



INVESTMENT STRATEGY UPDATE

July 1, 2004

PROBABILITIES AND CONSEQUENCES

In structuring investment portfolios, we at BTR consider a range of possible outcomes. What are the probabilities and likely consequences of each? But there is more. As an investment manager that specializes in individually-tailored client portfolios, we must also consider what our client has asked us to accomplish. And, what is his or her willingness to accept risk? The next step is building a portfolio structure that is designed to balance the client's return objectives with his or her risk tolerance. In the current environment of heightened event risk, the risk/reward trade-off seems disproportionate. Thus, the client portion of our focus seems particularly important.

We have commented extensively in recent *Investment Strategy Updates*, on our financial-market expectations for the next several years. We anticipate that the current recovery rally off the secular bear market bottom will most likely be followed by a series of cyclical bull and bear markets, much like those which occurred during the second half of the 1970s. The overall result, in our opinion, will be relatively modest net progress. We believe that a key to investment success in the coming environment will be to proactively utilize the expected periods of strength and weakness to vary asset allocation and shift sector and industry concentration. Note that we are talking about modest, sometimes subtle shifts, and not major market timing moves. Our expectation is that the period ahead will favor those investors with a willingness to occasionally hold some defensive cash, as well as those with the strength of conviction to sometimes be out of sync with the existing stock market trend.

So here we stand. The fundamental environment remains quite strong. And that strength, combined with the benefit of historical perspective, suggests that there is more upside ahead. Yet, with the uptrend aging, the largest part of the recovery rally is seemingly behind us. The risks appear to be rising as well, be they related to Iraq, politics, oil prices, or terrorism, and the consequences for stocks could be quite negative. Given the current mix of opportunity and risk, we focus on an important question, "What would our clients want us to do?"

The Months Ahead

There are a number of reasons to remain positive about the intermediate-term stock market outlook. The economy is expanding nicely, corporate earnings are very strong, and inflation and interest rates remain quite low. 2004 is a presidential election year as well as the second year of a bear market recovery. Historically, both occasions have been accompanied by favorable stock market returns. Furthermore, for at least the time being, the Federal Reserve Board remains in a highly stimulative posture.

The fact that the stock market is not particularly cheap would seem to limit upside potential. Yet, stocks are not that expensive either, particularly when considering the current level of interest rates and the pace at which earnings have been rising. From a fundamental standpoint, the stock market should not come into any real danger until the monetary environment becomes more hostile.

Inflationary pressures have been building, and with this week's one-quarter point increase in the federal funds target rate, the Federal Reserve Board has started the process of raising short-term interest rates. As a result, a lot of investors are worried that the more hostile monetary environment mentioned above is right around the corner, and that it would be bad for stocks. We disagree. In its battle against the deflationary pressures that followed the bursting of the great technology bubble, the Federal Reserve Board reduced the fed funds rate to 1%, its lowest level in forty-one years. There it stood for twelve months, until this week. Since we believe a policy-neutral fed funds rate would be at least 3%, the current 1¼% rate is really quite far below equilibrium. From here, it seems there would be a lot of room left to raise short-term interest rates before the higher rates would actually have a restrictive effect on the economy.

S&P 500 Performance After Federal Reserve Rate Increases 1946 To Date Median Returns								
		7	14	22	63	126	190	252
	# Of	Trading	Trading	Trading	Trading	Trading	Trading	Trading
	Cases	Days	Days	Days	Days	Days	Days	Days
	*****	*****	*****	*****	*****	*****	*****	*****
1st increase	15	-0.57%	1.09%	0.76%	-0.99%	3.91%	6.26%	9.87%
2nd increase	12	0.05%	0.49%	0.96%	-0.32%	3.93%	7.27%	6.45%
3rd increase	12	0.23%	-0.24%	-0.36%	0.13%	3.46%	1.62%	-2.72%
4th increase	8	0.33%	0.45%	1.95%	3.83%	-1.37%	-1.93%	-2.79%
5th increase	5	-1.44%	0.48%	-1.12%	1.60%	-5.38%	-5.67%	-2.86%
6th increase	3	0.13%	2.97%	-1.92%	-6.43%	-5.20%	-3.25%	-6.98%
Average For Entire 1946 To Date		0.23%	0.45%	0.71%	2.04%	4.19%	6.45%	8.67%

Source: The Leuthold Group

There is an old stock market adage: "three steps and stumble." Essentially, it suggests that the stock market is likely to thrive until the Federal Reserve Board takes its third step toward a tighter monetary policy. In fact, as shown in the chart above, in the six to twelve months following the first two Fed-driven interest rate increases, the stock

market has fared quite well. That's because, typically, the Fed's earliest moves are more a reflection that an improving economy requires less stimulation, than they are an intention to combat a rising inflationary risk.

But our opinion is that the current situation is really quite different from past experience. And this time, we do not believe the "three steps and stumble" rule will hold true. Given that Fed Chairman Alan Greenspan is such a gradualist and that this is an election year, it seems probable that additional increases in the fed funds target rate will continue to come in relatively small increments. Therefore, we do not think it will be until sometime next year that the Fed actually becomes restrictive enough to negatively affect the stock market. Longer-term, our interest rate targets are 4% for Fed Funds and 6% for the ten-year Treasury note.

The Bearish Case

Most of the bearish camp's arguments focus on longer-term problems, such as the excessive levels of government and consumer debt, and on the fact that in the years following previous speculative bubbles stock market valuations fell to very low levels. We would comment that in those previous instances, the very low valuations were a result of economic distortions caused by significant mistakes in monetary policy. That has not been the case this time. Shorter term, in addition to rising interest rates, the bears worry about the economic drag from very high oil prices and the seemingly increasing potential for negative geopolitical events.

Regarding oil prices, there is little doubt that the very high price of energy is placing a drain on world economic growth. But in a testament to the underlying strength of the recovery, the drag thus far has been only moderate, and certainly not strong enough to stall the recovery. It seems to us that speculators in energy futures have provided the major momentum behind the most recent boost in oil prices, but currently, that speculation shows signs of waning. Furthermore, history has demonstrated that the energy markets have a strong tendency to be self correcting. During previous episodes of very high oil prices, the demand for oil fell, while on the supply side, exploration and production rose. Our expectation is that oil prices will retreat further from current levels, barring further threats to Middle Eastern oil supplies.

Insofar as geopolitical risks are concerned, we believe the stock market would be a lot higher now, were it not for the threat of terrorism. It is very difficult to estimate the probabilities of terrorist acts or the likely financial and economic effects. Unfortunately, the threats are very real. Al Qaeda, for instance, has the stated goal of chasing the Western infidels out of Saudi Arabia and subsequently toppling the Saudi Royal Family, events which would certainly affect oil prices. Closer to home, we are told that U.S. intelligence capabilities have improved significantly. But disparate and embedded terrorist cells tend to operate independently of their parent organizations and are not easily infiltrated. By their actions in Spain, the terrorists learned that they could affect the election outcome in a free nation. We can only imagine that Al Qaeda would love to take credit for an act aimed at displacing the Bush administration. Our government recently issued a heightened terrorist alert. We are inclined to believe that the timing of that alert was not politically motivated, as we have little doubt that terrorist plans

against the U.S. are in the works. Of course, we have no idea as to their intended scope, or whether we will be able to successfully block their heinous efforts.

Conclusion

All in all, positive fundamentals would seem to indicate the likely continuation of the current bullish stock market trend into at least the later part of this year and perhaps into the early months of next year. But with current valuations relatively full, the upside potential does seem limited. At the same time, the *things that go bump in the night*-type of risks appear to be rising. And, at least some of the events we can imagine would likely have very negative short-term consequences for stock prices.

So while the probabilities favor the bulls among us, the consequences of being wrong are quite asymmetrical. Our instincts suggest that it would be prudent to utilize future stock market strength to modestly pare our equity exposure – subject, of course, to account-specific guidelines. That, we believe, is what most of our clients would want us to do.

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