

INVESTMENT OUTLOOK

Second Quarter 2005 Review

By Whitney Brown

- Stocks tread water.
- Oil prices surge.
- Fed continues with rate hikes.
- Bond yields present a “conundrum.”



You can call this stock market a lot of things but exciting is not one of them. So far this year, we seem to be watching a re-run of 2004. Stocks are simply stuck in neutral with the bulls and bears trading places on a daily basis. For the quarter, the major averages turned in mixed results, and all remained confined to fairly narrow trading ranges. For the year-to-date the major averages are all moderately lower.

Reasonably good reports on GDP growth and corporate earnings have combined with very low bond yields to make stocks seem reasonably valued (but not cheap) and attractive to hold, especially dividend payers. On the other hand, high energy costs and the threat of higher interest rates are casting a long shadow over the market and dampening investors' appetite for risk taking. The net effect is a market where there is no sense of urgency to buy or sell.

The real action so far this year has been away from the stock exchanges. Oil prices and interest rates have put on a very interesting show while stocks have tread water. After backing down in April and May, crude oil prices blasted ahead in June topping \$60 per barrel near quarter end. Although the high prices for crude oil and natural gas have yet to dampen demand or substantially impact overall inflation, conventional wisdom dictates that high oil prices are bad for the economy and therefore bad for the stock market. Conventional wisdom sometimes misses the point.

It is well worth noting that the recent boom in oil prices has been the result of surging demand born of economic growth, primarily in the U.S. and Asia. Prices have

<u>Market Returns & Rates</u>		<u>2nd Quarter</u>	<u>Year 2005</u>
S & P 500		0.9%	-1.7%
Dow Jones Industrial Average		-2.2%	-4.7%
NASDAQ Composite		2.9%	-5.4%
Morgan Stanley EAFE		-2.0%	-2.8%
Lehman Bros. Intermediate T-Bond Index		2.4%	1.6%
	<u>6/30/05</u>	<u>12/31/04</u>	<u>6/30/04</u>
10 Year Treasury Bond Yield	3.91%	4.26%	4.58%
90 Day Treasury Bill Yield	3.05%	2.22%	1.24%

climbed steadily over a period of time based on actual and anticipated demand. Previous oil shocks of the 1970's were sudden and resulted from geo-political events that restricted supply. Oil was actually in short supply. This time oil is available but simply in high demand because businesses need it to make and distribute their products and services, and people still want to and can afford to fill up their gas tanks and go places. In time, increased oil production, additional refining capacity and alternative energy sources should bring energy costs down to more moderate levels.

Interest rates are another area where the conventional
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Diversification by Company Size

by Walter Dixon

We continue to believe that the 18-year bull market for common stocks ended in 2000. The definitive July 2002 break in the long-term market uptrend signals that the market has probably entered a long period of consolidation or possibly further decline. However, as a famous American seer once opined, "Making predictions is hazardous, especially about the future."

We acknowledge that we might be unduly concerned; but some adjustments we have made over the past few years do reflect our wariness about stocks: (1) lower equity ratios in most portfolios, (2) focusing on the stronger segments of the market, and (3) taking a more tactical approach to changes in cyclical market trends.

Regarding item 2, above – focusing on the stronger segments of the market – the table below (courtesy of Ned Davis Research, Inc.) points out the difference in investment returns during the past 10 years from stocks of both large and small U.S. companies, foreign companies, and long-term Government bonds.

	Large U.S. Stocks	Small U.S. Stocks	Non-U.S. Stocks	Bonds
<u>Cumulative return</u>				
1995-1999	+250%	+134%	+85%	+55%
2000-2004	-11%	+95%	-4%	+63%
<u>Last 30 years</u>				
% of time with				
best annual return	16%	39%	26%	19%
Degree of risk	20	33	22	12
(higher is riskier)				

major domestic companies. Small U. S. stocks, however, were much more volatile.



The data highlight the extreme differences in returns available during the past 10 years from different segments of the market by company size. Of course, there are many factors other than company size that should be considered when making diversification decisions in a stock portfolio.

The main point is that market leadership does change whether it be small vs. large, growth vs. value, or domestic vs. foreign. Buying and holding one type of asset or segment of the market can be uncomfortable even as the short-term (say 3 to 5-year) trends change. But, it can be distinctly injurious to one's financial health when the long-term (15 to 20-year) trends change. The graph below serves to remind us of the long-term alternating trends in stock prices (in this case, large company stocks represented by the Dow Jones Industrial Average). It also illustrates the July 2002 break in the 1982-2000 secular bull market.

That same famous American sage also once said, "A person can see a lot just by looking!"

Several observations:

1. Large U.S. companies (which account for most of the return in the S&P 500 and the Dow Jones Industrials) performed extremely well in the late 1990's, but very poorly during the last 5 years.
2. Small U.S. stocks were the place to be after the early-2000 peak in the popular stock market averages. Bonds also performed relatively well as interest rates continued their long decline.
3. During the past 30 years, risk (defined as volatility of stock price) was not appreciably higher for foreign stocks than it was for



The Housing Bubble?

by Watt Dixon



It is no secret that home prices have been rising at an alarming rate, and the increase has been most dramatic since 1998. The housing market is driven mainly by mortgage rates. With the 30-year fixed mortgage rate trending down now for over 20 years, owning a home (or two), has become increasingly attractive.

This rise in home prices has been an international event, occurring in many developed countries, not just the United States. Since 1998, the huge rise in home prices has far outpaced the increase in personal incomes. Home prices rose again in the first quarter of 2005, which was the record 40th straight quarter of increasing home prices. The previous record was 34 consecutive quarters. These facts, along with speculative behavior by home buyers, raise concerns about the long-run stability in home prices.

Most people assume that house prices continue on a steady uptrend, with prices always moving higher. The chart below, borrowed from Robert Shiller's updated version of his book Irrational Exuberance, shows a different picture. From 1890 through 2004, home prices increased 66%. As you can see, most, if

not all, of that increase came in two time periods, the first being at the end of World War II. This post-war period can be somewhat misleading due to the fact that the government offered subsidies to returning soldiers, thus artificially inflating prices. The second great increase is the one we are currently experiencing, perhaps due to disenchantment with stocks after the bursting of the market bubble of the late 1990's. Other than those time periods, home prices have been flat to down. In any case that 66% return, from 1890 to 2004, represents an annual return of just 0.4%.

The stories we currently hear on cable news and read in national magazine publications show signs of a housing bubble. A bubble in any type of market, be it stock, oil, housing or tulips is defined by several characteristics. There is extreme optimism in the investment of choice, a feeling that prices cannot really go down. The general public also often has a fear of "missing the boat." People feel that they better buy now, before it is too late. Investors will often try to rationalize their behavior with the idea that things are different now than they were 20 years ago. We witnessed these types of attitudes with the dot-com, telecom and technology stocks in the late 1990's.

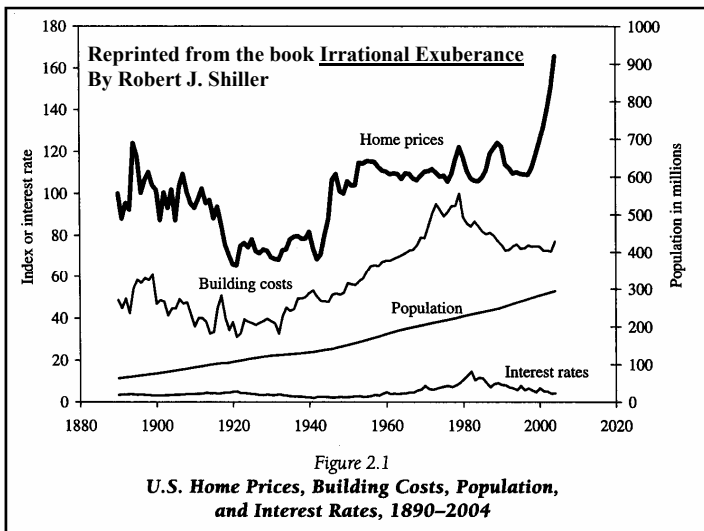
The housing market is often thought to be many smaller regional markets rather than one market, like the stock market. This has been, and still appears to be, somewhat true. However, home prices are beginning, more and more, to move as one market. As stated earlier, the rise in home prices

has not been limited to several hot cities, but has occurred through much of the U.S. and many of the developed countries. Of course, some areas have experienced faster growth than others.

A recent study by the National Association of Realtors found that 23% of all houses bought in 2004 were for investment purposes. The study also found that 13% of homes bought were second homes. In Miami, apartments are bought and sold two or three times before someone moves in. In California, over 60% of all new mortgages this year are interest-only loans, up from 8% in 2002. The national figure is one-third. These buyers are gambling that prices will continue to rise rapidly. The buyer will then sell the home for a quick profit before any principal has to be repaid. Most of these loans are adjustable rate mortgages (ARMs), leaving the borrower exposed to rising rates.

The current rate of increase that the housing market is experiencing clearly will not last. The question is whether home prices will stabilize or decline. If prices decline, as long as people can afford their mortgage payments, many will not sell until conditions improve. However, people may be forced to sell due to unforeseen events like job losses or rising rates on their adjustable mortgages. The ability to service mortgage debt can be tied to the nation's employment figures. If people lose their jobs to foreign competition, corporate layoffs, or other reasons, they could be forced to sell their homes, regardless of price.

While a housing bust similar to the stock market blow-off in 2000 seems unlikely, the housing market must eventually slow down. As with all markets, many factors will determine the degree to which the pace will slow. However, the longer prices continue to move up at the current rapid rate, the less likely the chances for a soft landing.



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wisdom has come up short. For well over a year now market forecasters have insisted that long-term interest rates must go up. To avoid a deep recession the Fed reduced short-term rates to historic lows in the wake of the burst stock market bubble and the 9/11 attacks. With our economy back on firm footing the Federal Reserve has been steadily raising short-term interest rates for a year now to correct overly accommodative monetary policy. That, along with the inflationary effects of high energy and commodity prices and an expanding economy, should have caused longer-term rates such as the yield on the ten-year Treasury note to rise. Yields have actually gone down. In fact, the yield on the ten-year Treasury is lower now (3.9%) than it was a year ago (4.6%) when the Fed started the rate hike campaign.

According to the Bank Credit Analyst, Chairman Greenspan himself has referred to this situation of declining yields while monetary policy is tightening as a "conundrum." However, the BCA has cited several reasons why yields can, and should, remain low for the foreseeable future even as the economy remains healthy:

- Globally, there is an excess of savings over demand for

capital, especially in Asia. The excess savings are invested in bonds, mainly U.S., keeping prices up and yields down.

- Globalization of the economy, particularly manufacturing capacity, is deflationary. Competition is intense, and producers find ways to absorb higher costs through greater efficiency.
- Growth in some developed economies especially Japan and Europe is weak.
- Low interest rates boost demand for housing that in turn promotes consumer spending. This allows healthy levels of economic activity while rates remain low.

Looking forward to the end of 2005, the stock market should hold up. We expect stocks to finish the year with modest gains. Since 1890 the fifth year of every decade has been a positive one for the market. Longer-term yields are likely to remain range-bound, and the Fed may well complete the tightening cycle by fall. Our investment approach continues to be flexible and careful, but optimistic.

Best wishes for a relaxing summer.