

Portfolio Update

August 2005

■ Domestic Market Commentary

July was a good month for the stock market. In our July Portfolio Update we pondered whether the rally, which began in late April, was sustainable. At least through July, the answer is "yes." We think the move higher is sensible and justified based on value and fundamentals. Stock prices were far below our estimate of fair value so prices are just trying to catch up.

There Seems to be a Pattern Here

There has been a pattern to the stock market's move higher the last couple of years. Prices get stuck in a sideways trading range while investors are concerned over various issues such as oil prices, terrorism, war, and/or Federal Reserve policy. During those times of volatile stock prices, value is not stagnant, but is increasing because of fundamentals such as interest rates and corporate earnings. Then fears subside as investors realize that the financial and economic setting is better than they had feared. Stock prices then surge as, from our perspective, prices are just trying to catch up with value. This pattern of sideways volatility followed by surges or rallies has repeated itself the last couple of years.

Rally Participation

Participating in the rallies is critical for earning the returns available in the stock market. To participate, an investor has to be invested when the rallies begin. We believe it is impossible to consistently predict the exact beginning of these rallies. Our approach to these market conditions is to concentrate on value and be invested if price is below fair value. That often means riding through choppy periods such as the first four months of this year and the first seven and a half months of 2004.

During the choppiness earlier this year, some observers thought that the increase in oil prices would slow the economy. There is no evidence of that as GDP was announced July 29. Some observers predicted the higher oil prices would cause inflation to increase. We disagreed and so far there is no evidence of higher inflation. Now as investors are realizing that the fundamentals of equity valuations are just fine, stock prices are moving up towards our estimate of fair value.

Current Valuation

Now, back to the question as to whether this rally is sustainable. Based on value, we think it is. We measure stock prices, on average, to be about 18% below our estimate of fair value. Of course, surprise news events could interrupt the rally and set prices back, but value defends the case for the market to move higher later this year.

The industry and sector leadership was clear in July. Generally, industries that are economically sensitive or cyclical led the way. Industry examples include steel, construction materials, and railroads among the top industries for July. Among the bottom are industries not sensitive to economic condition such as education services, brewers, and distiller & vintners. The move higher is very broad as only 16 of the 139 Standard & Poor's Industry Indexes were negative in July.

■ Bond Commentary

The Federal Reserve has continued to drain reserves from the banking system which has raised short-term interest rates. The annualized yield on the 6-month Treasury Bill is now 3.68% — a year ago it was 1.76%. Monetary policy and short-term interest rates are not what determine long-term interest rates lately. We believe the determining factor for

long-term interest rates is inflation expectation. The Consumer Price Index (CPI) was down .1% in May and was unchanged in June. For the 12 month period ending June 30, 2005 the CPI advanced 2.5%. With such a docile inflation setting, bond investors have not seen the need to price higher yields into bonds. It appears bond investors view the tighter monetary policy as favorable, meaning it will prevent higher inflation.

■ International Market Commentary

July appeared quite synchronized for international markets. Most international markets moved higher, just like the U.S. markets. The rally seems to be global, which agrees with our valuation readings and the view that stock prices are just catching up to value. Most international markets struggled early this year driven by the same concerns as in the U.S. Investors worldwide are realizing the economic and financial setting is better than they had feared earlier this year. Similar to the domestic market, news events could interrupt the rally and even send prices lower, but based on valuation, we expect higher stock prices later this year.

■ Summary

Whether it is good economic data or good corporate earnings, investors and the media seem surprised by good news. There is some horrible news from around the world on television, but it is incorrect to think that it always affects the economy and corporate earnings. The fundamentals for valuations are quite favorable. Long-term interest rates are fairly low, and corporate earnings are generally growing. We expect the stock prices to move higher; subject to jolts and setbacks as news events jostle investors.

Yours truly,



Craig T. Callahan, DBA
President

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Data Source: Bloomberg
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