2005 FIRST HALF REVIEW: BACK TO THE FUTURE

"A bubble may be defined loosely as a sharp rise in the price of an asset or a range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers—generally speculators interested in profits from trading in the asset rather than its use or earnings capacity."

Charles Kindleberger, from The New Palgrave: A Dictionary of Economics

The quote above is offered in reference to the market's current obsession/debate about whether or not the nation's housing market is in a "bubble". While we will explore this later in our discussion, we offer first our conclusions and guidance for investors in light of market developments during the last six months.

By way of review, both stock and bond markets have produced flattish returns year-to-date:

ANNUALIZED RETURNS AT JUNE 30, 2005

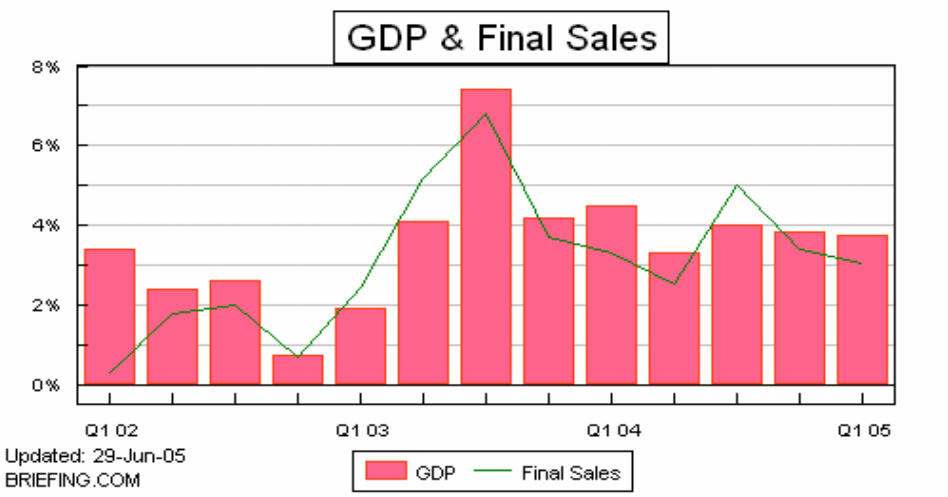
	Year To Date	Last 12 Months	Three Years	Five Years	Ten Years
S&P 500	-.82%	6.31%	8.27%	-2.38%	9.94%
Citigroup 5 Year T-Note	1.22%	4.14%	4.64%	6.65%	5.92%
Lehman Five Year Muni	.74%	4.41%	3.98%	5.55%	5.22%
Citigroup 3 Month T-Bill	1.26%	2.04%	1.47%	2.49%	3.83%
CPI	2.15%	2.48%	2.62%	2.43%	2.46%

For stocks, this is a reasonable outcome given our outlook since last winter, namely that profit growth is slowing. In essence, stocks have been in a "consolidation" phase. Despite declining from high teens growth, profits are still trending up at a steady 5-7% rate in aggregate. The economy continues to expand along a 3% pace. With profits up and prices flat, stocks have gotten cheaper this year, and we expect a more supportive environment in the second half of 2005 to produce modest single digit gains.

For bonds, the environment is largely unchanged on the inflation front. The Fed has continued to raise short term rates, but long rates have declined, producing a flatter, though still positively sloped, yield curve. Spreads on corporate bonds, meanwhile, have not widened meaningfully except in select issuers. In our view, interest rates and credit spreads are therefore still supportive of a healthy economy. However, there may be a significant anomaly at work currently suppressing yields on longer term maturities, which we discuss later. We expect the Fed to finish their tightening campaign this year, and for the yield curve to re-steepen once this point has been reached.

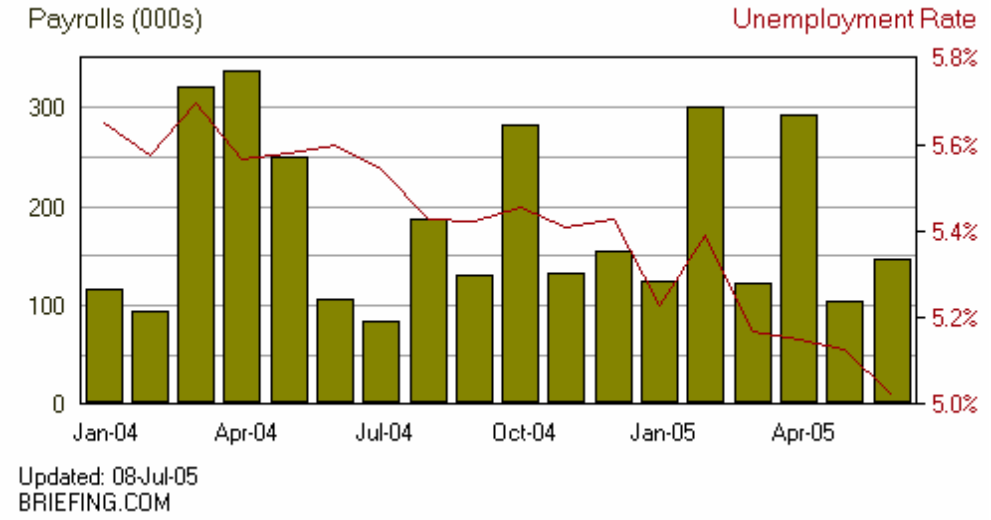
Macroeconomic Review

The economy has muddled through the first half of the year, with pockets of strength (housing and consumer) offsetting pockets of weakness (manufacturing and exports) to produce a reasonably steady pace of growth:

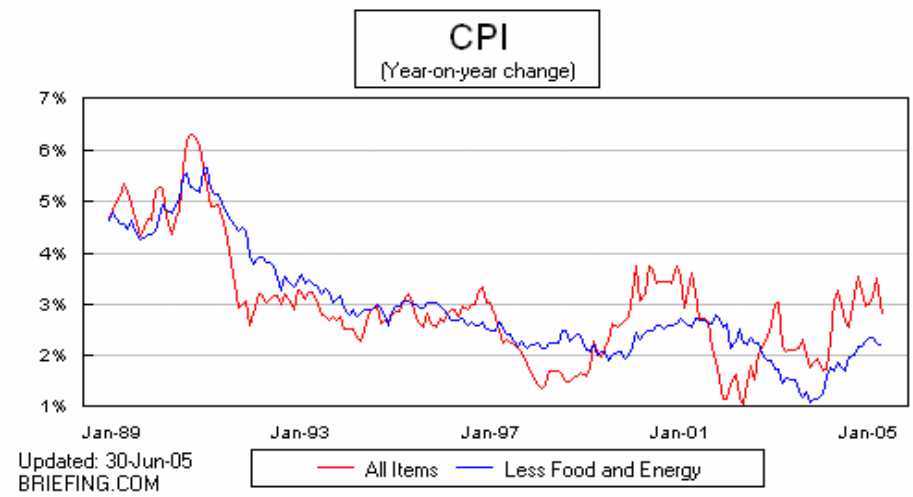


However, with oil prices still high, manufacturing weakening, and global economies generally slowing, we expect second half GDP growth to ease to the 2.5%-3.0% range, a still very respectable showing which is supportive of continued profit growth.

Employment trends are constructive, with no clear signs of deceleration:



Lastly, on the inflation front (and contrary to concensus opinion at the start of the year), both consumer and producer price indices have moderated:



Much of the inflation debate currently centers on energy prices, which are a small component of the larger picture. Wage and compensation increases are a far greater contributor, and they are modest. In our view, as long as the CPI trends below 3%, the market will perceive inflation as being non-threatening, thus supporting the case for the Fed to end its' tightening campaign.

The Stock Market

Defensive sectors like utilities (+13%) and health care (+2%) performed best in the first half, with energy notching a standout 18% gain. On the downside, more cyclical areas like technology, materials, and industrials lagged by -6 to -8%.

In the style category, value stocks are outperforming growth by roughly 1-2% this year, and small and mid cap names have tended to do better than large cap. We are not changing our tune from year end, though, and think that large cap names will serve investors better in an environment of slower growth, particularly after an extended period of outperformance by their small and mid cap brethren.

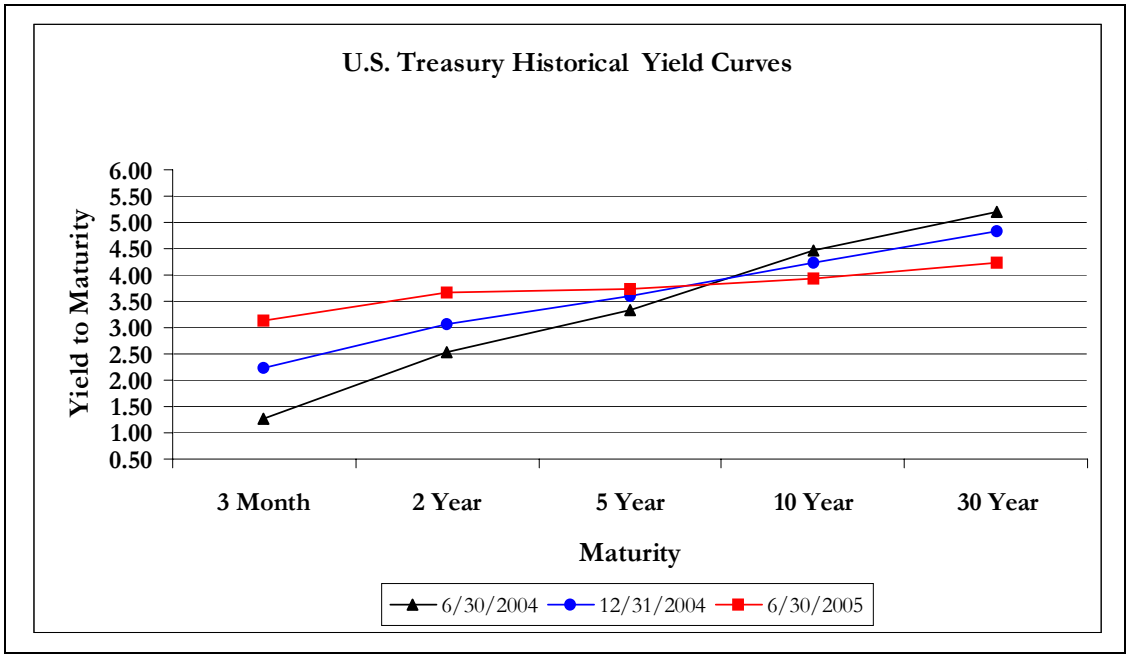
On the whole, the market bought the doom and gloom line that higher energy prices, an overextended consumer, a housing bubble, and rising interest rates, deficits, and inflation would cause a meaningful economic slowdown. It didn't happen.

So while the market is still in a state of transition to admittedly slower growth, the wheels aren't falling off. Corporations are still hiring, they have very healthy balance sheets, and they are actively raising dividend payouts and buying back their stock.

With positive GDP growth, inflation back to the 2.5% area, and a Fed that is in the latter stages of a tightening campaign, the stock market should realize that the sky is not falling and instead will focus on steady, if unspectacular profit growth. Stocks will end the year higher.

The Bond Market

The Fed recently raised its overnight lending rate (Fed Funds) for the ninth consecutive time by a quarter of one percent to 3.25% on June 30, causing short rates to continue their upward ascent:



Meanwhile, 30 year bond yields have declined. Why this divergence? To some extent, the bond market is giving us a signal that economic growth is moderating, and that Fed policies are succeeding in cooling growth and inflation. In addition, there is a persistent "flight to quality" bid supporting longer term bonds, partly from ongoing geopolitical risk, and partly from occasional turmoil in corporate bond land (most recently the downgrading of GM bonds to high yield, or "junk", status).

However, a very underappreciated anomaly is at work now in the bond market, namely a large and growing imbalance between supply and demand of long bonds. Simply put, the world's pension and retirement funds have experienced disappointing returns on their assets these past several years, and are now looking to "lock in" some portion of the returns they have guaranteed their pensioners by buying long bonds. Unfortunately, the U.S. government stopped issuing 30 year paper in 1999, and very few European or Asian governments issue maturities beyond ten years. Thus we have a colossal mismatch in the works which will persist for some time and which has the potential to cause bond yields to stay low(er) than normal. Investors should take note of this "pension underfunding/bankruptcy" issue as we believe it is going to evolve into one of the pre-dominant themes of the coming decade for the mature, G-8 economies. (Ask a retired Bethlehem Steel worker or United Airlines pilot if this affects the real world.)

Risks and Rewards

The greatest risks to the market at this point are a sharp and sustained spike up in the price of oil and a more severe terrorist incident. So far, the economy has absorbed higher energy costs without significant dislocation. Any further increase from the $60 a barrel current oil price will detract fractionally from GDP growth. The recent attacks in London underscore the continuing risk from terrorist incidents, although a resilient recovery suggests that markets are adjusting to these new realities. An increase in the severity of the next attack will test the market's meddle.

On the policy side, as usual, all roads lead back to the Federal Reserve. Based on Fed minutes and public statements, it appears that the Fed is going to continue raising rates in an effort to combat perceived incipient higher inflation arising from oil prices and runaway housing prices. They would also like to see long yields rise in tandem with short rates to help restrain the froth in the housing market.

One of the primary issues for the market is that the Fed moves have lost some of their potency because they have been so widely anticipated. Rather than announcing an (unanticipated) 50 or 75 basis point increase in the target fed funds rate, the Fed appears content to plod along its current path of gradual 25 basis point increases, at least until Mr. Greenspan retires this coming February. The risk here is an "overshoot" that significantly impedes growth.

In addition, Euroland is slowing, and most observers feel it is only a matter of time until the European Central Bank and the Bank of England lower their short rates. Many pundits have commented that the Fed has already done the heavy lifting of raising rates, and it is time to stop and let higher energy prices provide their own self-correcting mechanism, particularly against a backdrop of less robust global economies.

In the meantime, the housing market should remain buoyant because of "cheap money". From the research that we review, it appears that interest rates would have to rise 2-3% to meaningfully dampen housing finance activity (i.e. a 10 year Treasury at roughly 6.5%, versus 4.0% currently).

As to a "bubble" in housing prices, there is clear evidence that prices have become overextended in certain areas. However, real estate always has been a local, or, at best, a regional market. What is happening in San Diego has very little to do with San Antonio. In addition, a primary residence has a very high "utility" value which cannot be monetized until closing upon sale (high satisfaction/low liquidity). So let the condo flippers proceed apace. The era of cheap money will end someday and prices will find a normalized level in each market according to supply and demand. In the meantime, investors should not confuse their home (sweet home) with a stock portfolio.

As for the dollar, we advised investors at year end to expect some moderation in the dollar's descent near term, and in fact, the dollar has rallied this year. Sentiment on the Euro is poor after France and the Netherlands refused recently to ratify the proposed European Constitution. This does not change our view that the dollar is in long term decline unless or until global trade imbalances begin to correct. From the U.S. point of view, this means cajoling the Chinese to revalue what is widely perceived to be an undervalued currency, allowing them to manufacture on the cheap and export to the rest of the world while

keeping their masses employed. The Chinese, as an aspiring Superpower, naturally don't like being told what to do, and are delicately balancing between nationalist rhetoric and the threat of protectionist trade legislation by Congress in retaliation (most European countries are in the same boat as the U.S.). Investors should pay careful attention to this story, as its results will have global ramifications. We count it as one of the top stealth risks to the market's ongoing health. In the meantime, we think investors are well-served by owning shares of select foreign issuers.

As to rewards, we think equities are more attractive than bonds at this point, particularly more modestly priced shares with a good dividend stream. There have been eras in the past when equities have outyielded government bonds, and, while we haven't seen one recently, we are experiencing a definite sense of déjà vu. Currently, the S&P 500 yields 1.9%, and 10 Year T-Notes yield 4.1%. It could be that markets are headed "back to the future", where "risky assets" like stocks compensate investors with dividend yields that are higher than "risk-free assets" like U.S. Treasuries. Stay tuned.

To summarize, lowered expectations and improved valuations should lead to modest gains for stocks. Bonds should continue to see higher yields in the short end. Longer term yields may stay lower for longer than many expect. We continue to trumpet the advantages of diversification, high quality, and steady income.

July 12, 2005