AUGUST 2005 — MARKET REPORT

BULLISH BUT MORE CAUTIOUS

The question now on some investors' minds is when will the Fed stop raising key interest rates? The answer lies largely within the bond market, where the yield curve has been flattening. Although Chairman Greenspan implied that the Fed is not influenced by the yield curve, don't believe it. The already flattening yield curve is hindering earnings at major banks. Putting it mildly, a chokehold on the major banks at this point would not be an ideal situation for the economy. Regardless, now that the 10-year Treasury bond yield has risen from only 3.9% to over 4.25% in the past month, the Fed may still have enough room to raise key short-term interest rates at least once, maybe two more times after August 9.

Chairman Greenspan implied that the Fed is keeping a close eye on labor costs. Clearly, the labor market in the U.S. remains very strong. However, Hewlett-Packard and some other major companies recently announced substantial layoffs. What is essentially happening is that major U.S. companies are continuing to outsource jobs, which is why labor costs have not risen as much as they did during similar stages of previous cycles.

Jobs data alone will not be enough to put a halt to the interest rate increases. There are just too many signs of an improving economy that will force the Fed to lean toward the hawkish side by raising rates a bit more. Consumers, which are about 70% of the economy, remain very upbeat. Once again, the consumer is proving to be a lot more resilient toward higher energy costs than many would have guessed. They are, quite simply, continuing to shop. Specifically, the weekly Redbook chain-store sales figures have been on fire lately, indicating that year-over-year sales are surging by 4.5%, the highest since June 2004.

Some observers believe American consumers are pumped up on debt and spending money they aren't earning. They note that the personal savings rate is down to zero. That's true; however, the strength in consumer and business spending is mostly based on solid gains in productivity, real pay per worker, and profits.

What's driving consumers? Real pay per worker is rising twice as fast as employment. The former is up 3%, while the latter is up 1.6% year-over-year. Together, they drive workers' purchasing power, which is up 4.6% before taxes. Together, they also drive real personal income, real disposable income, and real consumer spending, which are up 3.8%, 2.5%, and 3.9%, respectively. The personal savings rate is near zero. We are not concerned. Retiree spending is included in consumption, but their retirement incomes are not included in personal income, while the lower pension contributions are included.

Factories have big momentum. Orders are coming in at a fast pace and product is moving out fast too. Demand has been especially strong for machinery and high-tech equipment. This is bullish for the earnings and stock prices for several industries: 1) Construction & Farm Machinery & Heavy Trucks 2) Aerospace & Defense (L-3 Communications) 3) Semiconductors (Intel) and 4) Oil & Gas Equipment & Services (Schlumberger).

BULLISH BUT MORE CAUTIOUS (continued)

In conclusion, GDP growth is very solid, inflation is flat, employment costs appear to be in check, consumers are spending with confidence, corporate balance sheets are incredibly strong, earnings are up, for the 10th consecutive quarter, better than expected, and the Fed is, if anything, hedging risks several months in advance, unlike some previous cycles where it acted too slowly. And all this is occurring while stock valuations are low! It may not get any better than this!

We're obviously very bullish; nonetheless, this isn't the time to get reckless and buy the hype stocks. We expect that the stock market will become increasing selective as the second-quarter earnings announcement season continues, and we are now in the dog days of summer, when many Wall Street professionals have vacation on their minds more than investing, so any big rallies may be postponed until after Labor Day.

Our best bet is to stay disciplined, and remain diversified in a portfolio of fundamentally superior stocks. As always, we're eager to answer questions, so give us a call!