

Quarterly Market Review

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Financial Markets and Economic Analysis, Second Quarter 2005

Summary

With the first half of the year gone, many advisors are assessing what the market has delivered and what to expect from the remainder of this year and the first half of next year. To find the answer to the first half of that question, we would have to look at the major events of the first half, and there were quite a few. Energy prices garnered most of the headlines, with crude prices reaching \$60 per barrel during the second quarter. While this was good news for companies in the sector, the increase cascaded through the economy in the form of higher gasoline prices and increased costs for almost every manufacturer. While there is only anecdotal evidence of these price increases being passed on to the consumer, there is significant evidence of a slowdown in spending, leaving high inventory levels and a likely strain on second quarter earnings. Mr. Greenspan and the Federal Reserve were not exactly accommodating either, raising interest rates four times in the first six months of the year, following five hikes in the second half of 2004. Despite the increases, long term interest rates have remained largely flat over the last year, providing liquidity in the housing market. Rising interest rates also contributed to a mild strengthening of the dollar, which not only hurt exporters by increasing the costs of their goods, but hurt many multi-national companies, reducing the value of earnings abroad in dollar terms. The same geopolitical issues dominated the scene in the first half of this year as in 2004 – Iraq, Afghanistan, North Korea and China. All of these issues piled up during the first half of the year, leading to flat performance for the major indices, and only the midcap portion of the universe provided a return greater than the taxable bond market.

There is a broad range of issues that will likely shape the second half of the year for the domestic securities market. The Fed has made no indication that it plans to reduce the pace of rate hikes, and with four more Fed meetings planned for this year, short rates could increase by another full percent before yearend. This presents a number of challenges for the broad market. If the long term rates do not move upward, with the 30-year rate currently lower than it was when the Fed began tightening, we could easily see an inverted yield curve before the end of the year — something that has presaged the last two recessions. If rates begin to rise, and rise significantly, the drop in liquidity could burst the housing market bubble in many areas of the country. Given that many of the economic signals are mixed right now, further tightening could also strangle the already weak recovery. Increasing material costs for manufacturers, with little ability to pass the costs along to the consumer, will continue to put pressure on profit margins. Global concerns and pressures will also be a factor over the remainder of the year as some U.S. companies try to take advantage of growth in China, while others will be forced to compete with increasing exports from the world's largest market. It is likely that success in the markets over the next six months will be very company specific, rather than size or style specific.

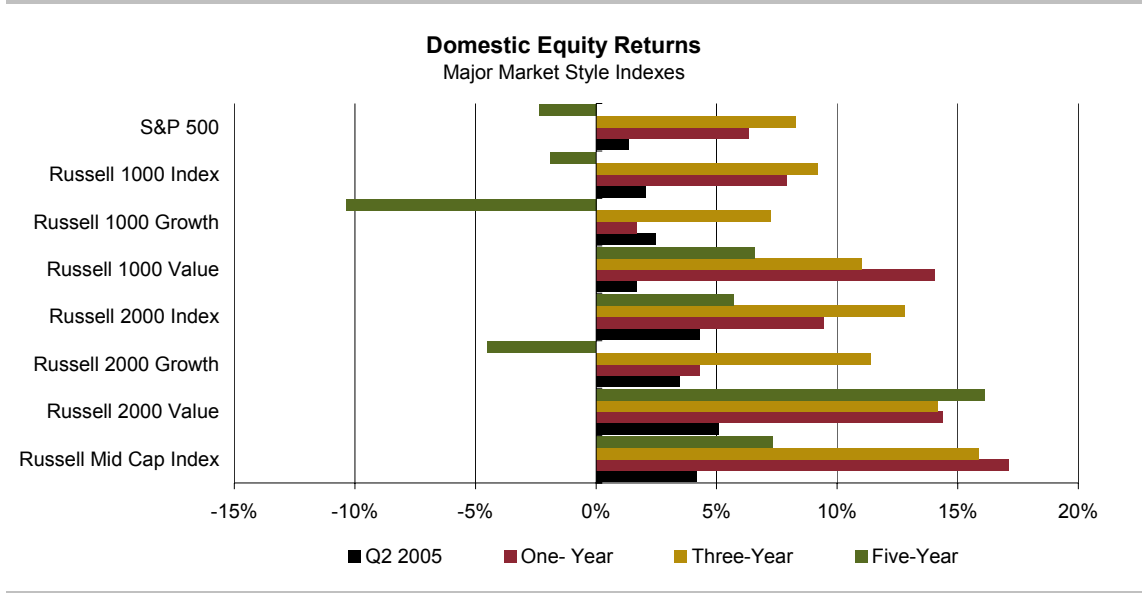
Domestic Equity Markets Overview

Overall, the domestic equity markets showed modest returns for the second quarter, bringing most of the major indices back to flat for the year. The largest gains remain in the small cap value portion of the market, largely due to gains in the Financials sector and a big surge in the Energy sector. The Russell 2000 Value Index had positive returns in every sector except Materials, giving it a total return for the quarter of just more than 5%. Although the indexes show a continuing bias towards value oriented stocks, the preliminary data from Lipper Inc. shows outperformance of growth oriented mutual funds over their value oriented counterparts. That is, the average growth fund exceeded its benchmark, and the average value fund underperformed, sometimes sharply.

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With the extended period of low long term interest rates that the U.S. has had over the last three years, it is not surprising that the Wilshire REIT Index was the quarter's biggest gainer, up more than 15%, reversing a first quarter loss of 7%. This also makes it the biggest gainer for the first six months of the year, after gaining more than 30% in both 2003 and 2004.



International Markets Summary

During the second quarter, the international markets told a tale of two very different markets. Overall, the developed markets, whether Europe or Japan, enjoyed about the same amount of success as the U.S. Market did, at least in local currency terms. The regional indices were up between two and six percent, with the exception of the Far East Index, which was flat. However, the strengthening dollar wiped out all but the largest gains, and only the Nordic Countries Index, up more than 11% in local terms, was up more than 1% in dollar terms.

However, the situation was reversed with many of the emerging markets indices. For the Emerging Markets Index as a whole, currency issues had little effect. But the Latin America Index, for example, was up only 1.4% in local currency terms, but up more than 9% when converted to dollars. Some of the bigger gainers for the quarter, in dollar terms, were: Egypt (31.33%); Jordan (25.65%); and India (11.96%).

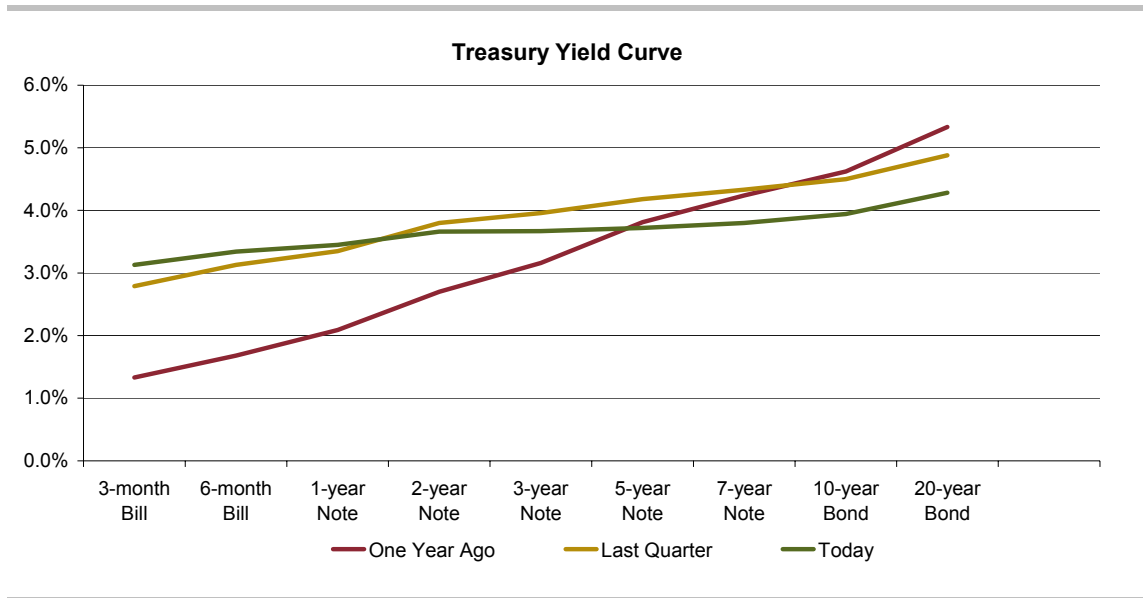
Fixed Income Summary

The story in the fixed income markets continues to be the flattening of the yield curve, and whether or not the curve will invert during 2005. The Fed has raised its short term target rate more than 2% over the last year, yet the yield on the 10-year Treasury was 0.68% lower at the end of the second quarter than it was at the same time in 2004. The total spread from the 3-month Bill to the 20-year Treasury is now just 1.15%. The remainder of the year should bring several more rate hikes from the Fed, but it will be interesting, knowing that Mr. Greenspan's final term as Fed Chief will end in early 2006. He certainly does not want to overdo it on interest rates and have a recession as his final legacy, but his term as Chairman of the Fed has been hallmarked by clear indication of future movements, and every indication points to further rate increases.

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As in the first quarter, the taxable bond market was led by longer maturities, more than 10 years. Using the Lehman Brother's indices, Treasuries as a whole were up 3.6%, Corporate bonds, 3.5%, and mortgage-backed securities were up 2.2%. High yield bonds turned in a positive return as well, in line with the overall Corporate bond market. The Lehman Brothers Municipal Index was up just less than 3% during the quarter after a flat first quarter. Like the taxable market, the municipal market was led by the longer maturities, with the largest returns coming from the 20+ year segment.



Outlook

The second half of 2005 may very well be dominated by the performance of individual companies rather than by broader sector or style factors. There is increasing evidence that growth in second quarter earnings will not be as robust as in the first quarter. The U.S. economy continues to grow, but at what appears to be a much slower pace, going forward. The Fed is continuing to increase short term rates, and trying to convince the market to increase the rates on longer term instruments as well. Rising energy and raw material costs will continue to be a significant factor for most companies in the second half of the year.