January 2005

Investment Policy Committee
Strategy Review

"Clearer Decks"

Although 2004 gains in the stock market were modest, investors have every right to feel that we navigated the year in reasonably good shape. Let us start with the numbers: the Dow Jones Industrial Average rose 3.1%, the Nasdaq Composite Index rose 8.6%, and the S&P 500 gained 9.0% last year. Within the S&P 500 the two strongest sectors were Energy (+28.8%) and Utilities (+19.6%). Of the remaining eight sectors the weakest two were Information Technology (+2.1%) and Health Care (+0.2%).

We find encouragement in these otherwise-modest numbers because (we suppose this is overdoing our metaphor…) there was so much 'clutter' during the year's 'voyage'. For ten months and two days we endured one of the nastiest Presidential races in American history. There is little doubt that the continual cross-fire of accusations and outright calumny had a negative effect on investor sentiment. Side-stepping the issue of whether the better man won - and our office, like any, continues to 'enjoy' an energetic difference of opinion on this – the simple fact that the election is *over* is a relief. As if the presidential campaign was not enough of a distraction, investors contended with grim news about the war in Iraq, the train bombing in Madrid, the slaughter of school children in Beslan, Russia, and soaring oil prices. Investors were also unsettled by fears (thankfully unrealized) that terrorists would attack during New Year's Eve in Times Square, the Super Bowl, the summer Olympics, the Oscars, the Democratic and Republican conventions, and, ultimately, the November 2nd election itself.

Looking ahead to 2005, our decks should be clearer. To begin with, this is an off-year for elections. Yes, there will be heated political battles in Washington, but in comparison to 2004 politics over the next twelve months will be bean bag. As for terrorism, we will, sadly, remain under its threat for years to come. However, roughly three and a-half years have passed since we as a country suffered a terrorist attack on our soil. Not only should that allow for our fears to recede to some degree, there simply will not be as many terrorist-tempting (i.e., large) events in 2005. None of this is to say that our decks are *totally* clear of worry. After all, our inability to stabilize Iraq is tremendously dispiriting, oil prices, though lower, remain quite high, and the Federal Reserve is in the midst of what promises to be a long string of interest rate increases. Still, it is our view that the start of this year looks more promising than did the start of last year.

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Before delving further into our expectations for the financial markets in 2005, we want to discuss the economy. We begin with manufacturing. This sector has achieved a moderate (and, we hope, a sustainable) rate of growth. We are greatly encouraged by a few items. First, the Institute for Supply Management's monthly Manufacturing Index has remained above the threshold level of 50 for over two and a-half years. Second, for 2004 industrial production posted its first full-year increase (up 4.1%) since 2000. Third, greater production has in turn increased capacity utilization to its highest levels (79.2%) since January 2001. Fourth, though the month-to-month pattern has been saw-toothed, factory orders have been growing, with the most recent two reports (October and November) being especially strong (up 0.9% and 1.2% respectively). We pay particular attention to factory orders, as these are an important lead indicator for manufacturing.

Another critical sector is housing. Despite repeated warnings about speculative bubbles, housing has been the 'Energizer Bunny' of the economy. We have typically paid more attention to the sales reports for existing homes than for new homes, as the former market is five to six times the size of the latter. However, our focus has now shifted. The reason for this change is that sales of existing homes are recorded at closing, whereas sales of new

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homes are reported at signing. Put another way, numbers for existing home 'sales' are really data on existing home *closings*; as such, these figures reflect buying decisions that were made weeks and months earlier. At the moment, we are of course concerned with how the Federal Reserve's string of interest rate increases will affect the housing. We now prefer to watch new home sales because this gives us more current information about the housing market than do the reports on existing home sales.

The latest reports (November) provide a striking example of the difference in methodology between new and existing home sales. Existing home 'sales' (i.e., closings) rose 2.7% during the month, which would seem to indicate that housing is not being affected by higher rates. However, new homes sales fell a dramatic 12.0%. It must be remembered that reports on the housing market can be somewhat erratic, and, without wading through the details, there are reasons to suspect that November's 12.0% drop is an anomaly. We are further encouraged on that score by the reports on housing starts. As with new homes, the November report was grim: housing starts fell 12.5%. The December report was released just this morning, though, and housing starts rebounded an encouraging 10.9% last month. One last calming note about housing is that building permits, which are a lead indicator for the market, have been stable. They rose 0.5% in November and fell a slight 0.3% in December.

The last sector of the economy to address is the largest: consumer spending. Despite relatively disappointing growth in employment, despite very high gasoline prices, and despite a housing market that is at least somewhat worrisome, consumers continue to spend. Personal spending as a whole rose 0.8% in October and 0.2% in November. In addition, we get strong numbers for retail and food outlet sales. These increased 0.1% in November and then 1.2% in December. As always, our preference is to look at the retail and food numbers with automobile and gasoline sales stripped out. On this basis sales rose 0.3% in November and 0.6% last month. Finally, though the figure here is somewhat old, it is worth noting that the government's reports on Gross Domestic Product shows that personal consumption expenditures rose 5.1% in the third quarter. This was a substantial improvement over the 1.6% increase seen in the second quarter.

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Where, then, do we stand on the market's prospects for 2005? We are actually more cautious than we have been in a while. This is not to say that we expect the market to fall this year; rather, we have a hard time envisioning more than meager results. Yes, investors' decks are clearer. On the other hand, high oil prices are a drag on the economy. Further, capital spending is more moderate than we had hoped. (Any signal that companies are more willing to spend what are growing cash hordes would be a very encouraging signal.) We are very cognizant that, though still quite low by historical standards, rising interest rates are typically not good news for either the stock or the bond market. And, lastly, corporate earnings had already grown strongly in 2003/2004. This elevates the base against which 2005 earnings will be compared, making continuing growth more difficult to achieve.

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For The Investment Policy Committee
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