

Economic Conditions & Market Outlook

What a difference a year makes. Economic data through May 2004 continues to be positive; dousing any lingering fears that the broad-based but paced economic recovery is indeed valid or will somehow vaporize at the first sign of stress.

For example, Gross Domestic Product (GDP) is an aggregate measure of overall economic activity and is probably the widely followed indicator of the economy's current health. Movement in GDP is what matters. First quarter 2004 GDP weighed in at 4.2 versus the 2.0 figure reported in first quarter 2003, a notable improvement. Lingering naysayers may note that some forecasters targeted a 5.0 number for this year's first three months but our sense is this is a 'glass half empty' view of what has been a solid economic turnaround.

The Composite Index of Leading Economic Indicators also rose again in March 2004 and is well off its low of a year earlier. This index is widely seen as a forward-looking gauge of economic activity over the next six months and points toward economic momentum remaining strong into at least the third quarter.

More specialized indicators also look positive. First quarter productivity rose at a 3.5% rate. Durable goods orders, factory shipments, consumer confidence, construction spending, and a litany of other measures were up in both quarterly and year over year comparisons.

Domestic manufacturing activity continues to grow at a healthy pace. The Institute for Supply Management (ISM) manufacturing index registered 62.4 in April - the sixth straight month the number topped 60 - well above March 2003's reading of 46.2. Any index number above 50 indicates an expansion in the country's overall manufacturing activity. Correspondingly, the ISM manufacturing employment index rose to 57.8, well above the index level (48) that indicates an increase in manufacturing employment.

This is important because jobs-related improvement has been the last area to experience any notable rebound during this recovery and, until recently, had provided skeptics with their last claim/salvo/argument that the U.S. economy was not heading in the right direction. Weekly new unemployment claims continue to drop significantly during 2004, ending the week of May 1 at 315,000. This is down markedly from the 453,000 jobless claims reported a year earlier. Additionally, April's recently released payroll figures continue an eight month upward trend in new jobs creation. April's surprisingly strong jobs number, combined with March's upward revision of the same measure, eliminates the notion that this is a 'jobless recovery'.

Much has been made of the delayed improvement of U.S. jobs, with many attempting to directly attribute this lag to politically polarizing issues (yes folks, it's election time again!) ranging from economic globalization and free trade to third-world job outsourcing and weakened unions. While some of these factors may have contributed to the stubbornness of employment figures bouncing back, new job expansion is typically the last result of an improving economy, particularly when productivity remains such a key measure of corporate success and companies control costs by delaying new hires as long as possible.

Reported company results have also been quite positive with corporate sales and earnings continuing to show increases, often with a notable upside surprise. In summary, the majority of indicators point to an ever-improving economic environment that should produce a solid foundation for fundamental market growth.

Does all this good economic news necessarily translate into a rosy path ahead for U.S. equities? Oh, that things were so simple. Several factors are providing a headwind against a smooth sailing stock market.

The first are temporary and somewhat psychological. Similar to the cynic's observance that, "No good deed goes unpunished," the most recent stock market response to good economic news has been a resounding, 'yeah, but...' For example, when April's surprisingly strong payroll figures were released the first Friday in May, helping substantiate a sustained economic rebound, the Dow Jones stock market index promptly shed 250 points during the next two days to close at its lowest point to date in 2004. Why this seemingly irrational response?

Because a strengthening economy means the Federal Reserve will start to raise interest rates sooner as opposed to later. Is this a bad thing? Not in our opinion. Interest rates had been dramatically lowered during the past recession to help prime the spending pump. Now that the economy is up and running, there is no need to continue to stimulate spending by keeping interest rates at 46 year lows.

While the market may recognize the necessity of a change in interest rate movement, it has historically despised the uncertainty of not knowing when or how much. Add rising oil prices and fear of inflation to the mix and you have a recipe that results in some of the recent market volatility. Once the Fed actually starts shifting away from its stimulatory position and begins to gradually increase rates, historically the market has tended to refocus on the more important fundamental issues and respond positively.

A second group of factors are more unpredictable and potentially more bothersome. Ever-increasing worldwide geopolitical tensions, global terrorism, and the ongoing war in Iraq all offer some wild card scenarios that could certainly create the disruption necessary to derail all current momentum in the economy. Likewise, daily news of international turmoil can easily overshadow positive economics results and create notable market drag.

The burgeoning federal debt is also a significant long term issue of concern. This firm does not adhere to the "How I Learned to Stop Worrying and Love the Deficit" school of thought apparently embraced at present by both political parties. Several years ago when stock market prices ballooned beyond all reason, we continually reminded investors that sooner or later the basic principles of Accounting 101 would again be applied to equity valuation. The readjustment to this reality was not pretty. The same applies to the federal government spending without a clue as to how this debt will be repaid. The reality is that at some point we all will be paying the bill.

Our Investment Stance

Roof Advisory Group's disciplined investment approach focuses on strategies designed to add value to client portfolios while controlling downside risk. These strategies include clearly defined investment policy ranges based on each client's personal investment objectives/risk tolerance, ongoing evaluation of relative portfolio return, and monitoring portfolio adherence to benchmark parameters.

Every client situation is unique, but outlined below are a few of the general tactics currently being applied:

- For the majority of clientele, we are ***one step below the maximum equity allocation*** as defined by their individual investment policy. In April 2003, the firm started moving off the *minimum* equity policy allocation we had maintained for several years; a position that helped our clients preserve portfolio value during the dramatically declining market. The move towards a *maximum* equity allocation accelerated throughout last summer but, as always, remained incremental and disciplined. At present, we see no reason to shift the current equity allocation position. However, ongoing international geopolitical factors continue to be weighed for a potential change in stance.
- We continue to ***selectively add equities*** when attractive buying opportunities are presented. Overall, individual equity focus tends to favor 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. Likewise, equities are sold when they reach their price target or no longer meet the parameters prompting their original purchase.

- As always, ***diversification remains a priority*** in our management approach. Equities are diversified based on industry group and business sector. Some above-benchmark concentrations may result when a portfolio's equity position contributes toward a specific objective, such as consistent yield. Fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region.
- At present, our ***bias towards large cap stocks*** with strong balance sheets remains intact. Mid/small cap equity exposure is at *mid-point* or below within policy standards. 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 the portfolio's objectives and enhance diversification.
- 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. The anticipation of increasing interest rates has prompted a ***shortening of the average maturity*** in our typical fixed income portfolio to approximately 5-7 years. Overall bond quality is not sacrificed in the pursuit of higher yield. A client's tax bracket/account type determines whether taxable or tax-free bonds are more advantageous.
- New accounts and large cash infusions are typically phased into their targeted investment policy levels. During the past several months, this ***repositioning of cash has been very selective*** due to less attractive valuations in equities and generally unappealing yields in bonds. Overall repositioning of cash will accelerate as the market stabilizes and bond yields improve.

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