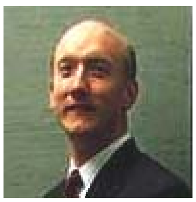
DIXON, HUBARD & FEINOUR, INC.
INVESTMENT COUNSEL

INVESTMENT OUTLOOK

Fourth Quarter 2004 Review

By Whitney Brown

- Stocks finish the year with respectable gains.
- Oil prices topped in October then retreated.
- Large cap growth stocks trailed the market.
- Fed continues “measured pace” campaign.



Market Returns & Rates	4th Quarter	Year 2004
S & P 500	8.7%	9.0%
Dow Jones Industrial Average	7.0%	3.1%
NASDAQ Composite	14.7%	8.6%
Morgan Stanley EAFE	15.0%	17.6%
Lehman Bros. Intermediate T-Bond Index	-0.1%	2.7%
	12/31/04	12/31/03
10-Year Treasury Bond Yield	4.26%	4.25%
90-Day Treasury Bill Yield	2.18%	0.90%

Stocks

A strong fourth quarter allowed the stock market to finish the year with very respectable gains. As noted in the table to the right, after languishing for most of the year the major averages climbed out of negative territory in the fourth quarter. Several key ingredients combined toward the end of the year to spark a rewarding rally: 1) The decisive conclusion of the presidential election removed a great deal of uncertainty from the political environment. 2) Consumers and investors gained a sense of relief as oil prices topped in October and retreated sharply from 14-year highs. 3) The market followed its usual tendency to advance in the fourth quarter on the strength of seasonal money flows into stocks.

Most market sectors made good progress in the quarter although well publicized troubles among some of the major pharmaceutical companies weighed down the health care sector. Energy, the leading sector for the year by far, also lagged for the quarter as oil prices pulled back.

For the year, the sectors dominated by large cap growth stocks such as healthcare and technology trailed. Cyclical and traditionally value-oriented sectors dominated with energy, utilities, telecommunications services, industrials and materials being five of the top six categories as ranked by performance.

Although periodic pullbacks and corrections are to be expected, objective measures of demand for stocks indicate that the primary up trend of this market is still intact and that the market has further to run. The warning signs of a market top such as fewer stocks participating in the rally and little upward progress on churning volume have yet to appear.

Along with last year’s gains, the two-year increase in the S&P 500 is 38% not including dividends. We’re still a long way from the record highs of 2000, but back-to-back years of solid gains can do a great deal to restore investor confidence. That is all the more reason not to get complacent in 2005. Our best estimate is that the current bull cycle may run through mid-year before giving us reason to become more defensive.

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Also in This Issue

Update on Estate and Gift Tax Exemptions

by Ted Feinour

The Federal Estate and Generation Skipping tax exemption remains at $1,500,000 for the year 2005. This amount will, however, increase to $2,000,000 for the years 2006-2008 and will rise to $3,500,000 in 2009. In 2010, as the law is currently written, there will be no federal estate and generation skipping tax and therefore no exemption.

Prior to 2004, the federal gift tax schedule was the same as the estate and generation skipping tax scale, but that exemption was frozen and will not increase. A single individual may still give any one person $11,000 annually, or a husband and wife $22,000 each year, without application to the $1,000,000 exemption.

The Congress will need to either make the 2010 year of no federal estate and generation skipping tax exemption permanent for future years or create a new schedule, since the current law states that in 2011 the exemption will revert to $650,000. It is likely that these matters will be decided through tax code reform legislation, which the Bush Administration hopes to accomplish.

It is important to work with your attorney or accountant to ascertain what your federal estate tax liability might be and insure that your will or trust provides for the maximum tax savings. Members of our firm are always interested in discussing your financial planning so that your ideas may be focused prior to meeting with your attorney or tax advisor.

A Forward Look into 2005

As Yogi Berra said, "Predictions are hard to make, especially about the future." But let's try anyway, since 2005 has a decent chance to be a pretty good year.

No doubt there could be some very anxious moments. But climbing a "wall of worry" isn't all bad; we tend to address the problems we worry about. We'll leave it to you to construct your own list of concerns, while we summarize our expectations for the areas usually affecting investment portfolios:

- *U. S. Economy* – Sustained growth at a somewhat slower rate than 2004 most probable.
- *Stocks* – Near-term outlook continues favorable.
- *Interest rates* – Fed on track to gradually raise short-term rates.
- *Bonds* – Long-term interest rates still in secular downtrend, but prices have leveled out and are consolidating after 23-year bull market.
- *Inflation* – Upward pressures are building, but fierce global competition likely to limit price increases. Inflation pressure most likely, worldwide, in commodities; domestically, in real estate values.
- *Dollar* – Further weakness probable long-term, after a near-term bounce.
- *Risks* – Very difficult to assess. Most serious problems are those that arise unexpectedly; and the risk of this occurring seems high.

Entering 2005, most likely news makers include:

1. Tsunami relief efforts.
2. Late-January Iraq elections.
3. Terrorist activities, Islamic and possibly other.
4. Israeli/Palestinian territorial and political difficulties.
5. Active Republican legislative agenda.

We are hopeful that substantial progress will be made in all these areas. And we wish all our clients and friends a healthy, peaceful, and prosperous New Year 2005!

Three Steps and a Stumble?

By Watt Dixon

"Three steps and a stumble" has been an old adage on Wall Street. This catch phrase refers to the stock market's tendency to fall after the Federal Reserve has raised interest rates three consecutive times.

After most stock indices peaked in early 2000, the Fed began a series of rate cuts to stimulate economic growth. From early 2001 through June of 2003 the Fed cut the Federal Funds target rate thirteen times. Once the economy and stock market began to show signs of life, Greenspan and Co. began raising rates, approximately one year after its last rate cut.

September 21 of 2004 marked the third consecutive rate increase. If the "three steps" theory had held up, as it did with great reliability in recent decades, we would have expected the stock market to suffer. From the date of the third Fed tightening, the market actually rose 7.3% through the end of 2004. This rise came in spite of the fact that the Fed raised rates an additional two more times in late 2004.

While we have not seen much of a reaction after the rate increases of 2004, history shows that a rising interest rate climate has not been good for equity prices. Higher rates slow the flow of money through the economy, hurting corporate earnings, thus making stocks less desirable. Higher yields also make bonds more attractive compared to stocks. Equity prices will often fall in price to once again become an attractive investment.

The explanation behind the "three steps" theory is that after three consecutive rate hikes investors are convinced the Fed is really serious about controlling economic growth. There are several factors present that may make the "three steps" pattern less reliable in today's investment environment.

In the 1970s and early 1980s the Fed would typically raise rates a full percentage point at a time. Today, a cautious Greenspan is more apt to raise rates ¼ to ½ percent at a time, lessening the shock to investors.

More important, though, may be that investors today are much more in tune to the Federal Reserve's actions thanks to cable television and internet news sources. Greenspan seems to have made a conscious effort to minimize the effects of rising interest rates on stock prices through much forewarning of his intentions.

The series of rate increases in 2004 came as no big surprise to investors. The rate increases were quickly factored into both stock and bond prices. The 10-year Treasury bond rate was basically unchanged for 2004.

An environment in which short-term rates are increasing but longer rates remain relatively unchanged is known as a "flattening of the yield curve." This flattening process has usually been a sign of a weaker economy. As mentioned before, rising interest rates have not been good for stock prices, however, in today's investment climate, it may take more than "three steps" to cause the stock market to stumble.

Fourth Quarter 2004 Review (continued)

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Interest Rates

The Federal Reserve continued its "measured pace" campaign to restore short-term interest rates to more "normal" levels. Since the Fed has done a thorough job of making its intentions known, the two one-quarter point increases during the quarter were fully expected and thoroughly discounted by the markets. The Fed continues to assert that the economy is on firm footing but has the leeway to pause or reverse course on interest rates if conditions deteriorate.

One of the more surprising developments in 2004 was something that didn't happen. Despite a wild plunge below 4% followed by a dramatic spike to almost 5%, longer-term interest rates finished the year virtually unchanged. The yield on the 10-year Treasury bond began the year at 4.25% and ended the year at 4.26%. Most prognosticators had expected much higher yields in 2004.

The stubbornness of the 10-year yield is curious considering short-term rates such as the 90-day Treasury bill more than doubled over the course of the year. If the bond market were as optimistic about economic growth and as concerned about inflation as the Fed, longer-term rates would probably be higher. We will be watching carefully to see what gives in the year ahead.

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On a Personal Note….

Whitney Brown, partner, recently became Chair of the Better Business Bureau of Western Virginia.

Jon Grace, operations chief, spent a hardworking week during the week of Thanksgiving in Milagro, Ecuador helping build infrastructure for a hospital under the auspices of his church.

David Camper, business development, has been elected Chairman of the Board of Directors of Apple Ridge Farm.

Jean ReMine, secretary/receptionist, and her husband Jeff breathed a sigh of relief when their son Jeffrey returned from an Army tour of duty in Iraq earlier last year. Jeffrey and his wife subsequently presented the ReMines with their first grandchild, a little girl named Ashlynn.

Dixon, Hubard & Feinour, Inc. Begins 25th Year

In January 2005 Dixon, Hubard & Feinour (DH&F), located in downtown Roanoke, begins its 25th year of managing investment portfolios. Assets under the company's management total $487 million, of which 70% are personal investments owned by individuals and 30% are trusteed and corporate funds. About 80% of DH&F's clients live within a 50 mile radius of the city.

The company is 100% owned by its four principals and is not affiliated with any other financial institution. DH&F has eleven employees, all of whom live and work in the Roanoke Valley. The company believes strongly in supporting the community, and its employees volunteer their time and resources to numerous civic and charitable organizations. The company also provides significant ongoing financial support to many worthwhile endeavors in the Valley and encourages its employees to do so as well.