Commentary - 1st Quarter 2005

The financial markets were difficult to navigate in the first quarter. Even though the economy is growing nicely, the stock market declined by approximately two percent in the first three months and broad bond market indices declined in excess of one percent. These are not major losses, but they frustrate investors who were spoiled by last year's fourth quarter rally. Higher energy prices, concerns about a weak dollar, more corporate accounting scams, inflation worries, and numerous other issues weighed on the markets during the last three months. These hurdles provide the financial markets with opportunities to purge excess speculation. They are a kind of disciplining mechanism that makes investing a matter of risk and reward analysis rather than mindless gambling.

The recent focus of the stock market has been the rise in oil prices, with one analyst predicting that oil prices could spike over $100 per barrel. A price surge could occur if there is a supply disruption, such as Venezuela cutting off shipments to the United States. While that may be an outside possibility, we do not think that kind of price move is likely; even though demand from Southeast Asia and China is strong, the laws of economics still apply. Higher prices lead to conservation and substitution on the demand side and provide incentives for producers to increase supply. Also, the Federal Government will complete the filling of the Strategic Petroleum Reserve this summer which will reduce demand pressures on domestic energy prices. If prices rise too high, there will be pressure from political sources to release supply from the SPR. We think that hot money has moved into the energy sector and more volatility will result. The energy sector exchange traded fund may become the speculators' vehicle of choice similar to the QQQs during the NASDAQ euphoria. As the Federal Reserve raises interest rates and reduces the supply of dollars in the global financial system, speculation in energy prices should subside.

The Fed raised interest rates again by twenty-five basis points at their most recent meeting but this time they expressed concern that inflation pressures were building. As Bart Simpson would say, "duh". When Fed Chairman Greenspan testified before Congress in late February, he stated that the lack of increase in long term interest rates was a "conundrum". To

us, that was a signal that long term interest rates were headed higher. Ten year Treasury yields have increased almost half a percent since then. The market perceives that the Fed will be more aggressive in its approach to raising interest rates and wants to head off inflation. So as the Fed raises short term rates, we should see corresponding increases in long term rates as long as the economy remains vibrant. Commodity prices, including gold and oil, will indicate when the Fed has raised rates enough to curb speculation and the dollar should stabilize at that point. As seen in Figure 1, the Ten Year Treasury Yield is approaching levels seen last spring during that violent sell-off in the bond market. As long as this year's ascent is more gradual than last year's, we should see orderly adjustments in credit spreads and yield product like junk bonds, REITs, mortgage-backed securities, corporate bonds, and MLPs.

The economy turned in a good performance in the first quarter and has decent momentum going into the second quarter. If we see a spike in oil prices or interest rates, we could see a slowdown in economic growth; otherwise we expect the "Goldilocks" economy to continue. Some analysts complain that this economic expansion has produced disappointing increases in payroll employment. A typical recovery will average between 200,000 and 250,000 new jobs per month, while the current recovery has averaged 112,000 per month over the last two years. The monthly employment report is the most closely watched economic release and its relative weakness is one reason interest rates have not gone up more dramatically. However, we read a recent analysis that showed that federal income tax receipts are growing much faster than the monthly employment report indicates. Given the assumption that most individuals do not want to pay more income taxes than are required, the analysis supports the theory that job growth is stronger than the monthly payroll report suggests.

Now a review of the sectors we cover:

Large Cap Stocks: The Blue Chip Strategy declined 2.07% in the first quarter, similar to the 2.13% decline in the S&P 500 Index. General Motors suffered the worst loss of the Blue Chips, falling 25% after the company reduced its earnings projections for 2005 and investors worried that their high debt load could eventually lead to bankruptcy. AIG also suffered during the quarter as regulators accused the company of misleading accounting reports and

the company's longtime chairman was forced to resign. Exxon Mobil Corporation led the gainers with a 17% increase, followed by Boeing's 13% rise. We predicted that large cap stocks would outperform small company stocks this year, but so far that means that they have declined less than small company stocks. In our opinion, large company stocks exhibit the best fundamental valuations we have seen since early 1996. We recommend over-weighting this sector.

Small Cap Stocks: As expected, the small companies are exhibiting more volatility than the large caps. Our Small Cap Value Strategy fell 7.18% in the first quarter, slightly more than the 5.60% decline of the Russell 2000 Index. The biggest decliner in the strategy was our newest purchase, Lannett Company, Inc., a generic drug manufacturer and distributor. (A research summary for the company is included for clients in this strategy.) Komag, a manufacturer of thin film media for disk drives, was our biggest gainer, rising 19%. We are seeing more opportunities to put money to work in this sector as a result of the market's decline.

Intermediate Bonds: The Intermediate Bond Portfolio Strategy declined 0.81% for the quarter versus a 0.89% loss for the Citigroup 1-10 Year Government Corporate Index benchmark. The Intermediate Tax Exempt Bond Portfolio Strategy fell 0.33% versus a 1.11% decline for the Merrill 3-7 Year Insured Bond Index. We are still positioned for rising interest rates in our bond portfolios and expect to remain in that status until the yield curve flattens more. One move that we made in our taxable bond accounts in the first quarter was adding a position in General Motors bonds. Unfortunately we were early in making our purchase. The bond we bought yields over 8.0% and we thought that would be adequate compensation for taking on the risk. However, after we made our purchase, GM lowered earnings guidance for 2005 and their bond prices fell more. There has been some speculation that GM might eventually declare bankruptcy to rid the company of its huge health care expenses. We think this is a very remote possibility since GM has over $20 billion in cash and many sources of liquidity. The company has many ways they can improve profitability and reduce debt before they have to take survival measures.

Convertible Securities: Our Convertible Securities/High Yield Strategy gained a whopping 0.53% in the first quarter. Our comparison indices both declined, with the Merrill Convertible Index falling 5.27% and the Merrill High Yield Index falling 1.44%. We were concerned at

the end of last year that credit spreads had tightened too much, meaning that lower quality bonds were priced too expensively. Now that the Fed has raised rates again and stated that they expect long term rates to rise, lower quality bonds have cheapened versus Treasuries. We recently added an investment grade-rated American Axle and Manufacturing convertible bond to the portfolio and are closely watching two other potential acquisitions.

With interest rates moving higher and the Fed reducing liquidity in the markets, it will be more difficult for the market to advance this year. We think that the market can generate positive returns this year because the economy is growing at a healthy pace and that should help corporate earnings. If we have a rapid rise in interest rates or a sharp increase in oil prices, our scenario could be derailed. Of course there are other unforeseen events that could cause problems in the financial markets, but most of the current hurdles seem surmountable.

On a closing note, we think it is appropriate to recognize the impact that Pope John Paul II had on the world in which we live. He was instrumental in the fall of Communism in Eastern Europe and the resulting liberty those countries now enjoy. He supported the inalienable rights that individuals in a free and democratic society possess. But he understood that any political system that is not based on a strong moral foundation cannot succeed. His work to spread that message will endure.