



## INVESTMENT UPDATE

January 2005

### **Economic Conditions & Market Outlook**

True economists are natural worriers. While Wall Street's market strategists often lean toward a 'glass half full' optimism when looking forward, pure practitioners of the dismal science tend to be a much more dour bunch.

And who can blame them? To begin with, the almost infinite number of variables potentially impacting the economy makes accurate forecasting a difficult task. Besides, it's much safer to identify economic factors that *may* go wrong as opposed to ones that *will* go right. Combine that inherent uncertainty with the current scenario of rising dual deficits (budget and trade), a falling U.S. dollar value, slowing corporate profit growth, yo-yoing oil prices and even an optimist might be hard pressed to predict a positive economic environment in 2005.

But that is exactly what the majority of fifty-six economists recently surveyed by the Wall Street Journal suggested the upcoming year was going to provide; a 'Goldilocks' economy that's neither too hot nor too cold. The consensus outlook of the group was that gross domestic product (GDP), the broadest aggregate measure of overall economic activity, would continue with a modest expansion of 3.6% in 2005. This projection is slightly below the 3.9% rate realized through the third quarter of 2004 but still reflects rather healthy, albeit controlled, economic growth.

Roof Advisory Group shares this moderately optimistic view of the economy for the upcoming year with the caveat that several key factors could make or break forward economic momentum in 2005. A few of these are outlined below.

While the expanding U.S. budget deficit is a significant long term concern that needs to be addressed, its direct impact on 2005 appears to be somewhat limited. As noted in our previous Investment Update, the move by the Federal Reserve in mid 2004 away from a stimulatory stance via the start of a progressive increase in the federal funds interest rate is not a bad thing since it indicates our economy needs less fiscal stimulation to remain healthy. However, it would not be positive if unexpected inflation prompted the Fed to raise interest rates more aggressively than planned. Near term, we see possible inflationary pressures coming less from U.S. budget deficit-related issues and more from changes in commodity pricing, specifically oil.

It's hard to overemphasize the impact of oil price changes on the petroleum dependant U.S. economy. While the price of oil has fluctuated dramatically over the years; not too long ago it was thought that a consistent \$40 plus price tag per barrel would, well, put us over one. Even though the late 2004 price spike to \$56 per barrel was not sustainable at the time, the end result has been a current dollar per barrel average that remains well above the previous price ceiling. While the current pricing level may be manageable, continued volatility in oil pricing could easily disrupt 2005's economic outlook.

Likewise, the now-record U.S. trade deficit continues to receive much attention. Frankly, it's hard to remember a time when our trade imbalance did not receive attention. While many experts thought falling dollar prices and record exports would narrow the gap, the above mentioned increase in foreign petroleum prices actually exacerbated the issue. Most importantly, the trade deficit continues to be pressured by the U.S. consumer's nearly insatiable appetite for foreign goods, which we see as another potential Achilles heel for 2005's moderately improving economy. Not the continued U.S. consumption of foreign goods per se but continued consumption by U.S. consumers...period.

For the past several years, U.S. consumer spending has fueled our domestic economy - long after many economists thought corporate spending would return as the main engine of growth. This consumer-buying bonanza occurred as lower interest rates created more personal disposable income, home equity was the piggy bank to be tapped and credit card borrowing reached an all time high.

(over)

When combined with recent mediocre job/wage growth and a limp average household savings level (October 2004's savings rate was .2%... yes, that's two-tenths of one percent - the lowest level since the U.S. Commerce Department started tracking the data in 1959) and it is not hard to imagine a potential problem. Maybe the U.S. consumer will have to cut back on their rate of spending because there's not much left in the pocketbook to be spent. If this occurs, and is not offset by overdue increases in corporate spending, 2005 could be more 'dud' than just dull.

While continued awareness of the economic pulse is extremely important, remember the economy and the investment markets do not necessarily move in lock step. As a recent example, both the Dow Jones Industrial Average and the Standard & Poor's 500 stock indices remained underwater through mid-October despite paced economic growth in 2004 and only surged into positive numbers after a notable yearend rally. Listed below are a few of the market related factors we feel could be significant in the upcoming year.

Corporate profits, which began last year by rising at an accelerated pace of 20% after predictably bouncing at the beginning of the recovery in 2003, should settle down closer to the normal historical growth average of 7%. In this type of environment, stocks with higher price to earnings ratios will be more susceptible to depreciation if their earnings do not match investor's expectations. Conversely, many companies have accumulated significant cash positions and will feel pressure to initiate or increase distributions to investors via dividend payments. Both factors are beneficial to our firm's equity management style.

Higher than expected interest rates or inflation will also negatively affect corporate profits and therefore equity prices. However, upward pressure on bond yields has been somewhat checked by high buyer demand from foreign central banks looking to control the value of their currency in relation to the U.S. dollar. This demand has meant interest rates have not had to rise notably to attract buyers. Should this foreign appetite wane, rates could move up, impacting both the fixed income and equity markets.

It is important to note that neither economic nor market factors can be accurately predicted nor directly controlled. We are firm believers that successful long-term asset management is not the result of crystal-ball prognostication but instead results from the diligent focus on portfolio fundamentals and the nimble response to inevitably changing markets.

### **Our Tactical Investment Stance**

Roof Advisory Group's disciplined strategic investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's personal investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- For the majority of clientele, we remain ***one step below maximum equity allocation*** as defined by their individual investment policy. The firm has maintained this equity position throughout 2004 after incrementally increasing equity exposure from a minimum equity allocation beginning in April 2003; a position that helped cushion portfolio depreciation during the dramatically declining market of the period. For the past several months, the firm has been weighing a possible change in the allocation weighting but the relative attractiveness of stocks versus bonds from a total return perspective does not warrant a shift at the present time.

- We continue to ***add new equity positions*** when attractive buying opportunities are presented. The firm's individual equity focus favors companies with solid management, consistent earnings, low P/E ratios (18 or below), dividend yield (2%+), and annual appreciation potential (10%+). Stocks outside these parameters are also used when unique pricing or appreciation opportunities exist. Equities are sold if they no longer meet the parameters prompting their original purchase or when reaching a predetermined price target.

- Our general allocation ***bias towards large cap stocks*** has served client's well and remains intact. Mid/small cap equity exposure is typically at mid-point or below defined policy range. Any specific international equity exposure has been, and will continue to remain, incidental. As outlined previously, individual stocks of companies with strong bottom-line fundamentals, attractive valuations, and consistent dividend yields are used in appropriately sized equity portfolios. These positions are often blended with managed funds that are complementary to that portfolio's objectives and diversification.

- As always, ***diversification remains a priority*** in our management approach. Overall portfolio exposure in equities is regularly evaluated for diversification based on management style, business grouping, and industry sector while fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region.

While the firm does not make deliberate industry sector bets, above-benchmark concentrations can result from our equity selection process. At present, ***Energy, Industrial Materials, Utilities, Consumer Staples*** and ***Telecom*** are often held at ***slightly above index weightings*** when compared to S&P 500 levels while Software and Consumer Services are currently below benchmark level.

- New accounts and large cash infusions are typically phased into their targeted investment policy levels. During phase-in, the ***deployment of cash for equity purchases was accelerated*** in early September 2004 and remains a bit higher than the norm. ***Deployment of cash for bond purchases remains slower than the norm***, with overall repositioning of cash for bonds being very deliberate in the rising interest environment. This will accelerate as bond yields improve.

- Individual bonds are used for larger fixed income portfolios to control quality, maturity, and yield. High-quality, ***investment grade bonds*** (BBB and better) of short to intermediate term maturity (5-15 years) are emphasized in our fixed income management. For taxable bonds, the firm tends to favor the yield pick-up typically offered by corporate paper, although some recent U.S. Agency issues have been attractively priced and selectively used. A client's tax bracket/account type determines whether taxable or tax-free bonds are more advantageous.

We maintain a ***shortened average maturity of 5-7 years*** on our typical fixed income portfolio in anticipation of increasing interest rates. Overall portfolio bond quality is never sacrificed in the pursuit of higher yield.

E. Jeffrey Roof