

January: Steady as She Goes (every which way)

Market Summary

January 2004

For those among us who have thought *Janus* to be the name of a mutual fund, or what the late rock 'n roll artist Janice Joplin was called when visiting Boston, be advised that it is the cognomen of the Roman god of gateways, or of new beginnings, depicted on coins and in ancient sculpture as a double-faced figure, looking both ways at once. So it was this year, as in many other years, that the month dedicated to Janus seemed to point both forward and back, acting as much like a refrigerated reprise of the 12 months just concluded than the embarkation point for the year ahead.

Byron Wien, the Morgan Stanley market minder who turns oracle every January, took the looking-two-ways gambit to an extreme, issuing twin sets of his much-watched annual list of Ten Surprises of the New Year. One set predicts a robust economy and a continued rally in financial markets; the flip-side prognostications are for an economic belly flop due to spiking interest rates, burgeoning trade and fiscal deficits and a tanking dollar. Rising oil prices are included in both sets of predictions*. He got it right through month one: All trends continued intact, however contradictory, and in whatever direction.

Certainly the markets continued on track. The Standard & Poor's 500 Index gained 1.8%, a rate that would produce a 23.9% gain if sustained over the entire year—an unlikely approximation of last year's 28.7% rise. It was exceptional that the big stocks' performance split almost evenly between growth and value (1.9% and 1.8%, respectively). Value was the winner last year by a full 5 percentage points (31.8% to 25.7%).

Small stocks also danced in the mirror in January, handily out-performing their larger

cousins, as they had all last year. The Russell 2000 Index leapt 4.4%, a rate that would produce a ridiculous gain of nearly 68% over 12 months, and trounce even the gaudy 47.3% gain the index produced in 2003.

The small-caps further echoed the year prior in favoring growth over value. The Growth segment of the Russell 2000 out-ran the value group 5.3% to 3.5%.

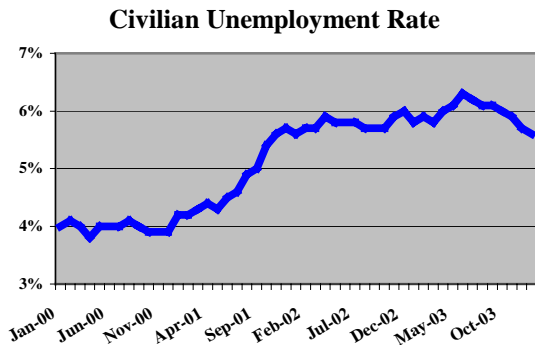
Stocks of mid-sized companies behaved in keeping with their capitalization, finishing in the middle. The S&P MidCap 400 Index rose 2.2%, with the "value" component out-gaining "growth" 2.6% to 1.7%. The Russell Midcap Value Index also rose 2.6%, but the Growth segment gained 3.3%, nearly twice as much as the S&P 400 growth group. The two indices are compiled differently—the Russell Midcap Index comprises 800 stocks chosen by a strict capitalization formula; the S&P 400 has half that many stocks (duh!), picked by committee.

International stock indices also continued along paths previously trodden, as MSCI's large-cap EAFE Index gained 1.4%, and its emerging markets index 3.5%.

Bond indices posted gains in January, regardless of type, duration or national origin of the issues benchmarked. The Lehman Aggregate Index gained 0.8%, which would work out to a nifty 10% over the course of a year. Junk fared even better, the Citigroup High Yield index gaining 1.8%. International issues were present and accounted for, as the Citigroup World Government Bond Index rose 0.3% and the JPM Emerging Market Bond Index Plus gained 0.5%.

If you relocated your portfolio to real estate in December, you had cause to be happy in January, as the Wilshire REIT index gained 4.0%, on top of a 45.9% gain last year. The question still in our minds, as we rub our eyes in amazement, is "How far can it go?" Fortunately, we have not pretended hitherto that we know the answer, and won't start now.

As for economic trends, they too continued unperturbed in January. The civilian unemployment rate dropped, however slightly, for the fourth consecutive month, to 5.6%, and now has dropped a half percent since September (see chart; source: Dept. of Labor).



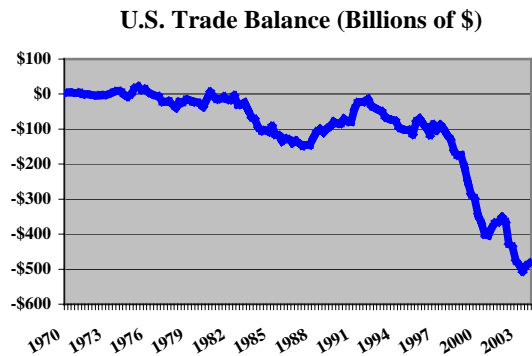
However, this is a poor showing indeed, compared to previous periods of economic recovery, say a number of economists, Stephen S. Roach of Morgan Stanley most vociferously. Roach calculates that job growth is less than half what it ought to be in period of rapid growth, with the difference summing to \$400 billion in absent spending power. Our economic rebound is being funded from “toxic” sources, meaning deficits, reduced private saving, debt and extraction of (over-stated) equity from real estate, says Roach.

That’s just what we need—a “spending power” deficit to go with the already familiar chasms in the federal budget and the national balance of payments, which sum these days to circa \$1 trillion. We’re not chartists, of course, but... the trend line in the balance of trade has begun to form the classic (i.e., just made up) “Angel Falls”** pattern (see chart, opposite; source: Bureau of Economic Analysis).

Of course, one man’s wage freeze is another man’s productivity gain, at least in times of rising output (more stuff @ the same or less labor cost = higher productivity). Financial markets found consolation in this equation when Fed Chairman Alan Greenspan, in his monthly remarks to Congress, cited the strength of U.S. productivity growth through both recession and recovery. That translates

into reduced inflationary pressure in the economy, Greenspan said to Congress. And that translates into continued low interest rates, the market said to itself, and promptly rallied.

Mr. Greenspan’s words came as welcome relief, for the Fed’s Open Markets Committee had only a few days before sent heebie-jeebies through the market by eliminating its benign phraseology about holding rates at the current level for “a considerable period.” The new wording promised only to be “patient” about hiking the funds rate. In a bond market in which sheer junk is priced to yield but a few points more than U.S. Treasury bonds, continual reassurance is required. For the moment, the Fed Chairman has furnished it.



**Both sets of Wien’s predictions also say that by year’s end Dick Cheney will be out (as Vice President) and Osama bin Laden will be in (custody). Aside from surging interest rates, the main difference in the two sets of surprises is the occurrence of a major terrorist strike.*

***Angel Falls, highest waterfall in the world, drops 3,212 ft. over a sheer precipice, virtually straight down into the Venezuelan rain forest.*



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Euphoric February? We'll Take It!

Market Summary

February 2004

What's the last thing you ought to throw to a drowning man (even if he's calling for it)? A floating yuan—at least if that man is an American, drowning in debt. It seems that the strain of keeping China's yuan (official name: Renminbi, or "Peoples' Currency") pegged at 8.27 to the dollar is having noticeable economic (and therefore political) consequences.

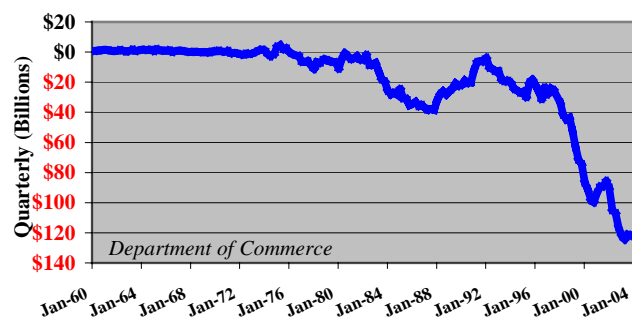
The odd thing is that this isn't the old and familiar refrain from a small foreign country faltering in its effort to prop up a currency too ambitiously yoked to the dollar. It's a question of China holding the yuan *down* to its current dollar valuation. And it's not China's officialdom wringing its hands, but ours: U.S. trade negotiators are anxiously prodding the Chinese to open their currency to trading, in hope that a market-valued yuan would dampen the burgeoning growth of the U.S. trade deficit (see chart, opposite).

This very clearly is a new thing, and certainly marks a sea change in the world distribution of economic power. But the more immediate issue is that China keeps its currency cheap vs. the dollar by buying up U.S. government debt, and has accumulated a hoard of Treasury and agency issues currently worth an estimated \$144 billion*. To float (or even revalue) the yuan, China certainly would eliminate or curtail these purchases, and quite possibly divest itself of a large portion of the existing stash of bonds. That would mean a lot more American government debt on the market. Add Japan's trove of \$525 billion in U.S. bonds, and another \$100 billion held by the Asian "tigers" (South Korea, Taiwan and Thailand), and you have the raw ingredients for a sell off that could hardly fail to send U.S. interest rates soaring.

Not to worry (yet), Federal Reserve Chairman Alan Greenspan told Congress in February. First of all, Asian countries are not anxious to slash the value of their own financial reserves. Secondly, their Treasury obligations are predominantly short-term, and subject to continual turnover anyway. Finally, said the Chairman, the Chinese banking system is in no condition to absorb a rapid appreciation in its currency, which in effect would tighten the supply of money. Greenspan, in a written response to questions from House Banking Committee Feb. 12, said up to 50% of Chinese bank loans already are non-performing. A freely traded yuan could spark an exodus of deposits from an already shaky banking system, said Greenspan.

Meanwhile, the Chairman said, our current accounts deficit (\$43.1 billion in January) means lenders around the world "perceive the

U.S. Trade Balance



United States as an excellent place to invest." Mr. Greenspan acknowledged a limit to such largess, but advised fiscal restraint as a first remedy, rather than currency intervention. Above all, he said, Congress should resist the temptation to retreat into protectionism.

Though certainly not an unmixed blessing, there is (for now) a distinct upside to China's use of its gargantuan trade surplus with the U.S. (\$11.5 billion in January) to buy Treasury bonds. This bolsters the value of the dollar vs. the yuan (its intended effect), but it also helps keep U.S. interest rates in check. In effect, the Chinese are not only lending America money

to buy their goods, but they also are cutting prices and subsidizing interest rates. It's a little reminiscent of Crazy Eddie, the New York electronics discounter who boasted, some years ago, that he was giving his merchandise away—and eventually proved his point by going broke. No one expects a large-scale replication of such a scenario, however, so we should be prepared to see Asian “tigers” diversify their holdings of U.S. government debt in the not far-distant future.

In February, it was the purr of kittens, not the growl of tigers that was heard across stock and bond markets. The one glitch—really, more like a welcome respite—came in small-cap growth stocks, with the Russell 2000 Growth Index dipping a miniscule 0.1%, and the NASDAQ 1.8%, after both had a very jolly January (+5.3% and +3.1%, respectively).

Other small stock indices, and all the large and mid-cap indices were positive, with value stocks taking the lead.

The Russell 2000 Value Index gained 1.9%, continuing the upward trajectory it set in January. The S&P 500 gained 1.4%; the S&P 500/BARRA Value Index gained 2.3%; the S&P 500/BARRA Growth Index moved up 0.5%. The Russell Midcap Value Index gained 2.5%; Russell Midcap Growth, 1.7%.

International stocks in February, as in many previous months, were so good as to be worrisome. The MSCI EAFE Index of large stocks gained 2.3%. MSCI's Emerging Markets Free index gained 4.6%, and has gained a vertiginous 8.2% through the first two months of the year. This suggests that, while the Asian tigers are buying America's bonds, America is buying *their* stocks.

Bond markets revealed no worries about disinvestment, or any other peril, in February, though junk slipped slightly, the Citigroup High Yield Index giving back 0.8% of its 1.8% January gain. The Lehman Aggregate Bond Index gained 1.1%, and its Government Bond Index moved up 1.2%. Emerging market debt gained 0.2%, and is up 0.7% for the year—

quite good, on an absolute scale, but modest for this (erstwhile?) red-hot category.

Real Estate is still on Cloud 9, a nice location while it lasts. The Wilshire REIT Index gained 1.7% in February, and is up 5.7% through the first two months of the year. Our question: Considering imputed sensitivity to interest rates, will American real estate float only so long as the Chinese yuan does not?

Speaking of real estate, the spoilsports at *The Economist* tell us that the infamous stock bubble that burst in March 2000 has been simply supplanted in American economic life by an equally gossamer (and equally treacherous) gas bag in property values. Instead of drawing on fictitious stock valuations to fill their shopping carts, American consumers are fiddling their way to catastrophe by borrowing against delusional real estate assessments. Household debt increased by \$900 billion last year, while earnings rose only by \$400 billion, so stow away the credit cards and get to work, says *The Economist*. Factoring in our ever-more notorious trillion-dollar twins**—the fiscal and current accounts deficits—you have total American indebtedness rising by \$6.5 trillion since 2000. It's “unsustainable collective euphoria,” clucks *The Economist*.

Compared to the mood that February usually evokes (Valentine's Day notwithstanding), euphoric is not a bad way to leave it.

**Source: Treasury Dept. and the OMB (Wall Street Journal, Feb. 5).*

***The 2003 trade deficit is estimated to be \$500 billion, the 2004 fiscal deficit \$525 billion (WS J, Feb. 25).*



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Flash: March Not Schizy (just dull)

Market Summary

March 2004

March is known for schizoid behavior—alternately leonine and lamb-like—but this year it produced neither bleat nor roar. March was instead rather blah, showing mixed returns from the stock indices and a respectable if unenthraling performance across the bond benchmarks.

Generally, March filed off the sharp peaks on what otherwise would have been some very gaudy first-quarter stock charts, and nudged bonds upward more or less in keeping with their coupon values.

Specifically: The S&P 500 index dropped 1.5%, and the Dow Jones Industrial Average fell 1.9% in March. These numbers put the DJIA under water for the year (-0.3%), and left the S&P 500 clinging to a 1.7% gain.

Value stocks continued to dominate their sibling “growth” issues in the large-cap sector, though both lost ground in March. The S&P 500/BARRA Value index finished the month at -0.7%; the Growth index closed at -2.3%. Value finished the first quarter up 3.4%; Growth was perfectly flat (0.0%).

In the mid-caps, the S&P 400/BARRA gained 0.4% in March, with growth stocks in the index slightly out-performing the value issues, 0.7% to 0.2%. The Russell Midcap indices had it the other way around in March, with the Value index outperforming the Growth group 0.2% to -0.2%.

The NASDAQ dropped 1.8% in March, as it had in February, thereby finishing the first quarter on negative ground (-0.5%). The Russell 2000 Index, which is more purely small-cap, gained 0.9% in March, and was up 6.3% for the quarter and YTD.

As measured by the Russell indices, value stocks led growth issues in all size categories,

through the first quarter. In the large-cap Russell 1000 index, value stocks out-performed growth by nearly 4-to-1: 3% to 0.8%. In Russell’s Midcap indices, which are simply carved out of the Russell 1000, value led growth 5.3% to 4.8% for the first quarter. In the small-cap Russell 2000, the Value sub-index handily out-performed Growth through the first quarter, 6.9% to 5.6%.

International stocks cooled a bit in March, with the large-cap EAFE index gaining a modest 0.6% for the month, but a healthy 4.3% for the first quarter. Emerging market indices were slightly subdued (by their recent standards), but managed solid gains in March: 2.6% for the S&P/Citigroup EMI-EPAC, and 1.2% for the MSCI Emerging Market indices. Their quarterly gains were 9.8% and 9.6%, respectively. However, the Pacific Rim X-Japan index fell 0.4%, the first negative month for any international index this year.

The only outright star performer in March was a familiar one: Real Estate Investment Trusts. The Wilshire REIT Index ploughed ahead 6% for the month, and ended the quarter at a very upmarket +12.1%.

However, if we might be permitted a peek at the next leaf on the desk calendar, March could very well have ended (at 14) REITs’ remarkable string of consecutive monthly advances. *The Wall Street Journal* reports that, in the first week of the new quarter, its REIT index encountered the two nastiest trading days of its 12-year history, losing 8% of its value and making it probable that, for this asset class at least, April will live up to the “cruellest month” moniker that poet T.S. Eliot slapped on it 82 years ago¹.

Over the previous 13 quarters, stretching back to a seemingly long-ago December 1999, the Dow Jones REIT index gained 63%, the *Journal* reported, making it by far the most lucrative U.S. equity category since the onslaught of the Y2K bear market. The S&P

500, DJIA and NASDAQ are still well below their March 2000 peak values².

So to what evil do we owe this crimping of the REIT growth curve? Why, to impending prosperity, of course. It seems that REIT investors—whether they knew it or not—were betting that any upswing in employment data would come later rather than sooner. Their fear, as described in the financial press, is that new jobs mean more consumer spending, which means economic growth, which means an eventual end to the historically low level of interest rates, which means the yields on REITs won't look so wonderful anymore.

Enter the Department of Labor, April 5, with the biggest uptick in its employment data in four years (308,000 new jobs in March). Exit REIT traders the same day.

But one man's dread is another man's dream, in this case meaning the news that brought migraines to REIT investors came as manna to politicians seeking re-election this fall—a group that conspicuously includes Republican President George W. Bush. In fact, if you squint at the chart of current employment data (right), it acquires a certain pachydermal aspect.

And not to worry (excessively) REIT holders: No sooner had the market slammed this sector than Wall Street analysts declared it attractive again, and issued renewed, if qualified, “buy” recommendations. The sell off was over-done, pronounced Goldman Sachs, pointing out that the Federal Reserve is very unlikely to raise interest rates precipitously in the early stages of an economic recovery. And, harmonized Merrill Lynch, health care properties will remain in high demand, so long as Baby Boomers keep doing what comes naturally (in middle age), i.e., getting older.

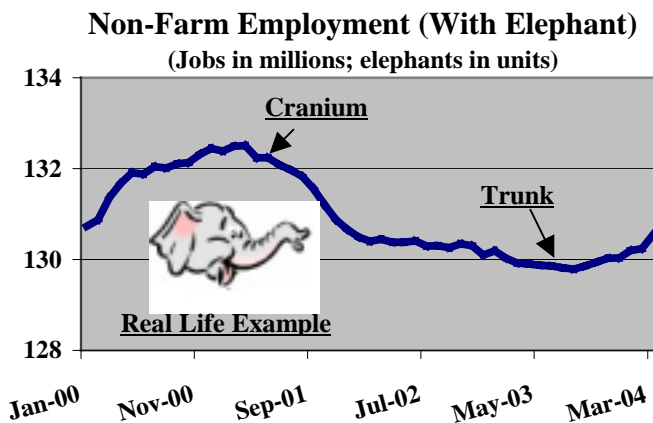
Many investors found themselves reassured, and bought back into REITs, pushing the sector index back up by nearly 3%.

All of which suggests REITs might be seeking a price level that will provide satisfactory yields to investors, but probably not enough appreciation potential for speculators.

Prediction: Speculators will not be long in discovering new vehicles.

Prediction No. 2: If the “jobless recovery” theme plays out as a drum to beat upon in this political season—and we all of course hope employment data will continue strong—others

will be found. If politicking futures were listed on the commodities exchanges, we would suggest going long noise and selling short common sense. (Possible proxy: shares of TV network owner³).



1. T.S. Eliot, *The Waste Land*. Archaic spelling is Mr. Eliot's.

2. The S&P 500 peaked at 1527, the NASDAQ at 5049, both in March 2000; the DJIA crested in January 2000 at 11723.

3. Choices are Viacom (VIA), General Electric (GE), Disney (DIS), and Fox Entertainment (FOX), all on the NYSE. PBS is not traded.



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April Showers Bring... Impatiens?

Market Summary

April 2004

April showers showed up on schedule this year, but the rain put a bit of a chill into the financial markets, and left some erstwhile stars wet and shivering. The traditional May efflorescence was therefore anticipated with feelings somewhat mixed. What sort of flowers would these ungentle showers bring? Would it be the violets, and crowds of daffodils about which The Great Al Jolson once sang (and sang again)? Or—worst case—were we in store for a crop of T.S. Eliot's dour lilacs, cruelly bred from the dead land? Neither, it turned out. We got petals of impatiens from the Federal Reserve.

The Fed's Open Markets Committee, in the minutes of its May 4 meeting, conspicuously omitted the word *patient* from its self-description. No longer forbearing of low interest rates, the committee reported itself disposed rather to raise them, but "at a pace that is likely to be measured."

The question is, measured by what: a stopwatch, a metronome, a calendar? The answer, or a first hint of it, comes when the FOMC meets again June 29-30. The prevailing interpretation is that committee meant to signal that bond markets will be spared the pounding they took in 1994, when the Fed meted out six rate hikes, averaging 50 basis points apiece.

Markets had taken their cue two weeks before, when the Dept. of Labor announced that the Consumer Price Index had risen a half point in March (see chart, next page). Those who keep ruler and pencil ready at hand were quick to draw a trend line between this 50-basis-point rise and a 30-point blip in the CPI reported in February. That is, inflation is back on the radar screen.

On the principle that it's never too soon to panic, markets promptly tumbled on the CPI news, led by everything with a fixed income bent. The biggest stumble came from the Real Estate Investment Trusts Index, which had been the most ranting among bullish domestic asset categories. The Wilshire REIT index concluded a string of 14 consecutive monthly increases with a resounding thud, dropping 475 points to 2772, down 14.6% from March.

Not terribly far behind REITS were its fellow high flyers, emerging market bonds. J.P. Morgan's Emerging Markets Bond Index Plus fell 5.9% in April, to 286.45. It was first negative month for the index since dropping 10.2 points in July 2003. The Lehman Long Government Bond Index surrendered 5.6% in April, its first down month since October.

Strings of consecutive gains by definition are made to be broken, as gains cannot be called *gains* if there are not also losses. So price reversals are to be expected, and it is common that they come in amplitudes proportionate to the length of time between them. Viewed in this way, neither REITS nor Third World bonds fared too badly in April.

Nearly all bond indices corrected, but generally more moderately. The Lehman Aggregate Bond Index dropped 2.6%, and Citigroup's non-U.S. Government Bond Index fell 4.6%. Citigroup's High Yield Index fell only 0.8%, however, and its short-term junk index actually gained 0.1%—the only bond benchmark to rise, excluding 90-day Treasury Bills, which are priced at auction to nudge up each month, about as they did in April (0.1%).

When bond markets go so uniformly sour, stock indices can hardly help but follow accordingly, and in April they did so, without exception. The Dow Jones Industrials Average dropped 1.2%, the S&P 500 Index 1.6%. The S&P MidCap 400, the Russell Midcap Value and Russell Midcap Growth indices, in a rare expression of unanimity,

were all down—by 3.3%, 4.2% and 2.8%, respectively. The small-caps followed suit, the Russell 2000 dropping 5.1%, and the mixed-capitalization NASDAQ falling 3.7%.

International stock indices also were down across the board, by amounts varying inversely to capitalization. The large-cap MSCI EAFE index fell 2.3%; MSCI Emerging Market Free Index was socked with 8.2% drop.

April's returns can be interpreted as an illustration of such clichés as “buy on the rumor, sell on the news,” or “buy on the cannons, sell on the trumpets.” Presumably, last year the cannons foretold economic recovery, and in April the trumpets sounded its arrival.

If the economic rebound seen over the past several months has matured into a bona fide expansion, the coming of higher interest rates would be taken as a matter of course. No healthy economy would require, or even tolerate, a prolonged policy of “free” money—i.e., interest rates at or below inflation.

The fear is that the modest hop in consumer (and producer) prices in April was not an artifact of recovery, but the harbinger of a new onslaught of inflation, sparked by surging oil prices and a spiraling federal deficit. If that scenario were to develop, the Federal Reserve would come under severe pressure to ratchet up interest rates beyond the 2.5% level economist expect to see by the end of the year.

Alan Greenspan lent weight to such premonitions recently when he referred to “our yawning federal budget deficit” as “a significant obstacle to long-term stability.”

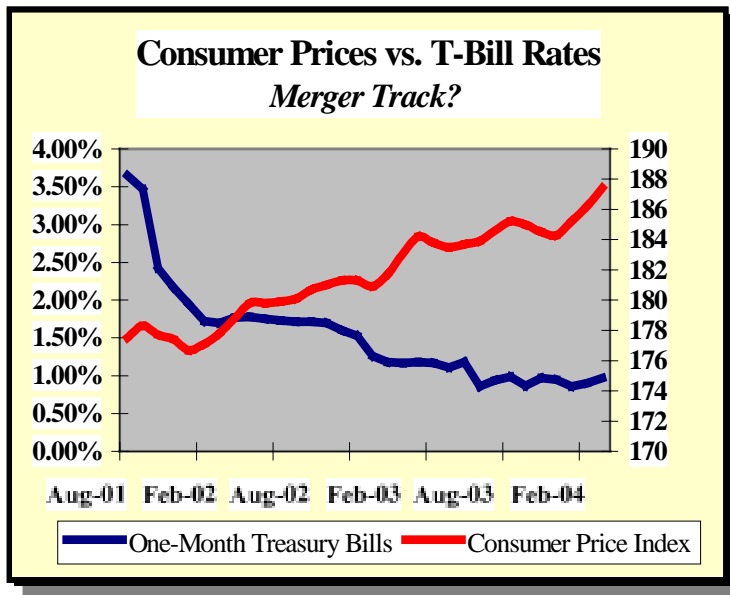
Stability, readers will recall, is a quality the Fed Chairman holds in high regard, and has been known to foster through the active application of interest rate policy. In short, “obstacle” and “stability” are not words financial markets like to hear Mr. Greenspan utter in juxtaposition.

Less discomfiting, perhaps, were Mr. Greenspan's

remarks on the national current accounts deficit, which reached a new record of nearly \$46 billion in March, and looks certain to surpass \$500 billion for the year. This prospective figure “does not strike me as overly worrisome,” said the Chairman.

Unlike federal spending, foreign trade is “subject to correction by market forces,” he noted—adding the “major caveat” that protectionism must not “undermine the adjustment process.”

That being a political question, it presents a logical stopping point.



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The Month of ‘Yes, You May(be)’

Market Summary

May 2004

Clear-headed and responsible behavior is not what May is supposed to be all about, but sticking to cliché is not what markets are all about, either. So this year we saw a well-behaved and relatively staid month of May—much in contrast to last year’s insouciant romp.

The big news—or perhaps, the news least small—was from the Labor Department, which reported that non-farm jobs surged by a net 248,000 in May. That raised the average monthly increase this year to 238,000, which is the highest rate for job creation in four years (see chart, next page). It’s also well above the 150,000 per month rate required (says the *Wall Street Journal*) for a stable jobs market.

“Economists,” reported the *Journal*, were surprised by the good jobs report, having expected to see only 215,000 positions created during May. A week later, the paper reported that “economists” were again taken aback by a 1.6% rise in import prices in May—twice the amount expected. Although it is difficult to see how the same group of people could be surprised in successive weeks by both a surge in employment and an increase in prices, we nevertheless admire the WSJ economists for their persistence. Being continually wrong does not deter them, even about points that—at least in retrospect—seem somewhat obvious.

Clearly Federal Reserve Chairman Alan Greenspan thinks jobs and price pressure go together. He recently cited the possibility of wages rising faster than productivity as a “worrisome element” in the inflation picture. Also on the short list of troublesome factors was an even more familiar—and recently more conspicuous—culprit: energy prices.

Mr. Greenspan’s remarks, made in a trans-Atlantic videoconference call reported in the

Wall Street Journal, prompted an immediate rise in Treasury bond yields. The current, historically low level of interest rates is an “unnecessary accommodation” in an economy now in an expansion phase, said the Chairman.

A hike in the Federal Funds rate (now 1%) is expected to be atop the agenda when the policy-making Federal Open Markets Committee meets June 28-29. The current Wall Street wisdom is that bond markets are “pricing-in” a quarter-point boost in the basic interest rate. More than that likely would roil the markets; less could leave them confused.

Mr. Greenspan expressed assurances that the required backup in yields will occur incrementally. But of course that promise was tucked inside the type of linguistic insulation Mr. Greenspan has become famous for—in this case two qualifiers and a double negative: “*So far, we have no reason to believe that we will not be able to maintain a measured pace* (emphasis added)”

Translated into direct language, Mr. Greenspan said: “We will try to keep the lid on rates.” A week later, however, Jack Guynn, president of the Federal Reserve Bank of Atlanta, said the “measured pace” language was “more of a plan than a pledge.”

Mr. Guynn raised the specter of 1994, when the Fed knocked bond markets cold by doubling rates in the span of a year, with six hikes averaging 50 basis points apiece. Such reminiscences are not pleasant for bond managers.

The message to take home is that the Fed is ready to slam on the brakes at the first sign of inflation. That means bond markets likely will be highly sensitive to any change in prices.

Stock markets in May were complacent enough about interest rates to make respectable, if unspectacular, gains, virtually across the board. Bonds were less sanguine, with all U.S. indices negative, except T-bills

and TIPS. All but T-bills are now negative for the second quarter, and all but T-bills, TIPS and junk are negative for the year to date.

International large-cap stocks treaded water in May, the EAFE index gaining 0.3%. The MSCI Emerging Market Free stock index dropped an appreciable 2%. International bonds mimicked stocks, with the blue chip government issues, measured by the Citigroup World Government Bond Index, rising 0.8%, and the and junkier JPM Emerging Market Bond Index Plus falling 1.5%.

Specifically: The S&P 500 Index gained 1.4%, while the Dow Jones Industrials sulked a bit at -0.2% in May. The S&P/BARRA Value Index gained 1.2%, the growth index 1.6%. The S&P MidCap 400 gained 2.1%, with its growth and value sub-indices each mirroring that mark exactly. The Russell Midcap Value Index slightly out-performed its sibling growth benchmark, gaining 2.6% to growth's 2.4%.

Small-caps stocks uncharacteristically lagged mid-caps, with the Russell 2000 Index gaining 1.6% overall, and its growth and value sub-indices gaining 2% and 1.2%, respectively. The NASDAQ gained 3.5% for the month.

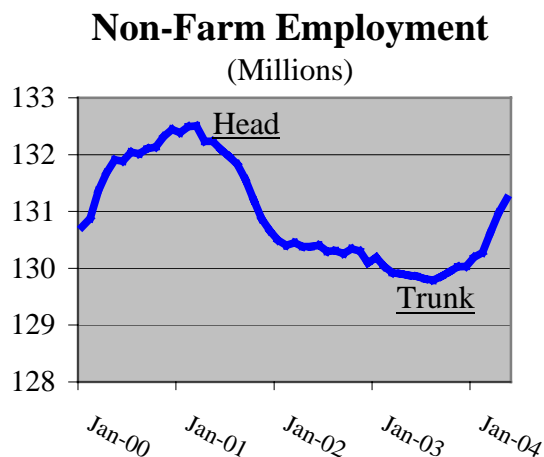
REITS were up to their old tricks, the Wilshire REIT Index gaining 7.6% May, putting the category back on solidly positive ground for the year (+3%).

The Lehman Aggregate Bond index fell 0.4%, and the Citigroup High Yield bond index fell 2.4% in May. The Citigroup Inflation-Protected Bond Index rose 1.8%.

The winners for the month, as the rise in price indices would portend, were commodities. The Goldman Sachs Commodities Index finished May up 4.9%, and is up 18.3% YTD.

Altogether, the year is turning out much as purported experts predicted in December—suggesting that the *Wall Street Journal's* stable of prognosticating economists, like others in the oracular trade, might do better with longer time frames (and vaguer pronouncements).

Most year-end optimism was predicated upon 2004 being an election year, which historically are more often than not good for (and to) economies and financial markets. The consequent higher employment numbers presumably are good for incumbents, such as President George W. Bush. As we observed in March, the chart of non-farm jobs data has a vaguely pachydermal outline, suggesting a Republican bent. The elephant's trunk now seems to turn upward, perhaps in a triumphant curl. Or is it merely artistic flair (see below)?



Juttonol the artistic elephant at work



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June Croons (despite rate hike)

Market Summary

June 2004

Ah, what is so rare as a day in June? Well, technically, a day in February is more rare by 2/365^{ths} (1/366th in leap years). But that's splitting nits. It's the quality of June days that's rare, not the quantity. There are usually about 50 or so truly drab, dreary days in a year, half of which typically fall in February. Nothing rare there. June, by contrast, is like a basket of flowers—fresh, fragrant, full of romance (a fact for which those of us with March birthdays have reason to be grateful).

This June, financial markets, whether under the spell of the season or just aglow after a fifth consecutive quarter of good returns, were as temperate as the weather—despite the return of that sorry rite, the Fed Watch. Perhaps on the principle that a watched Fed never boils, the nation's rate-makers (a.k.a. the Federal Open Market Committee) performed as expected in their month-end meeting, raising the short-term interest level by one-quarter point to 1.25%, the first rate hike since the stock market succumbed to the Big Bear's embrace in early 2000.

At the conclusion of its meeting, the FOMC threw a bone (and a bit of job security) to the Fed-parsers of the world by introducing a new phrase to its official press announcement: "price stability." It was mentioned *twice*, which, obviously, doubles its significance. The consensus interpretation is that the FOMC was stressing its readiness to raise short-term rates by a half point, should inflation raise its horned head.

Good news was quick to follow: activity in both the service and manufacturing sectors of the economy were deemed to have "cooled" in June, according to the *Wall Street Journal's* assessment. That means output was up in both

sectors, but by less than it had been in May. Translation: We're doing OK, *and* there's no impetus for the Federal Reserve to raise rates by any more than it had already planned to do.

In the Fed Watch mode, good news is bad news, unless qualified, and bad news is good, unless *not* qualified. Clear? Perhaps not.

Trying again: The rule of thumb is you take any bit of economic news (within certain reasonable bounds) and stand it on its head. All good news must be qualified (as in "jobs are up this month, but not by as much as last month..."), or Fed Watchers will regard it as a harbinger of a rate hike, and hence *not* good. And bad news, because it discourages a rate hike, is *good*, unless it tells of genuine disaster (real news trumps, even for Fed Watchers).

So the Institute for Supply Management reporting "the manufacturing sector grew at a slightly slower, but still aggressive, rate in June" is *good*, good news. And, likewise, the ISM's announcement that "business activity continued to increase in June in the non-manufacturing sector, but the rate of increase was slower than in May" is good, good news.

Specifically: The ISM's production index for June was 61.1 in the manufacturing sector (vs. 62.8 for May), and 59.9 in the service sector (vs. 65.2 for May). Anything above 50 represents expanding output.

The addition of this interpretative overhead to an already fully loaded daily information regimen is particularly inconvenient, coming just before the presidential election season. It's pretty certain that nothing whatever that you see or hear for the next four months can be accepted at face value. For those with the wherewithal, it might be a good time to take that extended fishing trip we all dream of to the Isle of Skye, or the Great Slave Lake (but *do vote*, absentee or not).

The markets, which have their own interpretative mechanisms, seemed sanguine

enough in June. The S&P 500 Index gained a respectable 1.9%, and thereby nudged back into positive territory for the second quarter (+1.7%), and finished the first half of the year with a gain of 3.4%. The Dow Jones Industrial Average did better for the month (+2.6%), but is lower for the year (+0.9%). Value stocks among the large-caps were better for the month, and the year: The S&P/BARRA Value Index rose 2.2% in June and finished the first half of the year up 4.2%. The corresponding numbers for the S&P 500/BARRA Growth Index were 1.7% for the month, and 2.7% for the year.

Mid-cap stocks followed suit, posting single-digit gains, and value out-performing growth. The S&P MidCap 400 Index gained 2.3% for the month, and a solid 6.1% for the first half of the year. The S&P 400/BARRA Growth Index gained 1.5% for the month, and 5.4% for the first half; the S&P400/BARRA Value Index gained 3.6% for the month and 7.2% for the first half of the year.

Small-caps once again led all equity categories, but by a smaller margin than was typical during their starburst last year. The Russell 2000 gained 4.2% in June, which put its year-to-date gain at a healthy 6.8%. Small value stocks continued their 2004 trend of out-performing growth: The Russell 2000 Value index gained 5.1% in June, vs. 3.3% for the Growth benchmark. The respective numbers for the first half of the year were 7.8% for Value and 5.7% for Growth.

International stocks “cooled” somewhat in June, to borrow a phrase from the *WSJ*. The large-cap EAFE index rose 2.2% for the month, and finished the first half of the year up 4.6%. The S&P/Citigroup EMI-EPAC small-cap index rose 3.5% in June and finished the first half with a robust 10.8% gain. The MSCI Emerging Markets Free Index gained 0.4% in June, and was down 1% through the first half.

Bonds eked out modest increases, which is notable, coming in the face of the Federal Reserve rate hike. The Lehman Aggregate

Bond Index moved up 0.6%, and the Long Government Bond Index 1.0%. For the year, the Aggregate Index is up 0.2%, and the Long Bond Index down 0.1%. The Citigroup High Yield rose 1.5%, to finish the first half of the year dead even.

International debt issues also were subdued in June, and generally finished the first six months on negative ground—perhaps showing a bit more sensitivity to rising rates. The Citigroup World Government Bond Index edged up 0.2% in June, and lost 1.5% through the first half of the year. The JPM Emerging Market Bond Index Plus rose 1.6% in June, and fell 2.8% through the first six months.

And then there are the REITs. The Dow Jones Wilshire REIT Index rose 3.0% in June, and finished the first half of the year up 6.0%. This is remarkable, considering the second quarter performance for the category was -5.4% (due to a horrendous April).

REITs out-performed all major large-cap equity indices in June, and now have done so over the past 1, 3, 5 and 10 years. That’s location to the 4th power (location, location, location, *location*).

In general, market trends remained intact, but attenuated, through the second quarter. That tapering off might have reflected the same economic realities that prompted the Commerce Dept. in June to revise its figure for the first quarter’s GDP to 3.9% from 4.4%. That means output was *lower* by 2/10^{ths} percent than it had been in the last quarter of 2003—not higher by 3/10^{ths}, as previously thought. What we want to know now is whether that qualifies as “good, good” news.



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July Slosy; No Redeeming Dafodil

Market Summary July 2004

April showers are no fun on the 4th of July, but that's what we got this year, as stock markets began the third quarter as they had begun the second—very slosy. Only this time, there were no promises of daffodils to come the month following.

In April, equities were down across the board, led by a very chilling -14.6% from real estate investment trusts. In July, all equity categories again turned negative, *except* for REITs, which managed a paltry (but comparatively impressive) gain of 0.4%.

The difference could be significant. The downturn in April followed immediately upon a report of a spike in inflation, which was universally understood to mean a long-anticipated round of interest rate hikes was sure to begin. It was therefore logical that the highly rate-sensitive (and quite richly valued) REIT category would be hardest hit.

When the Federal Reserve actually instituted the first of a (presumed) series of quarter-point rate hikes in June, the market shrugged it off. That meant, market-watchers hopefully concluded, the transition to more “normal” interest rate levels would be an orderly one.

So what is to be concluded from the not-so-orderly market reversal in July? Who dunnit?

Prime suspects include oil prices, which are at record (nominal) levels, and a tail-off in consumer spending. The September futures contract for crude oil soared past \$44 a barrel shortly after month's end, with traders guesstimating another 10% rise is within view. Meanwhile, consumer spending, while still increasing, did so only feebly in July. The 1% rise last month was the lowest since the second quarter of 2001, said the Wall Street Journal. However, the University of Michigan's much-

watched index of consumer sentiment rose to 96.7 at month's end, up from 95.6 in June, and 90.2 in May. A caveat: Researchers at the University of Michigan attribute the rise in the index to greater consumer optimism about oil prices, so the assumption must be that the July number is decidedly subject to change.

As for what the economy is, rather than what it is perceived to be, that is a stickier problem. For now, the number for the second quarter is growth at an annualized rate of 3%. However, it seems that the Department of Commerce, which is the keeper of this particular flame, has a habit of changing its mind—continually—and retroactive to whenever.

So the first quarter's GDP growth, which this publication duly noted last month had been revised downward to a 3.9% annual from the previously reported 4.4%, now has been revised back up—higher than ever—to 4.5%.

It is perhaps not terribly surprising that these quarterly numbers are subject to revision, considering that they are by convention projected into annualized rates. But it is still remarkable that the 2001 recession, the subject of an incalculable volume of verbiage for these past three years, now officially has disappeared! Technically speaking, two quarters of declining GDP constitute a recession. That occurred, it was believed, with several months to spare, in the first three quarters of 2001. But no. Data from the DOC Bureau of Economic Analysis now show a 1.2% gain in GDP for the second quarter of 2001 (see chart, next page)—revised from a 0.6% loss. So there are no longer two consecutive negative quarters in 2001 (sadly, three other quarters were all revised *down*). The moral of the story is: Never bet on the economy, because you can't settle a wager without a final result.

For Fed Watchers, who look at economic news through reversing lenses, this would be problematical: No recession means no clear

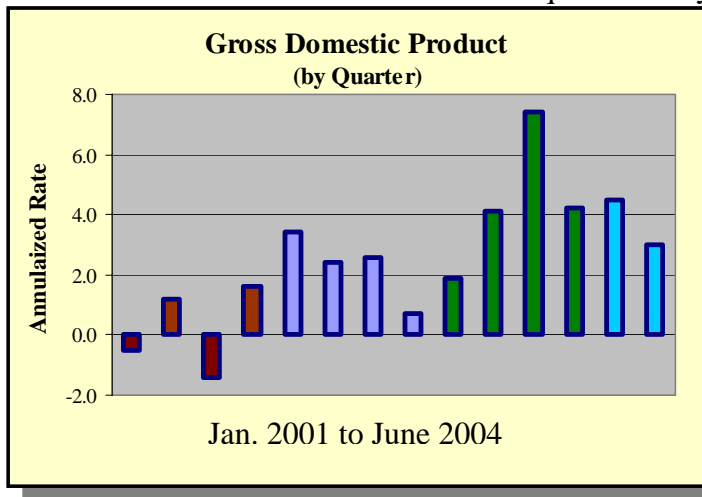
justification for the Federal Reserve's historically lenient interest rate policy, which began in 2001. However, the new GDP number for the first quarter, showing an uptick from the end of 2003 (not the slight dip the last revision had suggested), makes the 3% growth just reported look like a deceleration (see chart). Of course, all of this is subject to revision any time in the next decade.

Payroll numbers for July also were uninspiring for most of us, but candy to Fed Watchers. Only 32,000 jobs were added last month, vs. 78,000 in June. What's more, the employment figure for June was revised downward (from 112,000), as was that for May (to 208,000 from 235,000).

Oddly, the rate of unemployment, based on a separate survey, dropped to 5.5% in July, from 5.6%. That suggests employers are hanging on to their current employees—or that more unemployed workers have just quit looking.

All of these statistical down ticks sent federal-funds futures into a tizzy, and fueled speculation (hope?) that the Fed will back away from its presumed plan to bump up interest rates a quarter point in each of its four remaining FOMC meetings this year. For now, however, the consensus guess still calls for a Fed Funds rate of 2¼% by year's end.

Meanwhile, the Institute for Supply Management reported that its index for the manufacturing output registered 62% in July (readings above 50% represent expanding output). That is a point higher than in June, and the ninth consecutive month the index has registered above 60%—the longest roll of such readings since the 12-month stretch from July 1972 through January 1973, the institute said.



That is all presumably good, but we can't help pointing out that the period cited culminated in the second worst year for stocks in the 20th Century. And, as we of a certain age distinctly recall, the culprit in 1974 was oil prices.

By the way, the ISM reported that the non-manufacturing sector was even hotter in July, posting an index reading of 64.8%, up 4.9%.

Here is a quick & dirty recap of market indices for July.

U.S. Stocks: Large-Cap (-3.3%); Large Growth (-4.7%); Large Value (-1.9%); Mid-Cap (-4.7%); Small-Cap (-6.7%); Small Gr. (-9.0%); Small Value (-4.6%).

International stocks: Large (-3.2%); Small (-4.5%); Emerging Markets (-1.8%).

In bonds, the Lehman Aggregate nudged up 1%, inflation-protected Treasury bonds (TIPS) moved up 0.9% and junk bonds rose 0.5%. REITs, as noted, gained 0.4%.

So Quo Vadis, stock markets? Listen to Jeremy Grantham, chairman of GMO and curmudgeon nonpareil: "I still believe, first, that the market can do quite well this year, and second, that the ice is getting thinner."

OK, no skating this fall. What then?

"The next two calendar years still look like a black hole," says Grantham. We had to ask.



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REITs are Ah-gust in August

Market Summary

August 2004

Caius Julius Caesar Octavianus, in 27 B.C., was dubbed “Augustus” by the Senate of Rome, because he was *august*—pronounced “ah-gust,” and meaning “grand and dignified.” This year, the month named after Augustus didn’t quite live up to its moniker—though, we hasten to add, it could have been worse. In fact, the preceding month, which historians will recall was named for (and by) Augustus’ granduncle Julius Caesar, ended on a note rather sour (as did granduncle Julius).

Rather than replicate July’s wall-to-wall clunkers, August provided market returns that ranged from flat to stellar. Truly august in August were REITs, which rose 8.3%, reminiscent of their 17-month rampage from Halloween 2002 to April of this year.

Third World bonds were also luminous, as the JPM Emerging Market Bond Index climbed 4.4%. The Lehman Long Government Bond Index was not far behind at +3.7%.

There were no genuine star performances among stock indices, though the MSCI Emerging Markets Free Index did very nicely, improving by 4.1 percent.

Emerging market bonds and REITs have been a powerful tandem since conventional equities turned sour early in Y2K. This odd couple also kept pace, and more, when stocks staged an uproarious rally from March 2003-2004. And now it looks like REITs and Third World debt, having arrived earlier to the party than stocks, also might be staying later. The Dow Jones Wilshire REIT Index has moved back ahead of all other equity indices over the past 1 year (30.3%) and 5 years (18.1%), and leads all large-cap indices over the past 10 years (13.5%). Emerging market bonds are in second place over the past five years (15.5%), tied with

another non-equity benchmark, the Goldman Sachs Commodities Index.

The implication could be that the biggest story in the markets over the past four years might have been the most obvious one: declining interest rates. The fact that interest-sensitive securities are the top producers over both long and short periods—despite a 12-month rampage by stocks in between—is impressive.

Overnight rates now are moving back up, but the robust behavior of bonds and REITs in August bespeaks of an expectation in the financial markets that: A) further hikes will be at the “measured pace” publicly favored by Federal Reserve Chairman Alan Greenspan; B) the economy will continue to grow, but also at a measured pace—i.e., no spike in inflation.

That scenario certainly jibes with the latest figures from the Department of Commerce, which in its August report applied the shears to its estimate of the Gross Domestic Product for the second quarter. The new figure is 2.8% (annualized), revised downward from 3.1%. The figure is still called “preliminary” in the DOC’s announcement, so stay tuned.

Economic data of course are watched with special scrutiny in election years, and—with the exception those for GDP—no numbers are more carefully combed than the results from the consumer confidence surveys conducted by the Conference Board and the University of Michigan. The figures were not particularly elating in August, but neither set portended disaster. Indeed, with oil prices near \$50 a barrel in August, and signs of the economy cooling down, another strong uptick in these monthly data might have suggested consumers were putting the wrong kind of Kool Aid in their shopping carts.

That said, we might take consolation in the Conference Board’s report of 98.2 on its index of consumer confidence in August, down from

105.7 in July. The University of Michigan's index measured 95.9, vs. July's 96.7.

Either political party can find support in the confidence data, since it invites the dual interpretation that consumers remain optimistic about the economy, but are getting queasy.

Business activity in August also was strong, and also on a downtick, according to the indices kept by the Institute of Supply Management. The Manufacturers' Index registered 59%, down 3 points from July; the non-manufacturing sector registered 58.2%, down 6.6 points. Anything above 50% represents growing business activity.

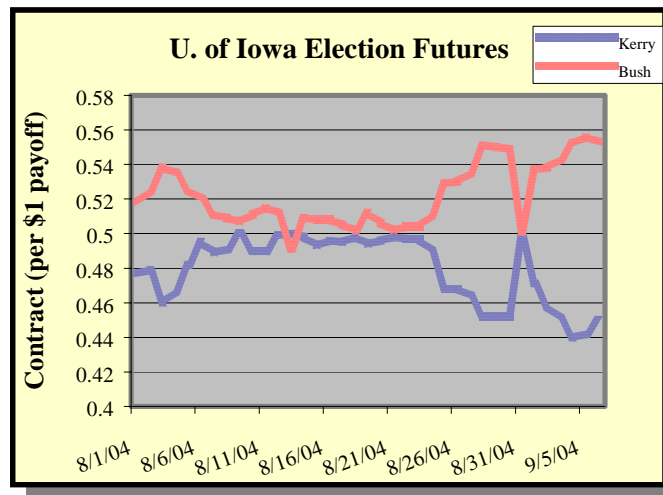
The most politically sensitive econometric of all might be the unemployment rate. It moved down a notch to 5.4% in August, which is as low as it's been since October 2001, and the same rate Bill Clinton campaigned on when re-elected in November 1996. That's salve to Republicans. It was 4.2% in January 2001, when President Bush took office, which is a datum for Democrats.

As the presidential election season moves into full swing, those who feel strongly about the outcome—or feel they have a financial stake in it—can hedge their risk (or go pedal to the metal and double down) with the University of Iowa's online political futures market (Iowa Election Markets, www.biz.uiowa.edu/iem). Contracts pay \$5, and the maximum investment is \$500. Through four presidential elections, the market has shown significant predictive power, especially in the days close to the vote. Not surprisingly, the result in 2000 was a bit confusing, as the market favored Bush by a sliver, but Gore was the contract to have, since the payoff is based on the popular vote. The

market moves from August 1 through Labor Day are shown in the chart (above).

In September, we can look forward (?) to still more heat from the political races, the Federal Reserve's Open Markets Committee Meeting on the 21st, (consensus expectation: a hike in the Fed Funds rate of 25 basis points, to 1.75%), a crude oil market rocked by hurricanes in the Caribbean, terrorist attacks in Iraq and political turmoil in Russia, and several red-hot races for the baseball wild card playoff slots coming to a resolution. Prediction: One of those will be fun to watch; one or more will be alarming; the rest, business as usual.

A quick re-cap of the August market data not already noted:



U.S. Large-cap stocks:
S&P 500, +0.5%;
S&P/Barra 500 Grwth, -0.3%; Value, +1.1%.

U.S. Mid-cap stocks:
S&P 400, -0.3%; S&P 400/Barra Growth, -1.2%; Value, +0.7%.

U.S. Small-cap stocks:
NASDAQ, -2.6%;
Russell 2000, -0.5%;
Russell 2000 Growth, -2.2%; Value, +1.0%.

International Stocks: MSCI EAFE +0.4%;
S&P/Citigroup EMI-EPAC, +0.8%; MSCI Emerging Markets Free, +4.1%.

Bonds: Lehman Agg., +0.1%; Lehman Long Gvt., +3.7%; Citigroup High Yield, +2.2%; Citigroup Inflation-Linked Securities, +2.6%.



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Solid September Despite \$50 Oil

Market Summary

September 2004

Major indexes delivered positive returns in September in a pleasant turnabout from the month's tradition of inflicting pain upon investors. As the chart below shows, the year is shaping up to deliver modest positive returns in most traditional asset classes with international equities outperforming domestic equities, a trend we anticipated and expect to continue. We would also note in the chart that the Lehman Aggregate Bond Index has returned 3.4% year-to-date versus just 1.5% for the S&P 500 index of large cap U.S. stocks.

Performance (%)			
	YTD	3Q	Sept.
S&P 500	1.5	(1.9)	1.1
Russell 2000	3.7	(2.8)	4.7
MSCI EAFE	4.3	(0.3)	2.6
MSCI Emerging Markets	7.1	8.1	5.8
Lehman Aggregate	3.4	3.2	0.3

Meager returns from traditional equity investments may last a while as GDP growth slows weighed down by

- high energy prices,
- sluggish job growth,
- a tightening Fed
- and post-election tax cut expirations.

One surprise so far this year is how well markets have held up despite the sharp rise in oil prices to over \$53 per barrel as of this writing. Thank goodness for that allocation to real assets. Over the past few years we have become accustomed to \$2.00 a gallon gasoline during the peak summer driving season but it is now becoming a permanent fixture. We should not however, whine too loudly. The Germans are paying \$7.00 for a gallon of gas these days. It seems likely that high gasoline prices combined with elevated home heating costs this

winter will result in continued tepid consumer spending and GDP growth.

Also supporting our modest GDP growth expectation was the September employment report released by the Department of Labor on October 8 showing net job gains of just 96,000 versus estimates of 150,000. The unemployment rate held steady at 5.4% in September, its lowest level since October 2001, and the same rate Bill Clinton campaigned on when re-elected in November 1996. But it was 4.2% in January 2001, when President Bush took office and the technology and telecom bubble was just beginning to burst. Voters and investors still long for those good old days.

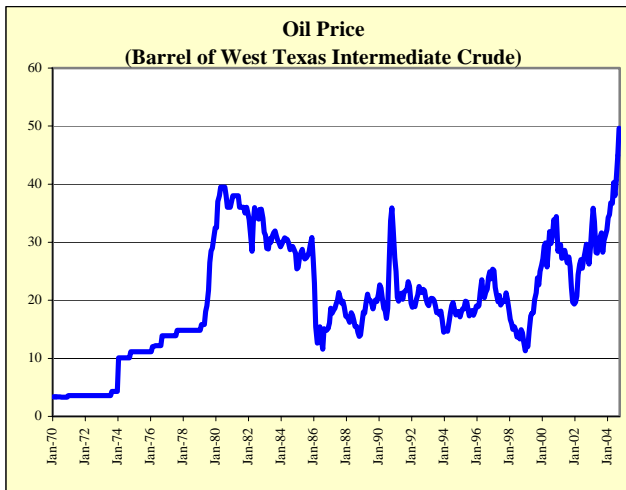
If investors need additional reasons to expect slow economic growth we could throw in a tightening Fed and post-election expiration of tax cuts. The Federal Open Market Committee (FOMC) raised the Fed Funds rate to 1.75% at their September meeting and the futures market is predicting a 2% overnight lending rate by the end of the year. The impact of a 2% Fed Funds rate, up from 1% at the beginning of the year, would be a 20% increase in consumer financing costs for home equity loans. That looks like a firm tap on the economic brakes.

The election cycle usually impacts the timing of tax cuts and tax increases, which helps explain why the quadrennial election cycle typically produces positive stock market returns in the third and fourth years of a presidential term. It is no coincidence that tax cuts on income, capital gains and dividends are scheduled to expire in 2009, the year after the 2008 election. It seems likely that investors would begin altering their behavior well in advance of the 2009 expiration date, placing yet another drag on the economy in coming years. And no matter who wins the 2004 presidential election, Congress may be inclined to let at least some of these tax cuts expire because the federal government is running a huge budget deficit.

Real Assets Shine

Our expectation of modest growth and returns for traditional asset classes has been the rule this year. Real assets, however have been performing quite well. The only traditional asset class to provide double-digit returns year-to-date is REITs, which have posted a 14.8% return through September. And REIT stock prices should be somewhat correlated to the value of underlying properties indicating that real estate is having another good year. We believe continued low interest rates and yield hunger among investors is driving REIT stocks. But slow economic growth is likely to pressure rents at some point keeping a lid on dividend increases and tempering share price gains. REIT stocks have also been volatile leading us to prefer an allocation to direct real estate.

Energy investments also fit in the real asset category and oil prices recently pierced the level reached in 1990 after the invasion of Kuwait and the previous \$40 high set in 1980.



In fact, oil prices hit \$54 in early October, a 65% spike since the beginning of the year. While this price spike hurts at the gas pump, it should improve returns on energy investments and further validates our real asset allocation.

Conclusion

2004 is shaping up as another year where diversification pays off as international equities and real assets outperform domestic stocks and bonds. We would mention again that so far this year bonds are outperforming the 1.5% return of the S&P 500 index. We counsel investors to stay diversified and to continue exploring real asset opportunities.



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Post Election Rally in October

Market Summary

October 2004

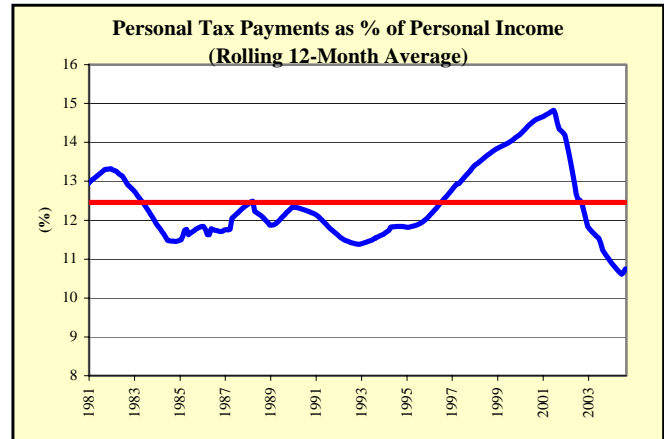
Major indexes began the typical post-election rally early this year, delivering positive returns in October and stellar returns in early November. As the chart below shows, the year is shaping up to deliver modest positive returns in most traditional asset classes with international equities outperforming domestic equities, a trend we anticipated and expect to continue. In the first week of November most equity asset classes enjoyed an additional 3% to 4% gain, hence the S&P 500 has returned 6.3% year-to-date and MSCI EAFE has returned 11.8%.

Returns as of 10/31/04	YTD %	Oct. %
S&P 500	3.1	1.5
Russell 2000	5.8	2.0
MSCI EAFE	7.8	3.4
MSCI Emerging Markets	9.6	2.4
Lehman Aggregate	4.2	0.8

A lot has happened in the last few weeks including U. S. elections, interest rate hikes by the Chinese central bank and by the U.S. Fed, a blowout October employment report, oil falling below \$50 per barrel, and the dollar continuing to slide. We will address their potential impact on future investment returns one at a time.

Taxes Aren't Going Lower

While a timely conclusion of the U.S. presidential election was clearly a boost for investor sentiment, we believe that the economic cake is already baked for the next few years. Investors are probably optimistic that President Bush will fight to make permanent his cuts on dividend and capital gains tax rates, which increased after-tax investment returns and thus share prices. But we find it unlikely that the President will push



for policies that further reduce the tax burden since the country is running large deficits and the baby boomers will start retiring in a few years placing budget busting demands on the Medicare and Social Security systems. And as the above chart shows, the tax burden is already at its lowest level in more than 20 years.

We would also point out that the first year of a presidential term is typically the poorest year for equity returns with the S&P 500 finishing in negative territory half the time. Even worse, when market P/E's are high as they are now, the first year of a presidential term is down 70% of the time. Happy New Year!

Cheaper Oil helps, Fed Hikes Hurt

The decline in oil prices and the strong jobs report are clear economic positives. Non-farm employment surged 337,000 in October, more than twice the consensus forecast and the biggest monthly job gain since March. This virtually insured another rate increase, which the Fed delivered on November 10th. The Fed has now doubled the overnight lending rate in 6 months. The last time the Fed undertook such a rapid pace of tightening was 1994 when the Fed Funds rate more than doubled from 3% to 6.25% but the FOMC took nearly a year to do that. And on October 28th the Chinese central bank hiked its one-year deposit and lending

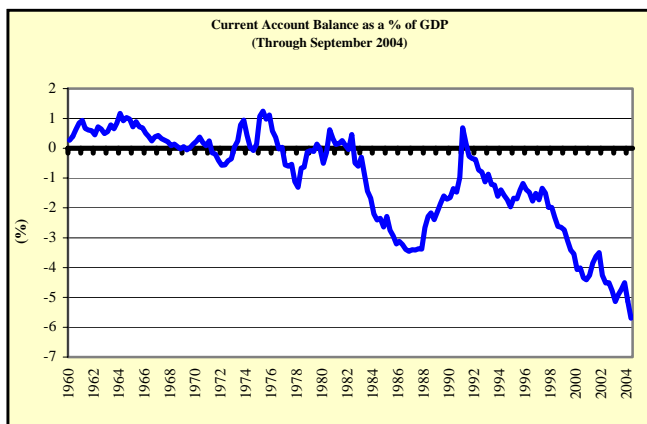
rates by 27 basis points in an attempt to contain inflation. Such coordinated global credit tightening is likely to slow economic growth in 2005.

While we cannot predict oil prices any better than a carnival fortune-teller, they could slide further over the next six months if global economic growth decelerates due to coordinated interest rate increases, the U.S. finishes filling the strategic petroleum reserve around May of 2005, and additional gulf of Mexico production comes back on line after hurricane related disruption this fall. This could ease pressure on consumers but oil and gas only account for about 3% of household expenditures now versus 5% back in the early 1980's. And the Fed's rate hikes are likely to hurt heavily indebted consumer pocketbooks much more than a modest decline in oil prices would help.

The Dollar Continues to Slide

We have expected international equities to outperform U.S. equities as the dollar depreciates against other currencies. It appears that 2004 will be the third consecutive year of dollar weakness. The large U.S. trade deficit highlighted in the chart below is likely to trigger continued dollar weakness.

The U.S. trade deficit now equals nearly 6% of GDP, a historically unprecedented level. As we



buy products from abroad, foreigners are buying U.S. Treasury debt with those dollars

and now own more than half of all outstanding Treasury debt. Remember that the dollar has been depreciating despite these huge purchases of U.S. bonds by foreigners. If foreigners slow their purchases of our bonds just a bit, the dollar would likely depreciate faster.

Our expectation of further dollar weakness supports our view that investors should overweight international equities. This advice has been working for several years now, and we see no reason for it to reverse in the near term.

Conclusion

The election is over but the economic landscape is little changed. The imbalances in the U.S. economy and continued dollar depreciation lead us to expect international equities to outperform domestic stocks and bonds. Returns in 2005 are likely to be modest as central banks tighten credit and the global economy decelerates. We counsel investors to stay diversified and to continue to investigate international asset classes.



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Strong Post Election Rally

Market Summary

November 2004

Major indexes began the typical post-election rally early, but partied even harder in November. Returns were positive in October and stellar in November. As the chart below shows, the year is shaping up to deliver double-digit returns in most equity asset classes with international and small-cap equities outperforming domestic equities. Combining October and November returns to analyze the magnitude of the pre and post election rally shows that the S&P 500 returned 5.6%, the Russell 2000 gained 10.7% and MSCI EAFE soared 11.8%, beating emerging market stocks, which gained 11.7%.

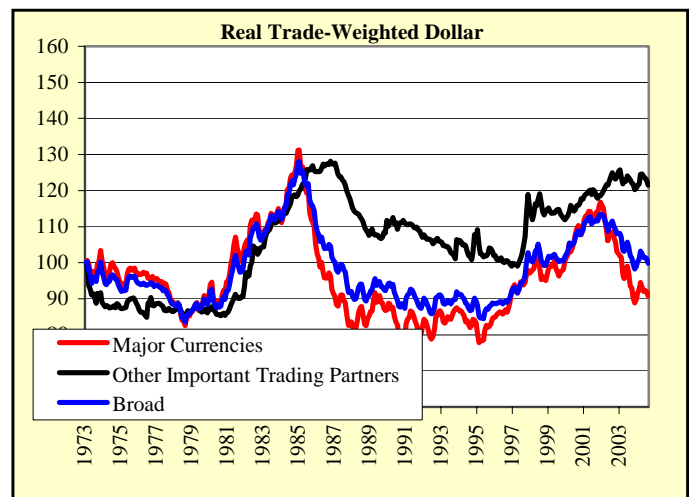
Returns as of 11/30/04	YTD %	Oct. %	Nov. %
S&P 500	7.2	1.5	4.1
Russell 2000	14.9	2.0	8.7
MSCI EAFE	15.2	3.4	6.8
MSCI Emerging Markets	19.8	2.4	9.3
Lehman Aggregate	3.4	0.8	-0.8

The source of these high returns in October and November is at least three fold: post election relief, falling oil prices and a sliding dollar. While the first two drivers aren't likely to aid stocks in 2005, the U.S. dollar appears likely to weaken further, enhancing returns on international stocks for U.S. investors. This has been a continuing investment theme for us, and while the dollar is likely to rally at some point, the long-term trend of a weakening U.S. currency remains in place. Another key piece of investment mathematics is that as asset prices rise, expected returns decline making 2005 expected equity returns appear meager.

The Falling Dollar

The U.S. dollar has fallen significantly over the past three years as measured against the Euro

and Yen. The bold red line in the chart below shows that since 2001, the dollar has depreciated nearly 25% versus other major currencies. This has enhanced U.S. investor's returns on international stocks by a like amount. The black line on the chart shows that the dollar has held steady against emerging market currencies such as the Mexican Peso and Chinese Yuan. The big story of 2005 could be a revaluation of the Chinese Yuan against the dollar, thus enhancing returns on Asian



assets. The Chinese government continues to maintain its currency peg to the U.S. dollar to protect its export industries and ensure continued employment growth. This creates internal inflationary pressure in the Chinese economy as its government creates Yuan at the same rate the U.S. Fed creates dollars. Those additional Yuan flow into Chinese assets, bidding up prices similar to what is happening in U.S. asset markets. Eventually this imbalance must be addressed, perhaps through an upward revaluation of the Yuan, which should benefit Asian equity investments.

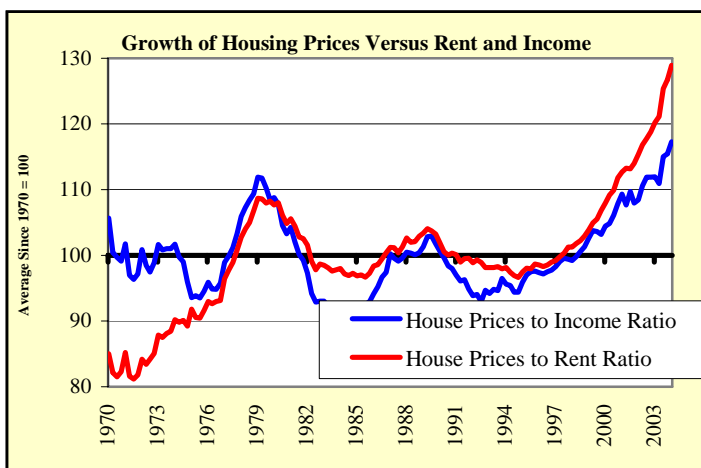
Meager 2005 Equity Returns

We have mentioned before that the first year of a presidential term is typically the poorest year for equity returns with the S&P 500 finishing in

negative territory half the time. Even worse, when market P/E's are high as they are now, the first year of a presidential term is down 70% of the time. One cause of meager equity returns in 2005 could be that economic growth doesn't meet expectations. U.S. consumers appear highly leveraged, and housing related debt continues to climb while job and wage growth remain tepid.

Home Prices Entering Bubble-ville?

The chart below shows why home price appreciation has been a concern. Now the Office of Federal Housing Enterprise Oversight (OFHEO) reports that home prices are 13% higher than in the third quarter of 2003, the largest year-to-year increase since 1979. Home prices rocketed up 4.62% in the third quarter



from the second quarter of 2004, a 19.8% annualized pace and the largest quarterly increase on record. These price gains appear un-supported by either falling mortgage rates or wage growth.

Historically, home price appreciation has closely tracked wage growth. The plunge in mortgage interest rates since 2000 has spurred home price gains by making monthly payments more affordable. But mortgage rates bottomed in 2003 and wage growth remains modest yet home prices are still rising at double-digit rates. Worse yet, 38% of new mortgage originations are adjustable rate loans, their highest share since 1994. This tells us that home price

appreciation is not supported by fundamentals but by cheap, short term borrowed money. Additional rate increases by the Fed will increase monthly mortgage payments putting a brake on consumer spending. This is just one factor that could cause slower-than-expected GDP growth in 2005.

It Is Up To Job Growth Now

With the pre-election stimulus now spent, economic growth must be supported by job and wage growth. But after a strong October jobs gain of 337,000, November came in at just 112,000, about half of forecasts. Continued modest job growth may result in slower economic growth than the 3.5% forecasters currently expect.

Conclusion

The election is over but the economic landscape is little changed. Imbalances in the global economy lead us to expect international equities to outperform domestic stocks. Returns in 2005 are likely to be modest because stock prices moved sharply higher in 2004 and central banks are tightening credit on highly leveraged U.S. consumers. Investors should rebalance portfolios and stay diversified.



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2004 Ends With a Bang

Market Summary

December 2004

Calendar year 2004 brought investors a second straight positive year from the S&P 500. As we approach the fifth anniversary of the bull market peak, the index's gain of 10.9% moved it closer to emerging from the pit. As the table below shows, the index remains 13% underwater on total return basis from the end of March 2000. At the trough, it was 44% off its peak. For investors that have ventured beyond the S&P 500, the picture is much rosier. Diversification has proved very rewarding since the peak of the bull market. That's because there many asset classes that remained moderately to very attractive at the peak when the S&P 500 was grossly overvalued. These included value stocks, small-cap stocks, REITS, international small-cap stocks, and emerging market stocks.

Returns as of 12/31/04	% Since Mar. 00	2004 %	Dec. %
S&P 500	-13.0	10.9	3.4
Russell 2000	28.7	18.3	3.0
REITs	168.7	33.1	5.2
MSCI EAFE	-5.4	20.2	4.4
International Small Cap	33.4	29.3	5.0
MSCI Emerging Markets	21.1	25.6	4.8
Lehman Aggregate	41.8	4.3	0.9

Investors that heavily employed these asset classes have likely found performance from the peak satisfactory in absolute terms and outstanding in relative terms. A sample 75% equity / 25% bond diversified index portfolio we track that is tilted towards small-caps, REITS, value stocks, and a healthy allocation to internationals has earned 35% cumulative, or 6.6% annualized, since the beginning of the bear market. In contrast, a 75% S&P 500 / 25% Lehman Aggregate Portfolio is down 0.3% cumulative, or -0.1% annualized, since the peak.

The problem today is that many of the opportunities that existed in 2000 have been priced away. Nearly all major asset classes are priced to provide low returns in the future.

US Markets

As will be a familiar refrain to clients that have been reading our commentary for the last six years, we believe the domestic equity market is priced to provide a disappointing real return of only 4% in the future. And that assumes valuations stay at current elevated levels. If valuations decline to historical norms, the realized real return for the index will be much lower than 4%.

2005 offers particular challenges for domestic equities. First, it seems very likely that earnings growth will disappoint the market, because profit margins are unsustainably high. A second headwind for 2005 is the Presidential election cycle. The first year of terms has been the worst in the cycle. Post World War II, the S&P 500 index experienced a loss in half of all inauguration years, twice the normal rate. Of the thirteen down years the S&P has experienced since 1948, seven occurred in the first year of the cycle. We wouldn't be surprised if 2005 is the fourth down year for the index this decade.

In the coming years, we believe that high quality multinationals (low debt, consistent profits) are best positioned to outperform the broad market. Multinationals are far from cheap, but they appear to offer the best value within the market, and as exporters these companies should benefit from the weak dollar.

The opportunity in value stocks, small caps and REITS also seems spent. At the beginning of 2000, REITS were trading at a dividend yield of 8.5% and a discount to net asset value of 17%. Today, they offer a dividend yield of 4.7% and trade at a premium to NAV of 13%.

This, combined with concerns about real estate fundamentals, suggests that REITS are only marginally more attractive than the broad equity markets.

Incredibly Shrinking Spreads

It's fascinating how quickly markets change. Just two years ago we were pointing out the fat credit spreads offered by high yield bonds. (We were recommending clients to play this opportunity through distressed debt, rather than high-yield bonds.) Since then, high yield bonds have gone from offering near record high credit spreads to near record lows. As of year-end, high yield bonds were offering a scant 3% premium to Treasuries. Academic research suggests that high yield bond investors should expect to lose in the neighborhood of 2% to 4% of their yield to defaults over a cycle. At best, high yield bond investors should expect a 1% premium to Treasuries net of defaults. The last time credit spreads were this thin was in April 1998. From that point forward, high yield bonds posted disappointing returns relative to Treasuries.

Therefore, we recommend exposure to investment vehicles that are short credit to capitalize on spread expansion and defaults.

International Markets

Thanks in large part to the weak dollar, international equities outperformed US equities in 2004. The MSCI EAFE index earned 20.2% for the year, versus 10.9% for the S&P 500. More than 7 percentage points of the outperformance was due to the declining buck. International small-caps earned 28.8% in 2004. As in the US, international small-caps look expensive relative to large-caps. Based on valuations, international equities appear attractive relative to US equities, although they are expensive on an absolute basis. Despite a 56% return in 2002 and 26% return in 2003, emerging market equities are still the most reasonably valued in the world.

We expect the trade-weighted dollar to continue to weaken; however, it may not help developed market indices much. Roughly 70% of the MSCI EAFE index is made up of the euro and other European currencies, which have already experienced significant appreciation versus the greenback. The euro appears overvalued against the dollar. We expect the euro to remain overvalued for an extended period because of the current account deficit, but we don't expect to appreciate much further. Japan and other Asian currencies remain undervalued, but they make up only 22% and 3% of the EAFE index, respectively. Asian currencies make-up two-thirds of emerging market equity universe; therefore, they may still enjoy a positive currency effect.

Conclusion

It is difficult to find attractive opportunities, so it will be harder to make a 5% real return over the next five years than it was in the last five. Diversifying away from the S&P 500 is unlikely to be as profitable, since many of the mispricings have been corrected. Nevertheless, in a low return world, we think it's important as ever to diversify broadly. There's little reason to make a *huge* bet on a particular asset class or strategy when the expected return premium is modest with high potential for error. But, two of the more compelling opportunities we see today are managed futures and short credit strategies.



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