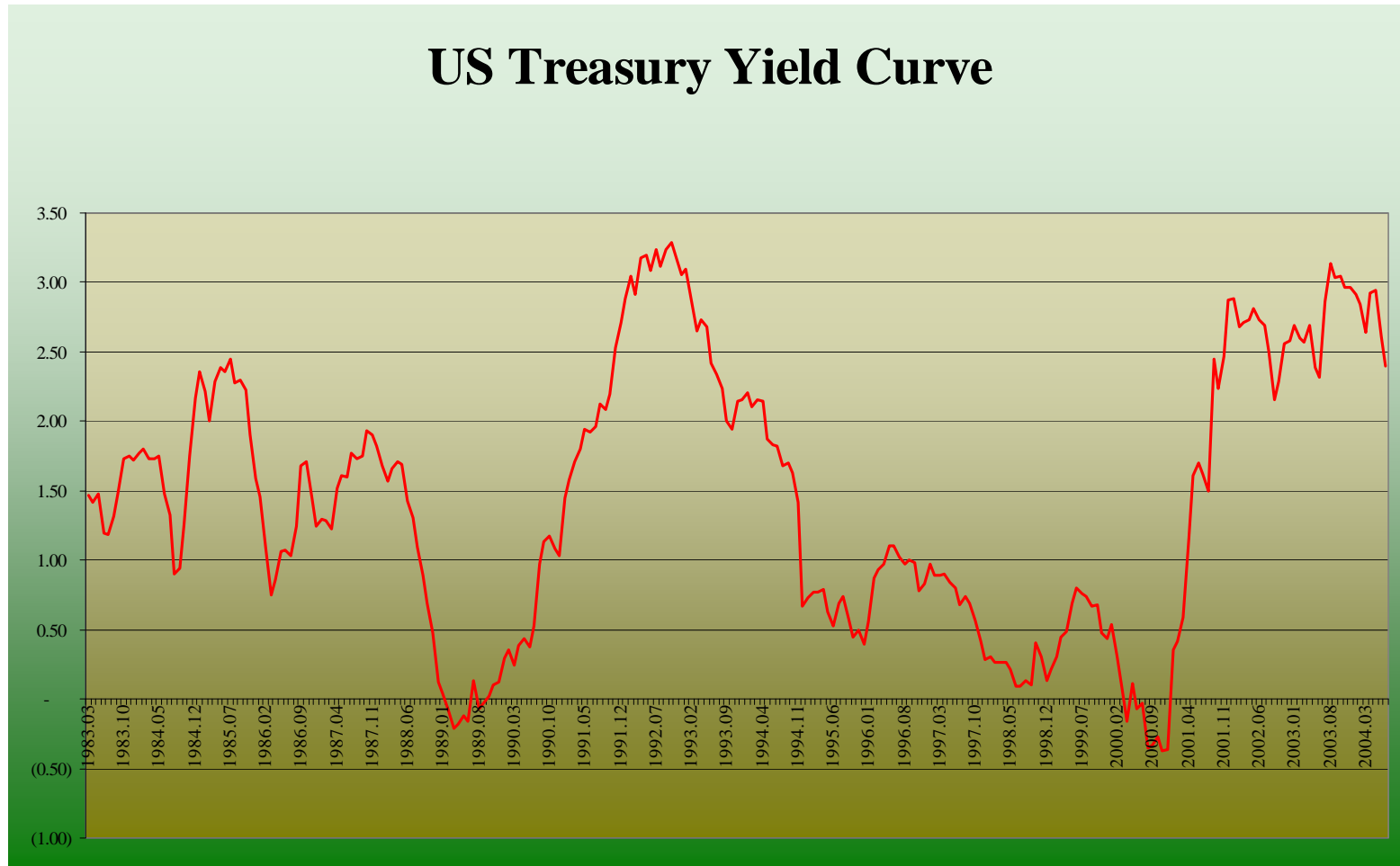
In this month's chartbook we will quickly address our indicators. As for an outlook, the best analogy is a weather analogy... partly cloudy, chance of rain, with a major hurricane in the gulf that we are monitoring.

Macro-economic Research



The correlation between crude oil (price inverted) and the S&P 500 is obvious. If energy prices spike from here we have real problems.

Macro-economic Research



The treasury bond yield curve has not discounted the perceived contraction in growth rates to the extent that the equity market has. Who has it right, stocks or bonds?

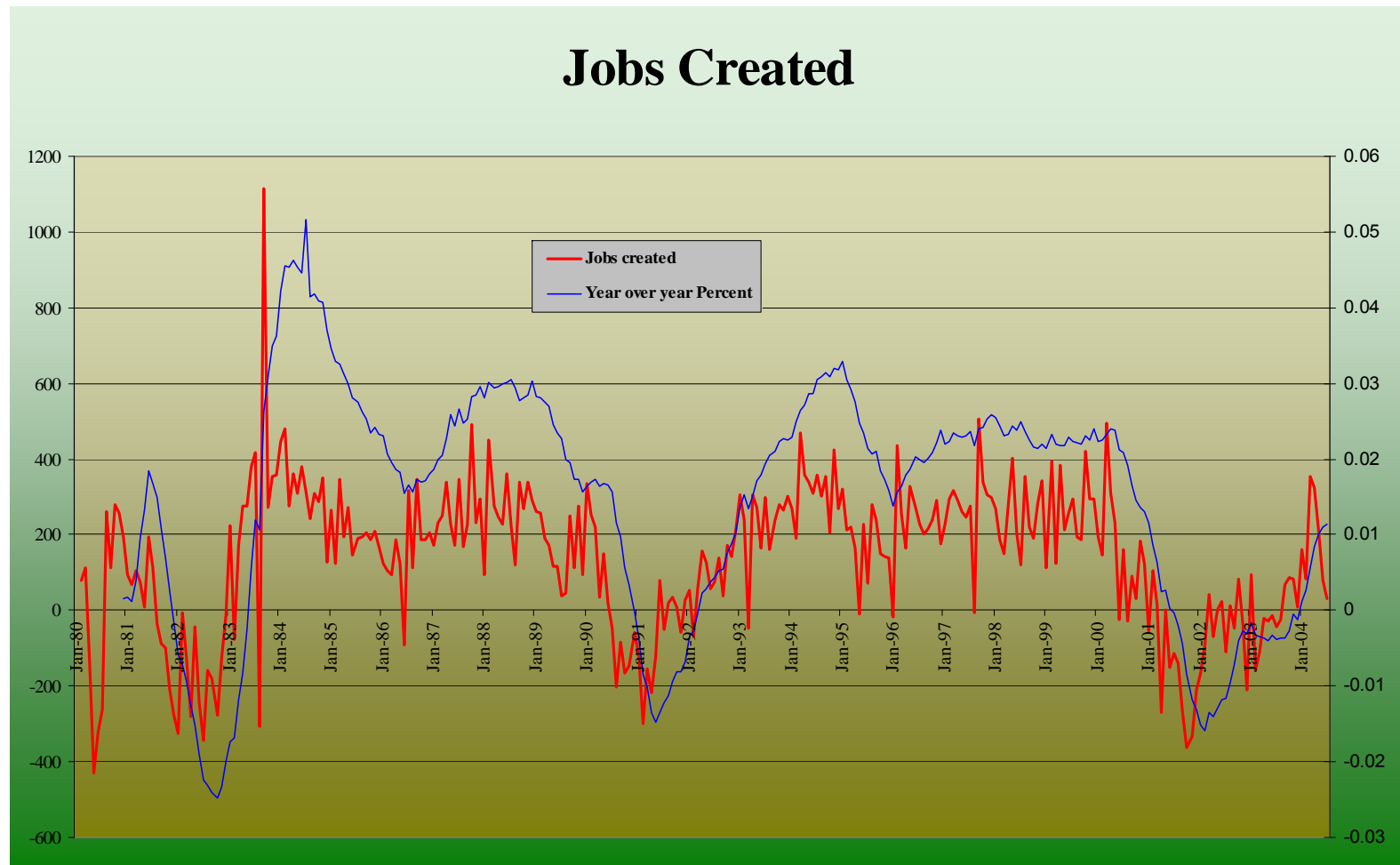
Macro-economic Research – Current employment

The payroll employment reports for the last two months have been murky. Seasonal adjustments can adversely affect these numbers, particularly in the summertime.

One thing that strikes us is that the payrolls report and initial jobless claims number (which are inversely related) just do not jibe for the last two months.

Another thing to note is that the payroll number is subject to large revisions at turning points in the employment cycle; major revisions down at this point would be a ominous signal to the markets.

Macro-economic Research



The past three months have shown a dramatic slowdown in the rate of job creation. The year over year number remains strong, but much, much weaker than over past business cycles.

Macro-economic Research



Jobless claims remain below the critical 350,000 level indicating continued growth in the labor markets.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1104.24	Trading range	↑	980-1180	End of 2004
Ten Year Treasury	4.13%	4.65%	↔	4.35%-4.875%	9 months
Inflation (all Urban)	2.94%	2.75%	↔	2.50%-3.10%	6 months
Fed Funds	1.25%	1.50%-2.00%	↑	1.25%-2.25%	6-9 months
S&P 500 Earnings	\$54.77	\$58.50	↑	\$55-59	4q2004
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

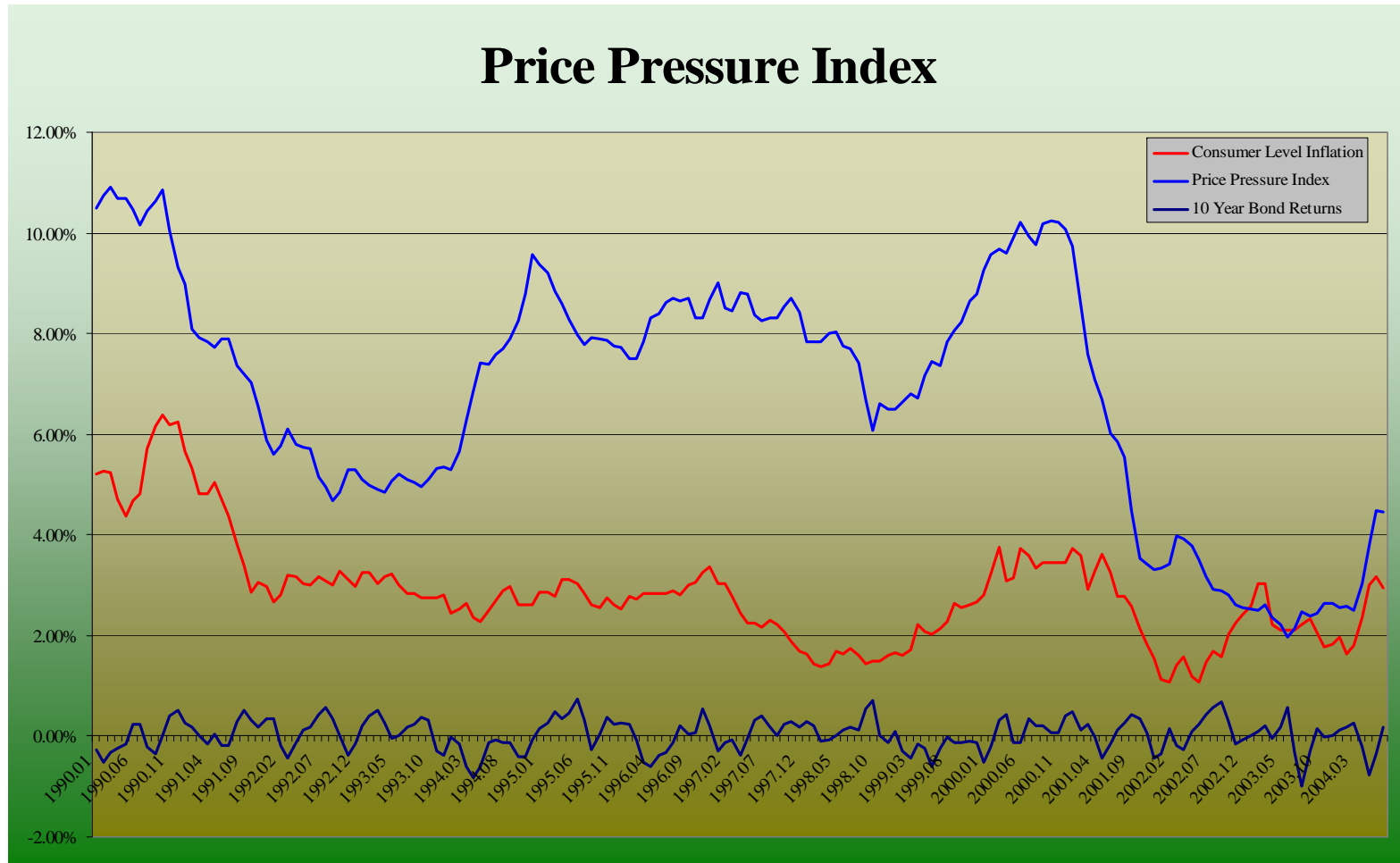
Inflation expectations

While the return in pricing power is evident, its duration and strength is not. The Fed has worked hard to fight off a real or imaged deflation threat and, to this point, they have succeeded.

It is important that the Fed's measured pace of rate increases be successful in containing the recent rise in inflation.

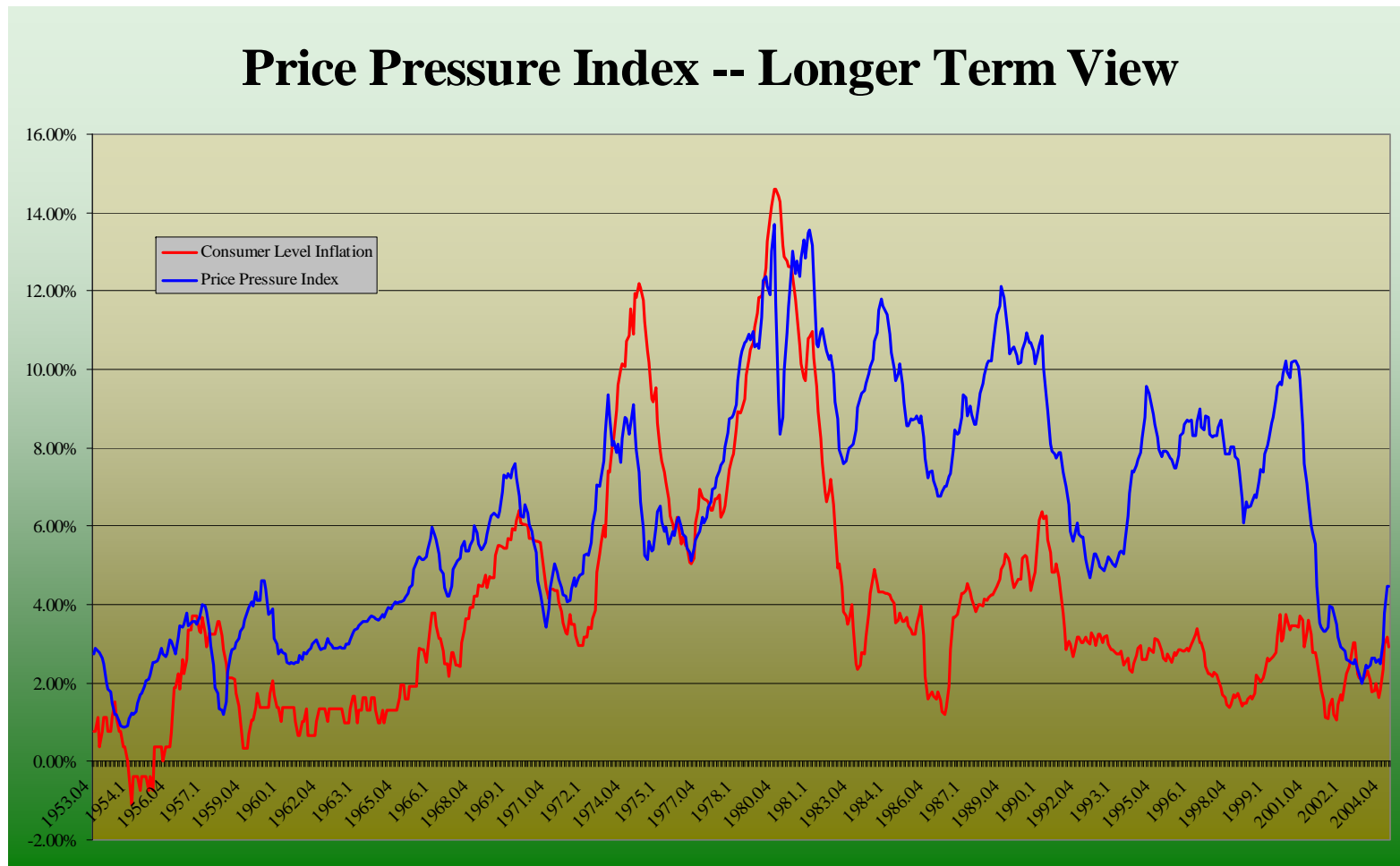
If above trendline inflation persists to the point that the Fed becomes concerned, we have a problem. Tight money at this point of the cycle will tip us into recession and knock the P/E on the market down. Not our prediction, just something to think about.

Inflation expectations



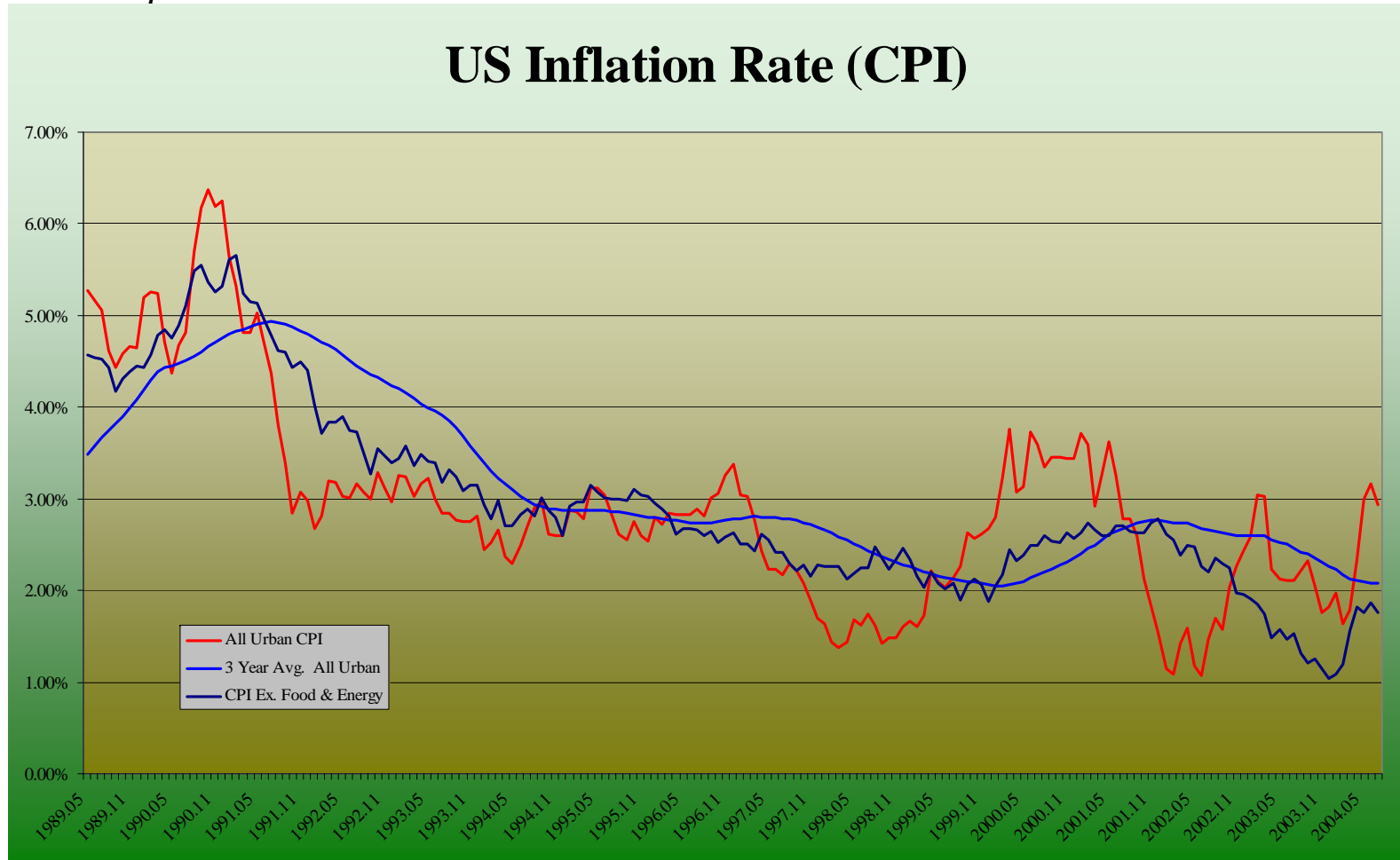
Price Pressure Index remains sharply higher. Good news for pricing power, bad news for rates.
This causes us to maintain a bearish outlook on bonds.

Inflation expectations



Although it moved off its low this month, price pressure and consumer level inflation are still well within reasonable levels. The long run average in inflation is 3.10% so recent history has been abnormally low.

Inflation Expectations



To the extent that higher prices are demand driven and not caused by supply shocks, the return of pricing power is bullish for stocks.

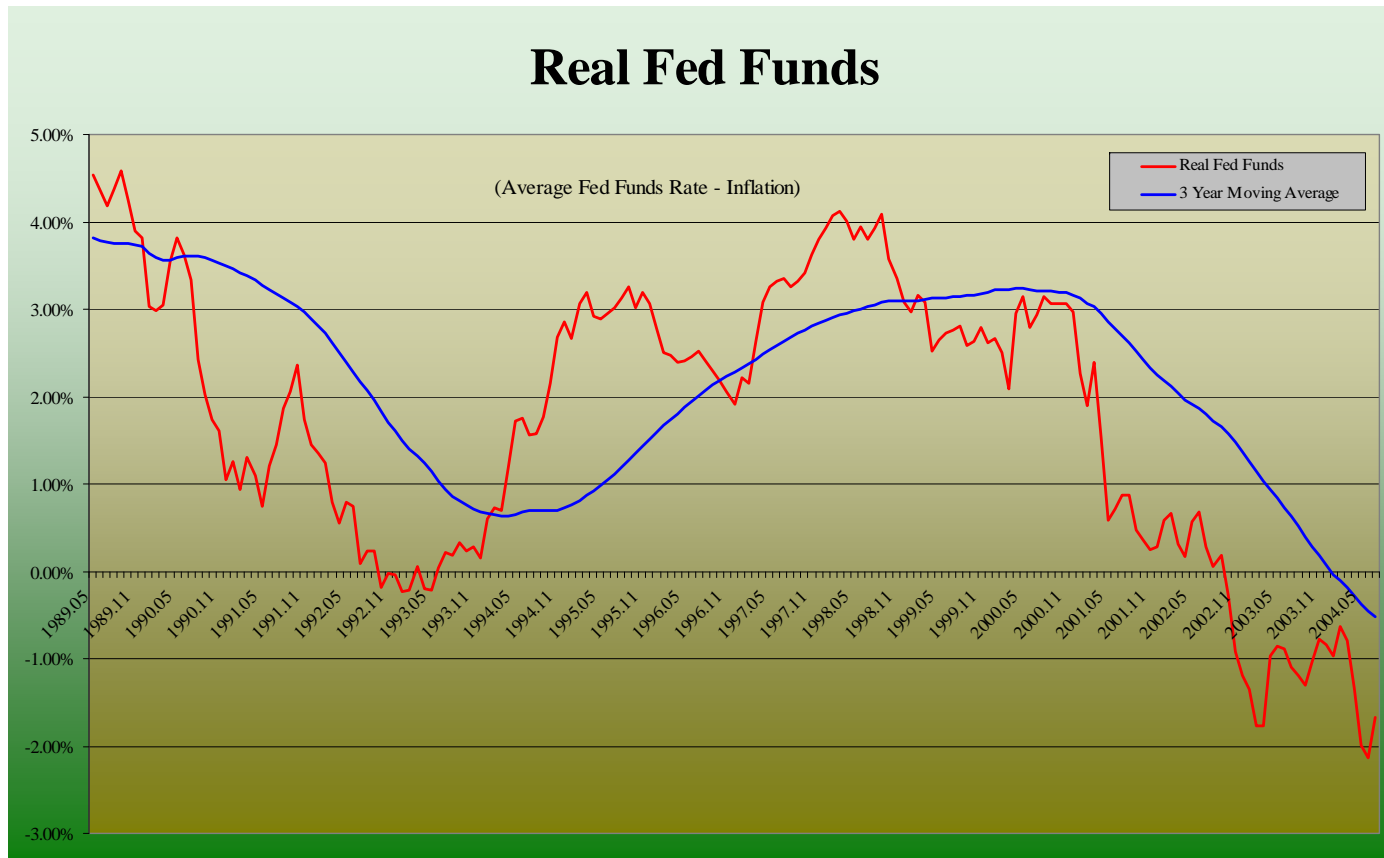
Federal Reserve Watch

At this point in the cycle, monetary policy has nothing left to add.

Margin, speculation and adverse risk-seeking are distinct possibilities with real fed funds where they are. To avoid the creation of another investment bubble, the fed must continue to move rates higher.

As long as the yield curve remains upwardly sloped and short rates don't rise more than 200 bps a year, the monetary headwind the economy is facing should not be that fierce.

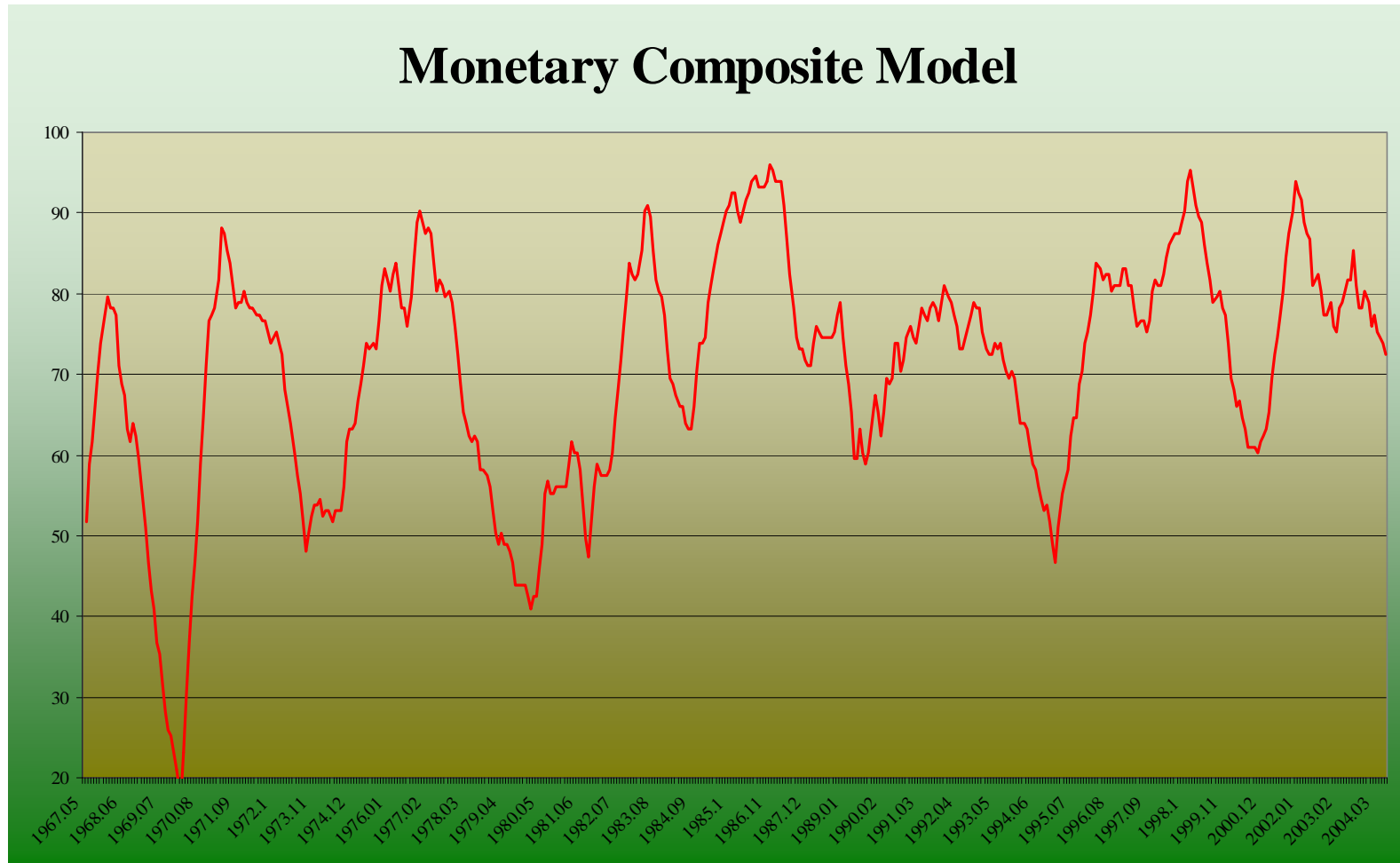
Federal Reserve Watch



Even with the rate increase, real interest rates are strongly negative as inflation has increased more than rates have.

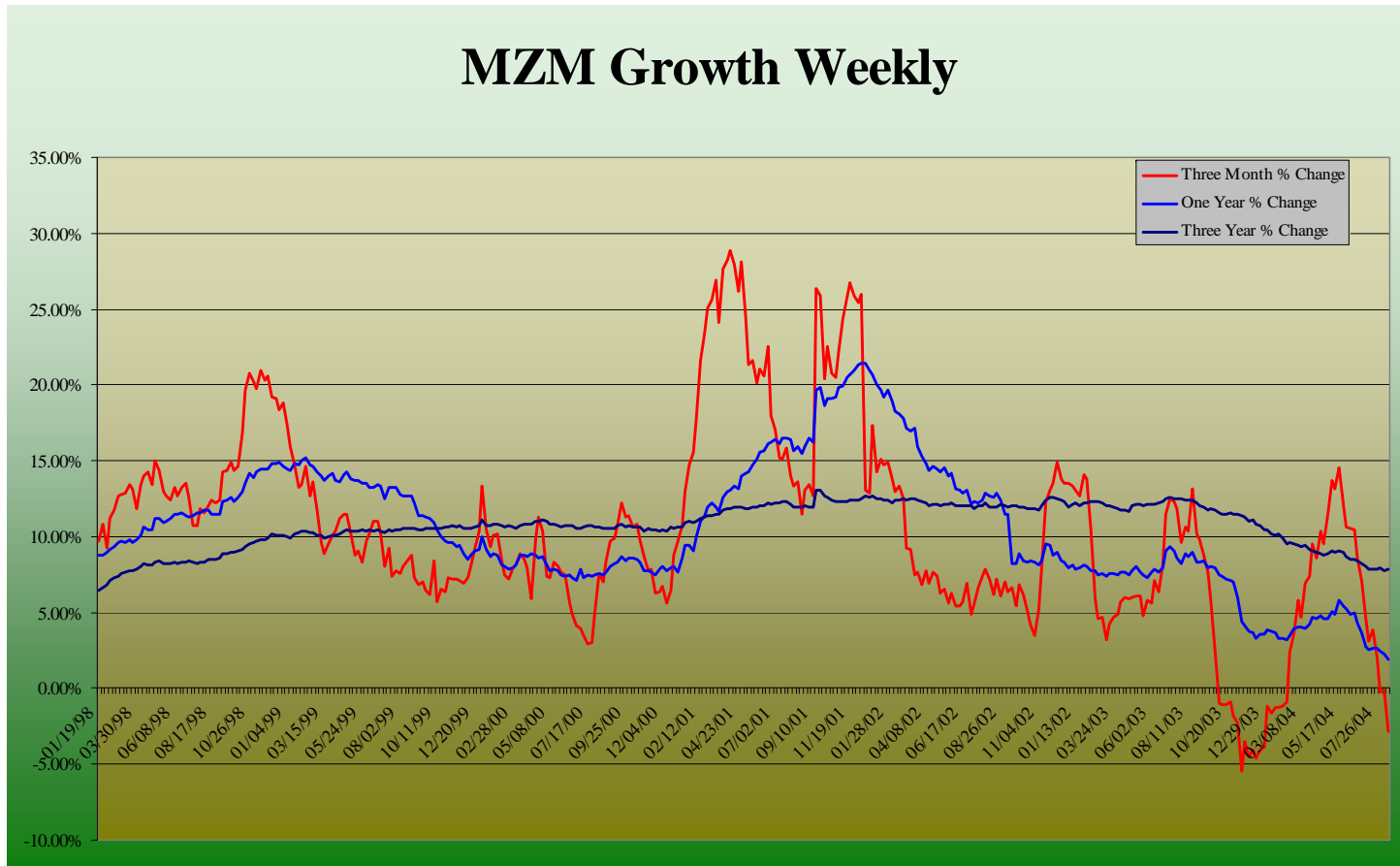
The year over year changes for inflation will likely moderate while interest rates gradually rise over the remainder of the cycle.

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. Higher interest rates as well as slowing money supply have effected this model and will likely continue to do so as its measure declines. Monetary policy could be a headwind for some time to come.

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 has declined after rapid growth since the beginning of the year.

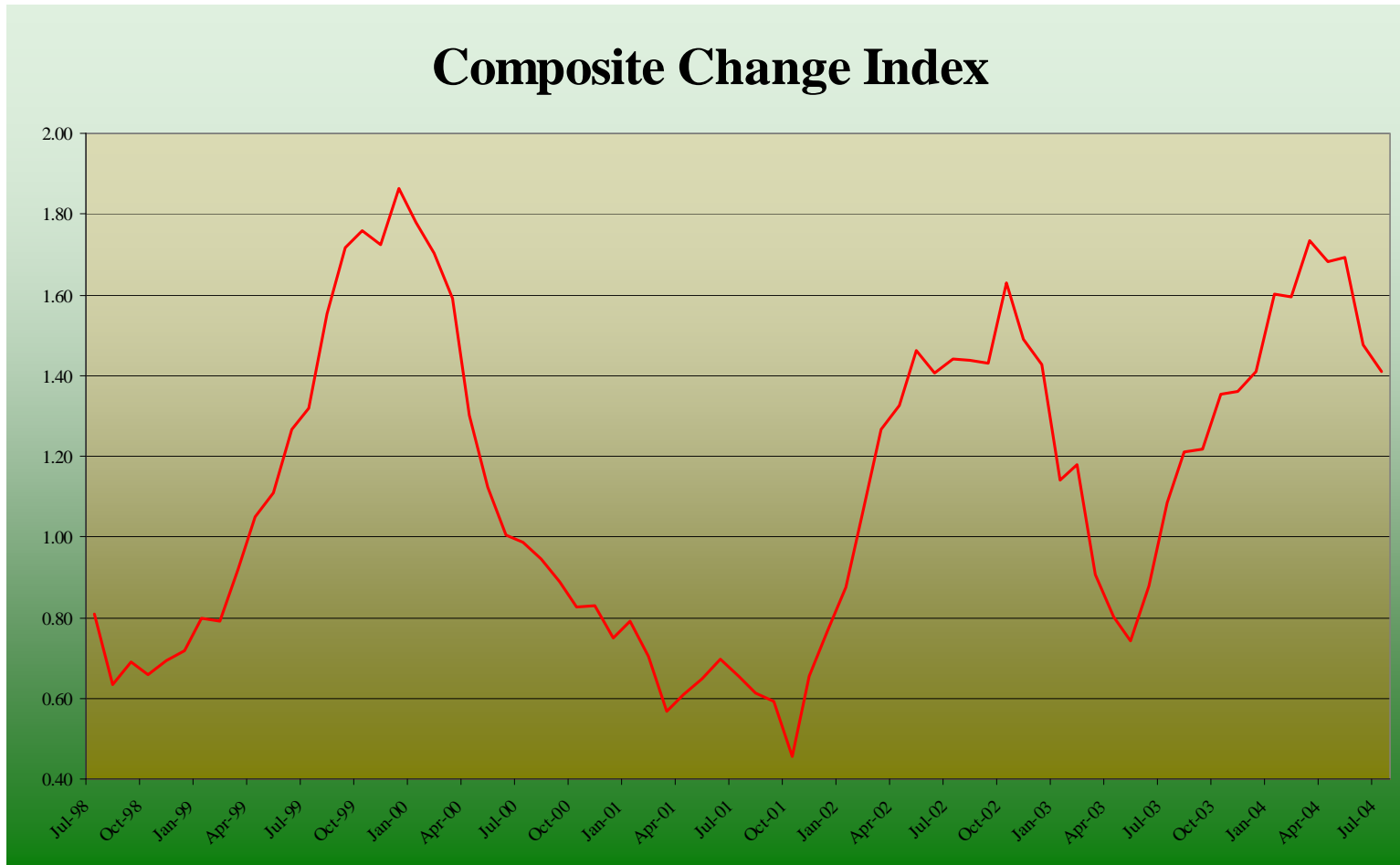
Outlook & Forecast

8% world part II.

With interest rates at 40 year lows and P/E ratios at the upper send of the Post world war II range the bond market is telling us something with a 4.27% year on the 10 year treasury; returns are going to be below the average of the last 20 years for the next 20 years.

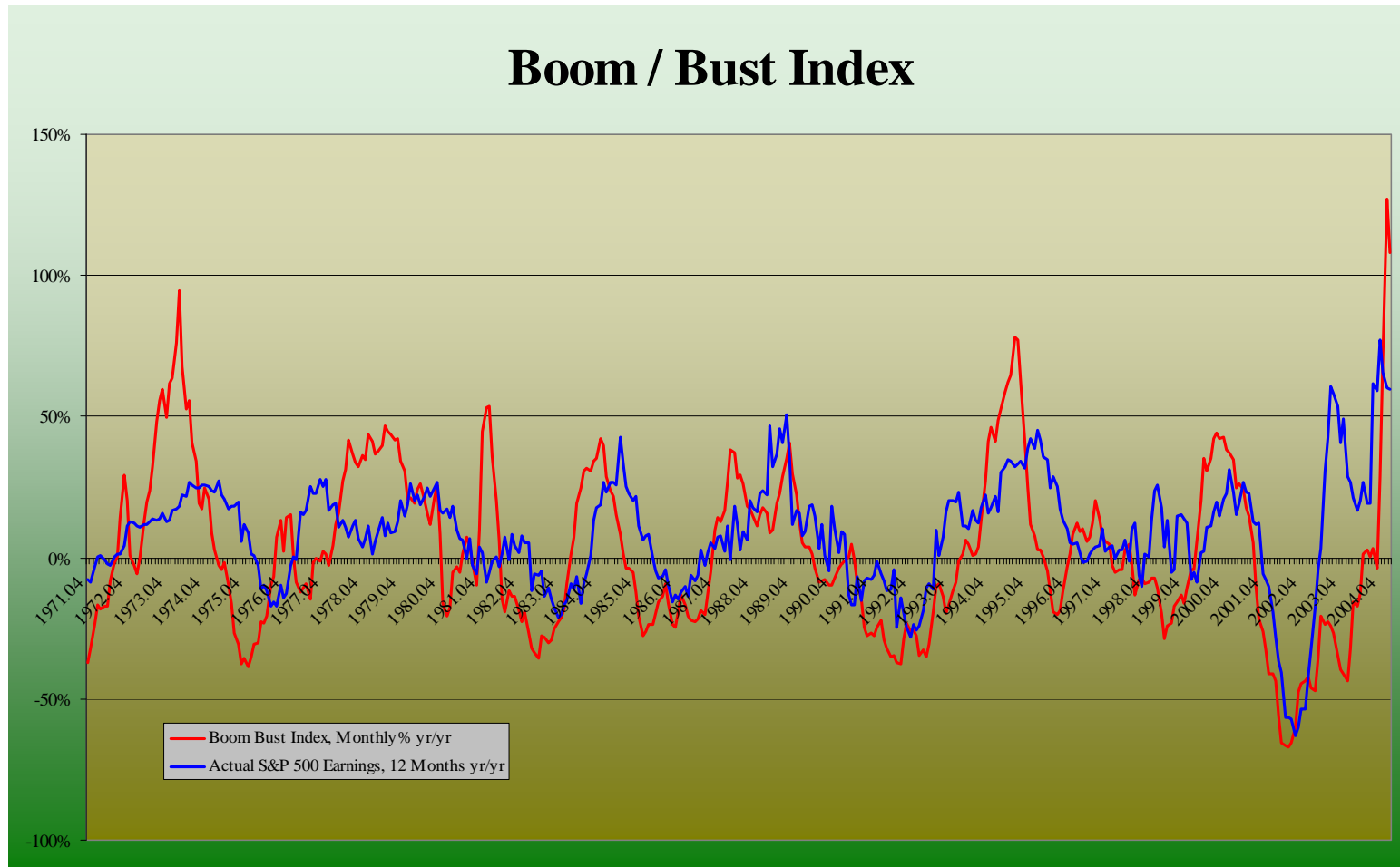
If your return assumptions are for 12-15% returns from the stock market, you need to rethink your position.

Outlook & Forecast



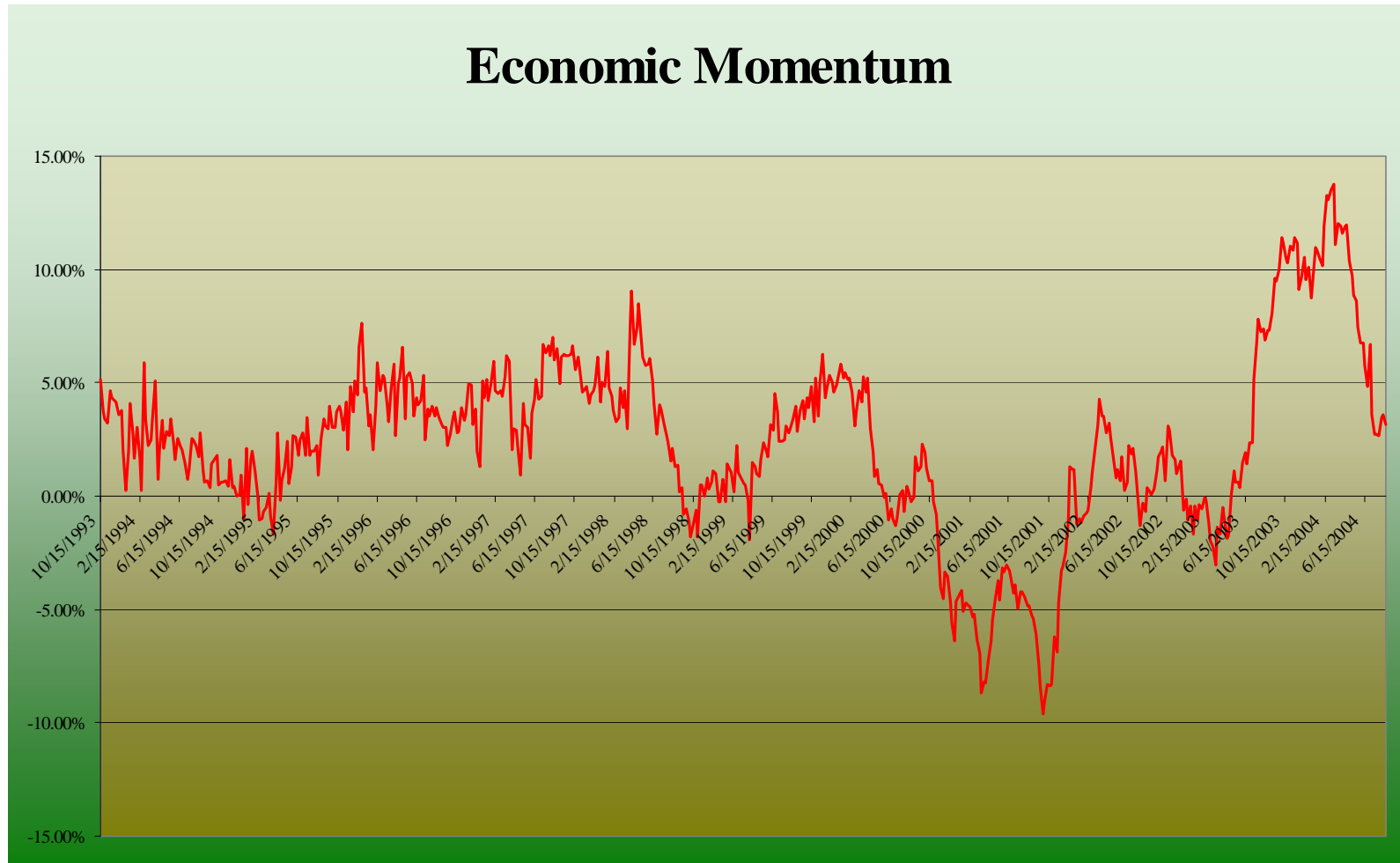
The composite change tends to lead earnings, and values over 1.00 are considered bullish. Growth for the cycle may have peaked but positive growth continues.

Outlook & Forecast



The Boom/Bust Index tracks key variables within the economy that correlate with earnings. The red line is predicted S&P 500 earnings direction, indicating positive movement continuing. The return of some pricing power has the boom/bust index at almost ridiculous levels.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).

The slide in the growth rate over the summer has abated in the last three weeks. We continue to monitor this series closely.

Final Thought

Unless forward growth rates are negative, the valuation of the stock market is quickly becoming attractive.

In the last month further evidence of the Summer slowdown appeared in the economic numbers, but there was little evidence that the Summer pause was worsening.