



<u>1st Quarter 2005</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	10,503.76	↓2.59%
Standard & Poor's 500 Index:	1,180.59	↓2.15%
10-Year Treasury Yield:	4.45%	

Investment Outlook

March 31, 2005

Dear Investors,

I would like to start with a personal note. You are all receiving this letter about one week later than you would normally receive it—but there is a good reason for that. That reason came into the world on Tuesday, March 29th. He weighed 9 pounds and one ounce and was 21 inches long. Janet and I named him Evan, and both he and his wonderful mother are in great shape. Now, on to investment matters. . .

The first quarter of 2005, at least from an investment perspective, was mostly one to forget. It was one of those quarters in which very little worked. The broad U.S. stock indexes were red, bonds gave up ground as interest rates moved higher, and even international stocks—from the perspective of U.S.-dollar-based investors—did poorly because the dollar gained ground against many foreign currencies.

In previous letters I have opined that an unexpectedly large increase in the rate of inflation would bode ill for both stocks and bonds. Well, we did not get hard confirmation of much higher inflation during the quarter. What we got, however, was an acknowledgement from the Federal Open Market Committee that higher inflation might be on the horizon. Specifically, the FOMC stated that “pressures on inflation have picked up in recent months and pricing power is more evident.” This is the first serious warning that the Fed has issued concerning inflation, and it is a signal that the Fed may have to begin a more aggressive regime of interest rate increases should the inflation outlook become more ominous. Both stock and bond markets responded by moving lower.

There are at least three major challenges that the U.S. stock market faces for the balance of 2005. The first is the prospect of higher interest rates. Investors everywhere have been worried about what sort of toll higher interest rates will exact on stocks, bonds, and real estate. The U.S. (to include the government, consumers, and corporations) has more aggregate debt outstanding now than it has ever had. As interest rates go up, this debt becomes more expensive to service. Consequently, when rates rise more money will go toward servicing debt—meaning there is less to put toward investment and consumption. Another dynamic of rising rates that is negative for the equity markets is the competition that higher-yielding instruments will pose for capital. With the 10-year U.S. Treasury note yielding less than 4.5%, the bondholder, after inflation and taxes, is reaping little or no return.

Should the 10-year Treasury yield move to 6%, however, money originally earmarked by investors for equities may get diverted to the bond market instead.

The second challenge the market faces is the rising cost of energy. The total outlay for energy in the U.S., as a percentage of GDP, has, however, fallen markedly over the past few decades as our economy has become more service-oriented and less manufacturing-oriented. Analysts are fond of pointing out that, adjusted for inflation, gas prices are still about 20% below the all-time highs reached in the 1970s. While the above are true, it is likely that sustained high gas prices will begin to erode first the confidence and then the expenditures of U.S. consumers. And because the consumer accounts for about two-thirds of economic activity, investors fear a cowed consumer.

The third challenge the stock market faces in 2005 is a slowing rate of earnings growth. After torrid growth in 2004, corporate earnings are likely to grow in the single digits for the next couple of years. The economy is still growing at a healthy rate, but the question remains: will the economy grow into the aforementioned headwinds at a rate that is fast enough to move stocks higher?

Overseas the economic environment is mostly in decent shape. Europe is still mired in a low-growth mode, but the emerging economies of Asia are helping global growth. The major cloud on the horizon for overseas markets is a potential slowdown in China. Of course the timing of this event will be difficult to predict, as will its ultimate impact on the suppliers of its raw materials. As a manufacturer of goods for global companies, China has a firm foothold; as a consumer of finished goods, however, the country is still in its infancy. Any downturn will likely be a mere blip on China's long, steep growth curve.

Investors should, in my view, remain well diversified by geography and by industry, and should settle in for the prospect of several years of single-digit returns. Because the broad indexes will not likely see large returns, capital should be steered toward companies that have some competitive advantage that will allow them to make headway in a sluggish economy. On the fixed income side of the equation, it would be prudent to keep maturities short and credit risk low.

My investment advisor registration, Form ADV, is being updated for 2005. Please let me know if you would like me to send you a copy.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

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