



<u>2<sup>nd</sup> Quarter 2004</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	10,435.48	0.75%
Standard & Poor's 500 Index:	1,140.84	1.3%
10-Year Treasury Yield:	4.59%	

## **Investment Outlook**

### **June 30, 2004**

Dear Investors,

During the second quarter of 2004, the stock market behaved much as it did in the first quarter. The broad market indexes spent the quarter gyrating around the flat line, then moved slightly higher as the quarter ended. The Dow Jones Industrial Average increased 0.75%, leaving it down a fraction of one percent year-to-date. The S&P 500 edged ahead by 1.3%. The bond market, however, behaved the opposite as it did in the first quarter. Interest rates on the 10-Year Treasury note increased from 3.85% to 4.59% by the end of the quarter, causing this benchmark note to plummet 4.93%. Bond investors may have to endure more such quarters in the years ahead.

The global economy is chugging along satisfactorily, but it is not quite as strong as it was three months ago. Japan continues to make progress in rebuilding investors' confidence. The Nikkei gained 1.2% for the quarter after a GDP growth rate for the first quarter that clocked in at a hefty 6.1%. Other parts of Asia suffered, however, as the Chinese leadership has made known its intention to tighten credit standards in order to keep growth from getting out of hand. Europe's markets performed fairly well during the quarter, but investors remain concerned that the European Central Bank's lofty interest rates are hampering growth potential. Nevertheless, Europe is benefiting from the growth occurring in other regions of the world.

The U.S. economy appears to have slowed significantly in June. Non-farm payroll increases of 112,000 for June were about half of what economists expected. June auto sales were down 4% for the month, the worst performance in 16 months despite the high levels of incentives that dealers continue to offer. Several big software companies told Wall Street that their second quarter results would not live up to expectations because many large business customers had slowed their buying. Exiting the first quarter, investors were wondering how fast interest rates would rise and how long corporate profits could keep up their pace of growth. Now, three months later, investors are facing a very different question: how long will this slowdown last?

What has happened since the end of the first quarter, when growth seemed to be on very firm footing? In my view a combination of factors have come together to slow both consumer and business spending. The consumer is being hit three ways. First, the recent tax cuts are now having a diminishing impact on spending. Second, high gas prices are cutting into consumers' discretionary spending. Third, the cash spigot of mortgage refinancing and home equity loans is being turned down as rates edge higher. Job and income growth have simply not yet been strong enough to offset these

three factors. Businesses are being very stingy as well, despite the fact that as a whole they have plenty of cash on their balance sheets. Technology companies in particular are finding their customers reluctant to begin big, new build-outs of infrastructure. The economy is thus facing a sort of chicken-and-egg problem. Businesses seeing a slowing consumer feel less pressure to invest in new projects and hire new workers, while consumer spending may not pick up markedly without job and income growth.

From an investment standpoint, slowing growth is not necessarily a bad thing. A less than stellar rate of economic growth may obviate the need of the Federal Reserve to slow the economy through a sustained succession of interest rate increases. The net effect might be a longer, albeit slower, economic expansion. Bond yields would remain lower in this scenario than they would in the fast-growth scenario, and bonds would therefore be less competitive to stocks for investment capital.

I welcome your comments and feedback.

Best Regards,

Peter

Peter C. Thoms, CFA  
Orion Capital Management LLC  
1330 Orange Ave. Suite 302  
Coronado, CA 92118  
Tel: 619-435-1701 Fax: 619-435-1706  
[www.orioncapitalmgmt.com](http://www.orioncapitalmgmt.com)