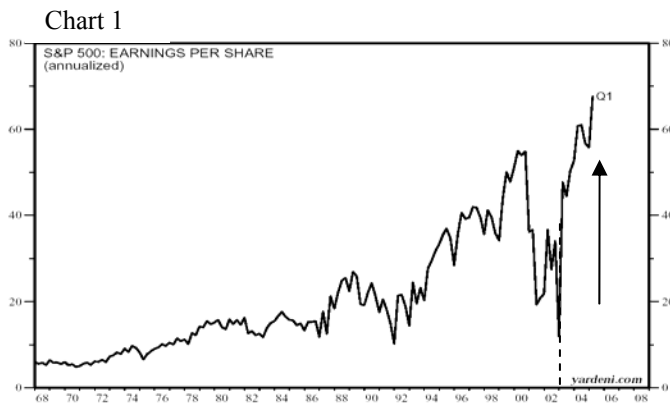


# C *Economic & Market* Commentary

## A Tale of Two Charts

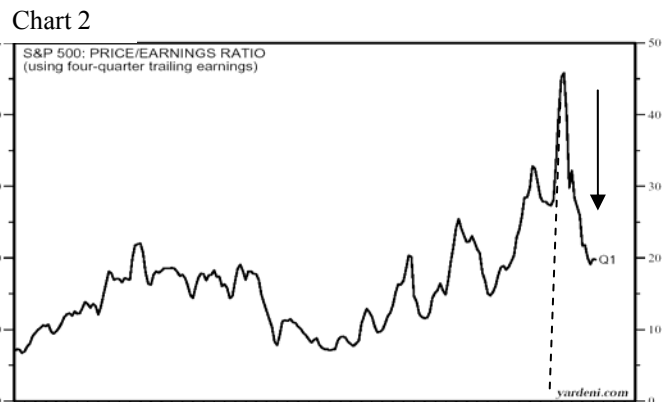
It was the best of times, it was the worst of times... The stock market has been stuck in neutral this year, taking two steps forward and two steps back. Earnings are increasing, but P/E (price to earnings) ratios are contracting. Simply put, stock market participants are paying less for a dollar of earnings today than in the past. This was discussed in last June's *Commentary* where we spoke about the prospect of corporate earnings growth exceeding stock price growth for a period of time.



Two factors behind the Tale of Two Charts are the unrelenting rate increases by the Federal Reserve, and concerns regarding future economic and earnings growth rates. In our opinion, the Federal Reserve could, and should be nearing a pause in the rapid rate increases as they consider the impact of other influences on our economy, such as rising oil prices, a firmer dollar, and slowing growth rates. The Fed Funds rate is at pre-1994 levels and has more than tripled (from 1 to 3.25 percent) since the tightening cycle began in mid 2004.

Recapturing past rate cuts to recreate flexibility in our monetary policy was necessary and, as we have commented on before, our economy can handle inflation much better than deflation. In light of our current situation, we would expect our policy makers to exhibit some patience in the future, even if their rate objective has not yet been met.

A picture is still worth a thousand words, and as Charts labeled 1 and 2 show, earnings per share (1) has risen sharply since the market bottom in 2002, while the P/E ratio (2) has dropped sharply. The result has been a relatively flat market for about the last seven years, as shown in Chart 3 on the back of this page.



Outside of the stock market, a stampede of money has been chasing real estate, extending those valuations. This is not unlike the stock market of the late 90's when expanding P/E ratios led to stock price gains, that outpaced earning gains, pushing the stock market to all time highs in 1999. Real estate is one asset class of many to invest in, nothing more and nothing less. Just like the stock market, the bond market, and other markets, each has its place and purpose.

We are not real estate experts, but if a real estate bubble does exist, the air must be let out carefully. The housing sector is intertwined with many other economic sectors and a sharp real estate correction will have ripple effects on many other parts of the economy. The Federal Reserve Chairman (Alan Greenspan) has been using some of the same terminology used to describe the exuberance in the stock market during the late nineties, never coming right out and saying it, but hinting

Chart 3



all around the edges. Real estate is an asset class that is usually leveraged, and typically, more leveraged than a margined stock portfolio. Leverage creates the potential for both greater returns and greater risks. As long as the stampede is moving in the right direction everything works just fine, but if the air comes out too fast, someone is left holding an empty balloon.

Expect to hear more about China, as one cannot ignore her impact on the global economies. Currently there is tremendous pressure on China to revalue or float its currency, as well as curb exports, and any number of things designed to protect non-competitive U.S. businesses from China. While implementation of one or more of these restraints may yield some short-term comfort and possibly votes for the politically inclined, tariffs, trade restrictions and currency adjustments only delay the impact on non-competitive businesses. The main losers will be our, and the rest of the world's, consumers and economies.

The U.S. economy is still growing, but at a slower rate than the initial rebound. This should surprise nobody, as growth rates experienced during a rebound are not sustainable in the long run. The 10-year Treasury bond yield is hovering around the 4 percent mark, and as short-term rates have risen, the yield curve has flattened. During periods when earnings rise and P/E ratios fall, companies can build a tremendous amount of value for their current and potential stockholders. While it may not result in immediate gratification, ultimately the value of growing earnings or dividends is realized.

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