

June 2005

Following a dismal equity decline in April, U.S. stock markets rebounded nicely during May and June. Overall equity averages, however, remain in negative territory for 2005. The increases were largely attributable to strong economic data that alleviated concerns of a slowing in the U.S. economic expansion. The most significant news was the revision of U.S. first quarter GDP upwards from 3.1% to 3.5%. This continuation of above trend growth was supplemented by strong retail sales data and benign inflation numbers. These positive figures were reflected in Consumer Sentiment indicators that pushed to a three-year high.

U.S. large cap equities fared better than their international counterparts during the second quarter and have outperformed on a relative basis during 2005. This result is misleading as it is dominated by currency effects. The U.S. dollar continued strengthening versus foreign currencies which eroded much of the gains made in the EAFE index. Thus far this year, the U.S. dollar has gained 11% and 7% versus the Euro and the Yen, respectively. Despite these short term swings, we remain committed to international diversification as a means of protecting client portfolios from the building pressures present within the U.S. economy.

Index	June	YTD
S&P500	.14%	-.81%
Nasdaq Composite	-.54%	-5.45%
Russell 3000	.70%	-.01%
Russell 2000	3.86%	-1.25%
MSCI EAFE (US\$)	1.37%	-.85%
MSCI Emg Mkts (US\$)	3.45%	6.26%
Lehman Agg Bond	.55%	2.51%

While economic growth continues at a healthy pace, growing deficits and high personal leverage persist within U.S. markets. Long term interest rates remain near historic lows despite the efforts of Fed Chairman Alan Greenspan. The combination of low interest rates and speculation within regional housing markets has the Fed Chairman genuinely concerned. The Fed has initiated nine rate hikes as a part of the current tightening cycle, and while short term rates have played along, the long end of the yield curve has continued to fall lower. This led Greenspan to term the situation “a conundrum” and most recently led him to voice concerns about speculative pressures in the housing market. For anyone familiar with Chairman Greenspan’s tendency to carefully orchestrate his words, these strong statements should give you insight into just how precarious he views the markets disregard for the Federal Reserve Board’s efforts. The positive to all of this is that the Fed seems less concerned with an economic slowdown and continues to nudge rates higher in hopes of staving off domestic inflation and an overheated economy. For the moment, corporate America seems to be the only one minding the store. Corporate balance sheets are flush with cash (leading to a sharp increase in merger activity), however, both the U.S. government and the U.S. consumer are highly leveraged. This leverage is providing an excess of liquidity that is propping up financial assets. At some point, the piper will come calling and a potentially painful reversal could result.

So far, 2005 has been dominated by a continuing long-run theme that has provided the backdrop for the world markets: Globalization. Whether it is China’s trade surplus, labor competition from India, or global demand for limited resources, more and more the interplay between world economies is affecting market performance here at home. If the world economy can unwind its imbalances, support may finally emerge and set the stage for the next long term push upwards in equities.