

INVESTMENT OUTLOOK

First Quarter 2005 Review

By Whitney Brown

- Stocks slip lower.
- Oil prices surge.
- Fed continues with rate hikes.
- Bull market intact but maturing.



The stock market disappointed investors in the first quarter. Momentum from last year's strong fourth quarter failed to carry through as the market pulled back in January, recovered in February and sank right back down in March. The net effect was a small loss for the quarter in both the S&P 500 and the Dow. The NASDAQ suffered a more substantial decline as tech stocks beat a hasty retreat.

Building on the heady gains from last year, stocks in the energy sector rose at a blistering pace. In fact, energy was the only market sector to show a meaningful gain for the quarter (+17%). By the end of March crude oil was flirting with \$60 per barrel, and gasoline prices were averaging well over \$2 per gallon. There is mounting evidence to indicate that oil prices have stepped up to a new, higher long-term trading range above \$35 per barrel. As long as the higher prices don't significantly suppress demand, energy stocks should continue to do well.

Along with the rise in oil prices, other economic concerns remain in the forefront of investors' thinking. Economic expansion at home and abroad appears to have reached a self-sustaining level. In response, the Federal Reserve has continued its measured campaign to shift from an accommodative to a neutral monetary policy by raising short-term interest rates. The market seems to be sensing a whiff of inflation, and longer-term interest rates are now under some upward pressure. Rising interest rates generally create a headwind for stocks.

The question of the sustainability of China's economic expansion continues to loom over the market. There is a great difference of opinion among economists and market strategists regarding whether China's rapid rate of economic

<u>Market Returns & Rates</u>	<u>1st Quarter 2005</u>		
S & P 500			-2.6%
Dow Jones Industrial Average			-2.6%
NASDAQ Composite			-8.11%
Morgan Stanley EAFE			-0.8%
Lehman Bros. Intermediate T-Bond Index			-0.8%
	<u>3/31/05</u>	<u>12/31/04</u>	<u>3/31/04</u>
10-Year Treasury Bond Yield	4.48%	4.26%	3.83%
90-Day Treasury Bill Yield	2.71%	2.22%	0.92%

growth can continue. There is also much discussion over whether or not the pace can be deliberately slowed without causing a crash in the global commodities markets and an ensuing economic contagion. There is even much difference of opinion over whether or not the Chinese economic growth machine is the real thing or a colossal illusion perpetuated by cheap, government-subsidized credit and profitless business activity for the sake of keeping people busy. There is no doubt that the Chinese political and economic system is less than transparent, and China bears watching.

Geopolitical turmoil seems to have become part of the

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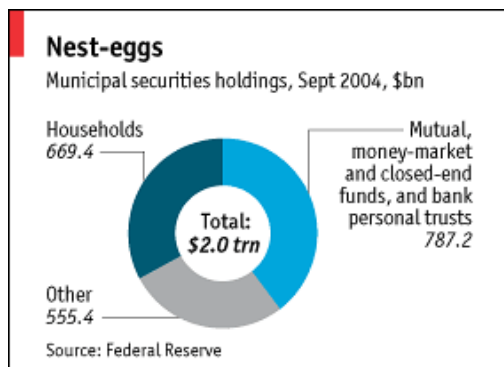
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Muni Market Less Murky

Compared to the stock market, the secondary market for municipal bonds is comparatively illiquid and “opaque,” especially to the only-occasional retail buyer of such issues. Earlier this year, the Bond Market Association began printing prices of actual municipal bond trades on their website, which should be very helpful to investors in receiving fair treatment from their retail brokerage firms. The following article abstracted from a February 2005 issue of The Economist is enlightening.

“LET THERE BE LIGHT



“On January 31st, the Bond Market Association (BMA) started to display prices of municipal-bond trades [on their website] within 15 minutes of completion.

“This shines a searchlight into a murky market that is widely seen as the last refuge of the broker-dealer. With more than \$2 trillion-worth of bonds outstanding and new issues last year of \$358 billion, the centuries-old, largely tax-exempt municipal-bond market plays a big role in

helping state and local governments to raise money cheaply.

“The lack of publicly available prices – as well as the fact that most bond dealers do not tell their customers how much they themselves are making on a trade – has meant that dealers can trade securities at exaggerated spreads between the prices at which they buy and sell them. Last summer, the National Association of Securities Dealers fined eight broker-dealers for “abusive pricing”.

“Bond markets in most places are far less transparent than equity markets. The argument is that the big institutional investors that dominate them do not need the same protection as mom-and-pop investors in shares. In the muni market, however, this argument makes particularly little sense.

“Individuals own about a third of all such bonds directly, and perhaps another third via pension funds, mutual funds, and the like (see chart). Individuals – especially rich ones – are happy to take lower yields in exchange for the tax exemption most munis enjoy. But transaction costs for *retail buyers* [our italics] of municipal bonds are about two-thirds again as high as in corporate-bond trades and nearly six times higher than in equities, said a study by the SEC, published last September and using 2003 data.

“There may be inherent limits, [however], to what disclosure can do. Unlike most corporate bonds, municipals tend to be wildly dissimilar. They are also sticky: only a third of the issues trade at all in a given year.”

*Courtesy of the Economist Newspaper
and The Economist Group*

Exchange Traded Funds (ETFs)

By Watt Dixon

An Exchange Traded Fund (ETF) is a basket of securities built to mirror the performance of a stock or bond index. ETFs possess qualities of both mutual funds and common stocks.

Characteristics of ETFs: shares are bought and sold intra-day on an exchange; low cost structure; no minimum investment amounts; passively managed; track a broad market index or target a specific sector or segment of the market; and track markets in various regions or countries.

At Dixon, Hubard & Feinour, Inc., ETFs could be implemented in several different scenarios. In the early stages of a new bull market, as most stocks are moving up, it is often difficult to determine what sectors of the market will be the big winners during this new market advance. The initial thrust from bear market lows often produces large gains for stocks. ETFs provide a means to get invested

quickly, so to capture as much of the initial surge in stock prices as possible. In this case, a broader market ETF may be appropriate.

ETFs also present an attractive way to invest in foreign markets. Due to currency fluctuations and a lack of information on many foreign companies, investing in overseas markets takes on added risk. ETFs allow instant investment diversification into either a specific country or defined region.

The growth of ETFs has been exceptional since the introduction of the first one tracking the S&P in 1993. At Dixon, Hubard & Feinour, Inc. we feel that ETFs, when used as previously mentioned, can work well with our method of portfolio management.



Slow Down Around Flat Curves

By Stebbins Hubbard



The yield curve for U.S. Treasury securities (bills, notes, and bonds) illustrates the tradeoff between yield and maturity: usually the longer the time to maturity, the higher the yield, or return from interest. In the chart below, time to maturity increases as you move to the right along the horizontal axis. The yield increases as you move up the vertical axis. By plotting various maturities and the corresponding yields available in the market you get a positively sloped curve known as the yield curve. This relationship generally holds true for most bonds, not just U.S Treasury securities.

The longer your money is at risk, the greater the return you expect. Since there is almost no risk of the U.S. Treasury defaulting on its debt, the primary risk for holders of U.S. Treasury securities is inflation. Owners of Treasury securities expect that the yield on their holdings will exceed the anticipated rate of inflation over the life of the bond.

The inflation rate is more predictable in the short term than the long term. Therefore, the risk premium (yield less the inflation rate) is usually much less for short-term bills and notes versus longer-term bonds. Inflation as measured by the Consumer Price Index rose from 1.89% for 2003 to 3.25% for 2004.

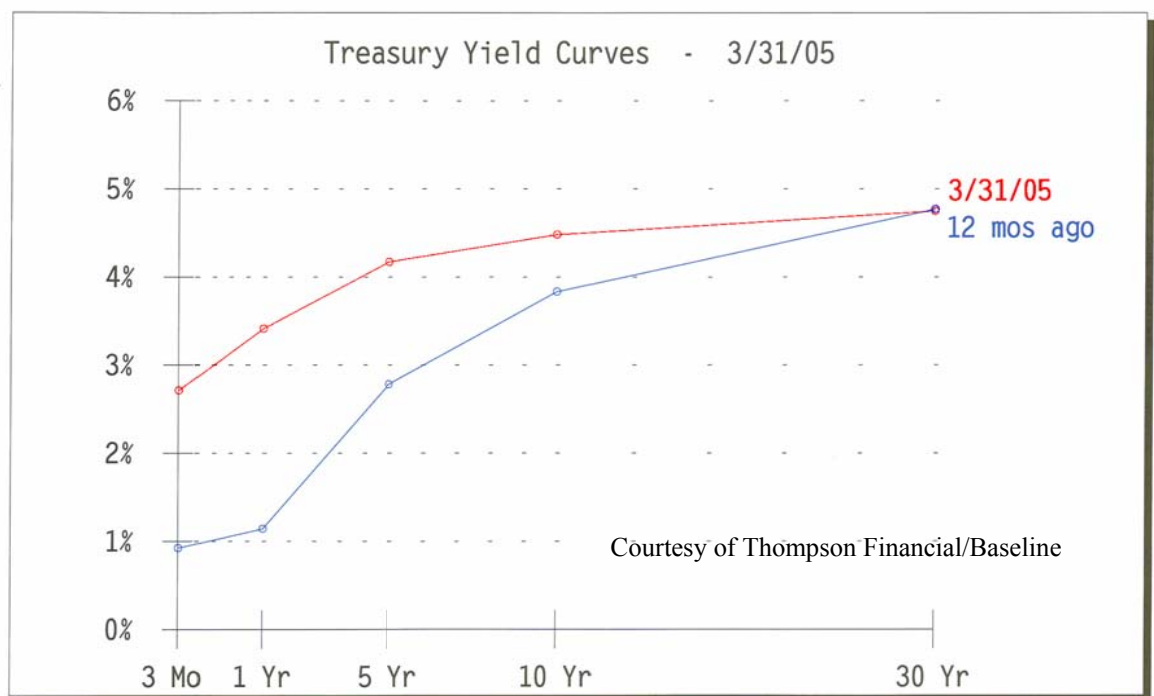
In anticipation of this rise in the rate of inflation, the Federal Reserve Bank increased the Federal Funds rate from 1% to 2.75% over the last year. The Federal Funds rate is the very short-term rate at which banks may lend their funds held at the Federal Reserve to each other on an overnight basis to satisfy reserve requirements. This increase has resulted in a rise for other short-term rates and thus a flatter or less sloped yield curve as indicated by the red line in the chart below.

What is the changing yield curve telling us? The conventional textbook analysis says that when the yield curve flattens, the market is discounting an impending economic slowdown, maybe a recession. By contrast, expectations for strong economic growth and consequent inflation would cause rates to rise all along the curve. If an economic slowdown does occur, the yield curve could even invert with short rates exceeding long rates.

However, not every flattened

curve has been followed by a slowdown. It is unclear if the current yield curve is predicting an economic slowdown since the flattening has occurred due to the Federal Reserve deliberately raising short-term rates while longer rates set by the market have remained essentially unchanged. From the chart below you can see over the last year the yield on the 1-year Treasury bill has risen 225 basis points (100 basis points = 1%) while the 10-year Treasury note has risen only 65 basis points, and the 30-year Treasury bond has stayed the same. The bond market seems to be telling us that inflation may be a concern for the short term but not for the longer term.

Whether the Fed can continue to succeed in checking inflation through monetary policy remains to be seen. There are other market-based forces working both for and against inflation in the global economy. For now anyway the flatter yield curve is not indicating that a slowdown is imminent.



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On a Personal Note....

We are pleased to announce that **Molly Lynn Henry** has joined Dixon, Hubbard & Feinour. Molly most recently worked for The Rutherford Companies as a healthcare consultant and broker. Previously, she worked for Carilion Health Systems as Benefits Consultant where her primary responsibilities included 403(b) and 401(k) compliance, communication, and administration. Molly will partner with David Camper in our defined contribution plan services area.

DH&F recently sponsored a team in CHIP's **Fitness Challenge** fundraising event. CHIP (Child Health Investment Partnership) is one of many local non-profit organizations DH&F supports. Thanks to fitness buffs Marcia Voudren, Heather Welter, Summer Coles, Cathy Charity, Rebecca Imhof, Sara Tootoo, and Jamie Roy for sweating it out on behalf of DH&F. They raised \$2,455.25 for CHIP, which put the DHF team #1!!

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atmosphere in which the world goes about its business in the 21st century. Situations like Iraq, the Israeli-Palestinian conflict, and upheaval in several former Soviet states don't seem to rattle the markets as they did just a year or two ago. In fact, many recent developments have been positive for the prospects of a broadening global shift toward democracy and freedom.

Regardless of what issues may keep investors awake at night, there is reason to believe the market has further upside potential. The notion that the market "climbs a wall of worry" is another way of saying that until everyone is fully invested the market has room to rise. It is true that the current bull cycle for stocks is aging, and there are indications of a transition to large company stocks at the expense of small company stocks. However, objective measures of supply and demand for stocks and other indicators of the market's health call for a continuation of the uptrend for equities.

Our best approach for 2005 is to remain flexible. Following areas of market strength, avoiding areas of weakness, and staying mindful of the primary trends for both stocks and bonds have been effective in avoiding large losses in down markets and generating capital appreciation in up markets.