

INVESTMENT OUTLOOK

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SECOND QUARTER 2004 REVIEW AND OUTLOOK

By Whitney Brown



The second quarter was a sleepy one for stocks. The major market averages meandered in a narrow range and finished nearly unchanged from quarter's start to finish. We may take

it as a positive that stocks held steady, considering the almost uninterrupted year-long advance from last March to this March. A period of consolidation has been in order.

The bond market was not so sleepy, after receiving something of a shock in April. A spate of good news on the strengthening economy convinced investors that the Federal Reserve might have to raise short-term interest rates more aggressively than originally anticipated. In response, bond prices plunged and interest rates spiked higher. Later, rates backed off on reports of more moderate growth. They have since settled into a range above the March lows but are still very low by historical comparison.

Considering the conflicting forces at work in the economy and the steady stream of grim news from the Middle East, it is a tribute to investor optimism that stocks haven't completely tanked. But, there are several good reasons investors have to be sanguine about the market:

1. Interest rates, while possibly headed higher, are still very low and not yet an impediment to continued economic expansion. The Fed has made it clear that it wants to enable economic growth but without allowing inflation to run away.
2. The negative impact of rising interest rates and higher oil

Market Measures		2nd Quarter	YTD 2004
S & P 500		1.3%	2.6%
Dow Jones Industrial Average		0.8%	-0.2%
NASDAQ Composite		2.7%	2.2%
Morgan Stanley EAFE		-0.7%	3.0%
Lehman Bros. Intermediate T-Bond Index		-2.3%	0.5%
	<u>6/30/04</u>	<u>12/31/03</u>	<u>6/30/03</u>
10 Year Treasury Bond Yield	4.58%	4.25%	3.52%
90 Day Treasury Bill Yield	1.24%	0.90%	0.83%

prices may be less than what much popular commentary would imply. The bulk of household debt, especially mortgages, is at fixed rates. Anyone who could have refinanced a mortgage to lock in a lower rate has likely done so by now. Research by the Bank Credit Analyst indicates that oil, even at recent higher prices, accounts for only 3% of consumer spending, as opposed to 6% a generation ago and 4% during the Gulf War.

3. Stocks have become cheaper. Stocks are not yet absolutely cheap, but the combination of very strong corporate earnings growth and little movement in stock prices has caused price-to-earnings ratios to retreat substantially from the extreme highs of recent years.
4. Many stocks are doing well. The more or less flat returns in the large cap market indices have disguised the

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Second Quarter 2004 Review and Outlook (continued)

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fact that smaller cap stocks have returned around 6% through the first half of the year compared to around 2% for the large caps. The large cap indices are dominated by a relative handful of well-known stocks that are still licking their wounds from the bear market beating of 2000 to 2002. Meanwhile many lesser-known stocks of smaller companies and in more cyclical industries have performed admirably.

Depending on your bias, bull or bear, you can always choose the facts that support your case. For that reason, we spend a lot of time looking at data, charts, and historical patterns in order to, as objectively as possible, view what's going on without getting bogged down in the vagaries of economics, investor sentiment and valuations. One chart that is speaking very loudly to us now is presented

below.

The blue line in the chart represents a composite model of how the S&P 500 Index could be expected to perform in 2004. The red line represents the actual performance of the index so far this year. Ned Davis Research prepared the composite by giving equal weight to three significant market cycles that have been well documented over the past 75 years of stock market observation:

1. The first cycle is simply a one-year seasonal pattern.
2. The second cycle is a four-year pattern surrounding the Presidential election year; we've commented about this one on several occasions.
3. The third cycle is a lesser-known but equally reliable ten-year pattern.

Based largely on this composite, and contrary to the

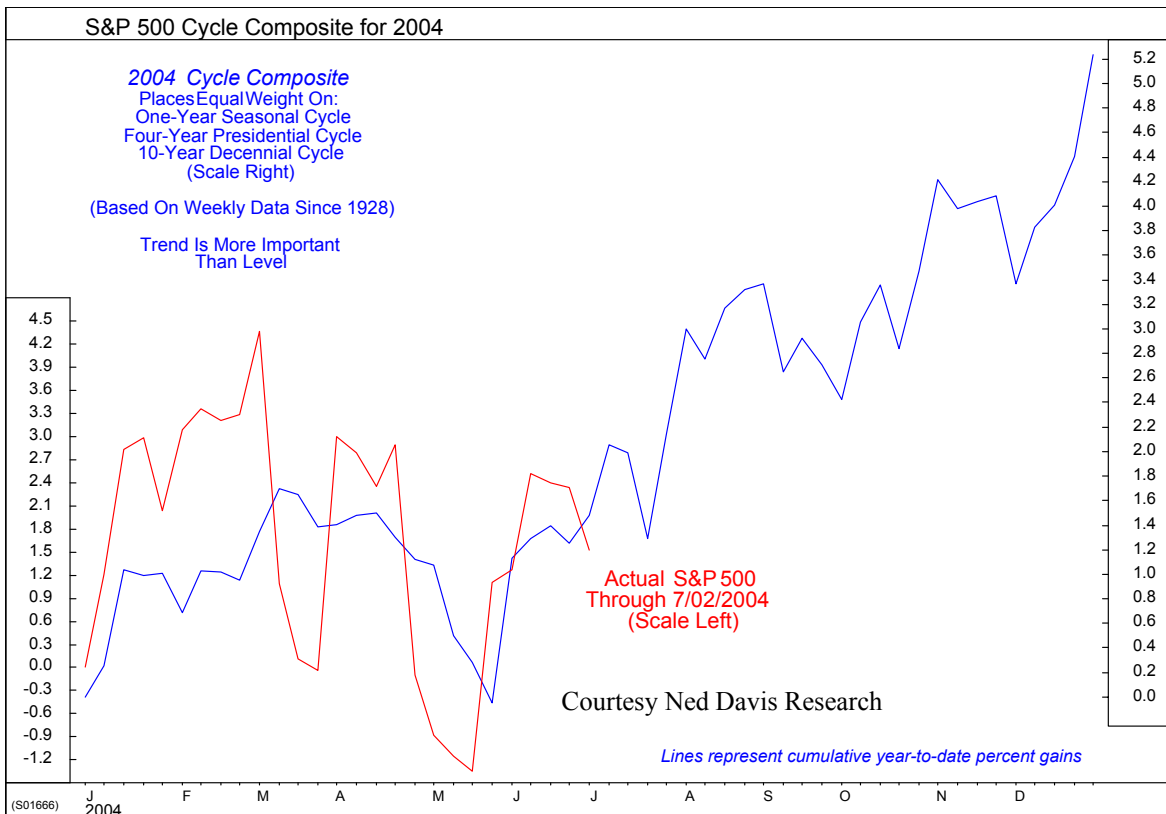
prevailing view, we commented this past January: "We would not be surprised to see some weakness in the first half of 2004, followed by renewed strength into the presidential election and year-end." The actual progress of the S&P 500 through mid-year has been remarkably similar to the composite model. Stocks reached a peak in late winter, dropped to a low for the year in May, and finished the first half of the year essentially flat.

If the composite continues to be as reliable as it has been so far, we can look forward to the second half of the year. Stocks should do well. Why should this happen? We don't know, but 75 years of stock market action, through all types of markets and all types of economic conditions, reflect more investment thought than we could hope to conjure up.

Our outlook for the balance of the year is positive for stocks and the economy. The Fed will very likely

increase short-term interest rates further, and longer rates may rise modestly as well. It's not likely we'll see a surge in longer rates this year unless the economy gets much stronger. Right now it's just steady. Our investment approach continues to hinge on flexibility. We are optimistic that stocks can finish this year with solid gains, but, as always, we will need to stay alert.

Best wishes for a safe and restful summer.



MAINTAINING PERSPECTIVE IN A VOLATILE WORLD

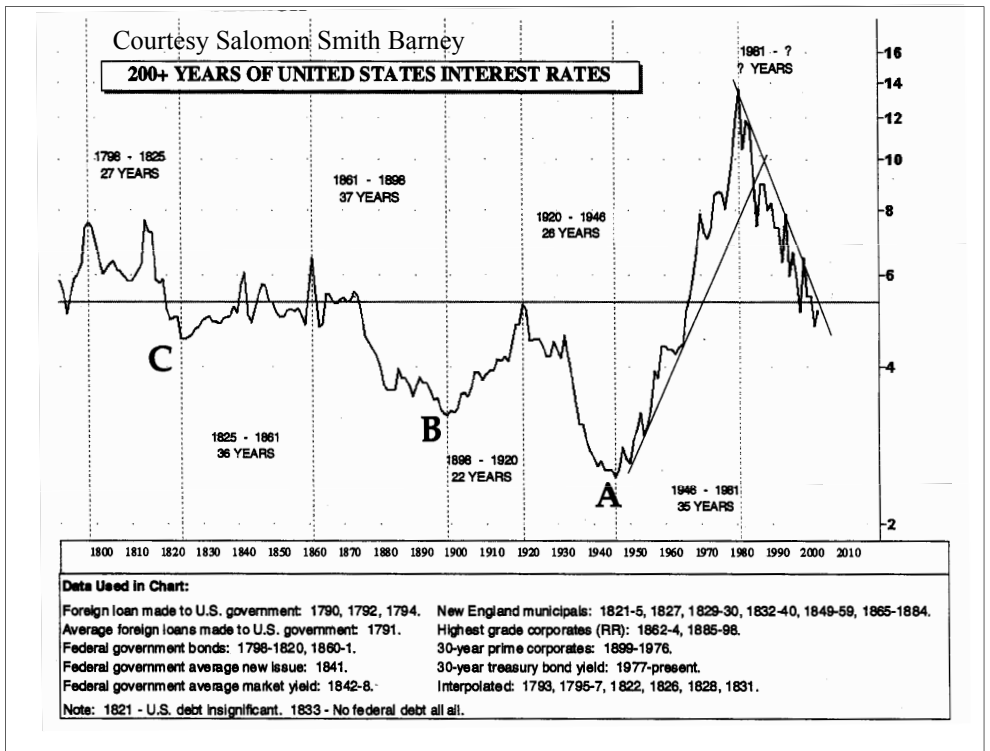
By Walter Dixon

Virtually 100% of our clients have long-term (15-20 year) investment objectives: saving for college, putting money aside for retirement, enjoying being retired. Quite understandably, however, the investment media focuses on what happened yesterday and what is going on today – interesting and sometimes exciting, perhaps, but usually of limited relevance to the big picture.



A little more than a year ago this quarterly newsletter carried a piece containing two unusual charts, one of the Dow Jones Industrial Average from 1925 to the present and the other a 200-year graph of interest rates in the United States. Since our portfolio management focus is long-term – like our clients' objectives – the perspective that these two charts provide is very important to us.

Much has happened during the last 12-15 months. The war in Iraq and the upcoming presidential election, of course, have garnered most attention; but the investment markets also have been very active.



In early June of last year, stock prices broke out of their eight-month holding pattern and then climbed over 20% to a peak in March 2004. In

addition, long-term interest rates, primarily reflecting concern about the rapid rise in prices of certain commodities, especially oil and gas, have shot up over 30%. (Remember, interest rates and bond prices move inversely: when rates go up, bond prices go down; and vice-versa.)

These moves have been rapid and dramatic. There now is widespread optimism that the stock market's worst days are behind us and, with the economy getting stronger, that share prices will move higher. In the bond markets, analysts almost universally have concluded that the 20+ year decline in interest rates is over and that even higher rates are ahead.

We thought it would be useful to update the two very long-term charts from the First Quarter 2003 Investment Outlook and view these short-term moves in their longer-term context.



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Maintaining Perspective in a Volatile World (Continued)

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Stock Prices

First, referring to the chart on the Dow Jones Industrial Average, during the past 15 months the index has recovered to the uptrend line, which extends from the 1982 low to the 9/11/2001 disaster. This line was broken decisively nine months later in July 2002.

After a major reversal in the long-term (up- or down-) trend, a pullback reaction to the old trend line is normal. The pullbacks don't repeat exactly in magnitude and duration, but the patterns are discernable. However, after the pullback, the new trend usually reasserts itself.

Long-Term Interest Rates & Bond Prices

The 200-year graph of long-term interest rates shows clearly that there has not yet been a reversal in the 23-year downward cycle in interest rates. The sharp rise in rates that started last summer could be nothing more than a short-term cyclical interruption in the long-term downward trend. Examining closely the alternating duration patterns of the cycles tends to reinforce this suspicion.

So...What Now?

Could the currently accepted wisdom about the stock and bond markets be wrong? The optimists among us say: "Yes, but..." (One college professor says the DJIA will be at 36,000 within ten years!) The pessimists say – as they've been saying for at least forty years – that it's the end of civilized world as we've known it (a slight, but *only* slight, exaggeration!).

We say (no surprise here!) that we don't know. However:

1. Our clients, almost all, have long-term objectives; so we should keep our eye on the long term;
2. We are by nature risk-averse money managers. Big losses in our portfolios are difficult to earn back (hence, the old saying that a 50% decline requires a 100% recovery, to get back to even);
3. Our chances of success are much better when we invest *with*, rather than *against*, the underlying long-term trends.

We can be hopeful, but should not be complacent, when these trends may be reversing direction. At such times we should hedge our bets.

A Final Word on the Charts

A reasonable question is the relevancy of long-term charts. A skeptic might say that conditions are different now from what they were 100 or 200 years ago, which these charts reflect; and of course they are.

What is *not* different, however – and what in the final analysis these charts reflect – is **human nature**: all the hopes, loyalties, fears, greed, instincts, conditioned expectations, rational and otherwise, plus analysis, experience, prejudices, guesses, and intuition that come together on the floor of the stock exchange in the price that a willing buyer agrees to pay, and a willing seller agrees to receive, for a share of stock or a bond. And, after all, this price is the bottom line.

Note

During the last several years, in my free time I've pursued the hobby of researching my family roots. The next quarterly issue of the Investment Outlook will contain a personal story from this research that deals with conditioned expectations and lessons learned in the securities markets. (I'm not the first of my line interested in the stock market, nor the last!) I hope you'll enjoy it.

Walter Dixon