



<u>2<sup>nd</sup> Quarter 2005</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	10,274.97	↓2.18%
Standard & Poor's 500 Index:	1,180.59	↑0.91%
10-Year Treasury Yield:	3.92%	

## **Investment Outlook**

### **June 30, 2005**

Dear Investors,

The performance numbers for the second quarter of 2005 suggest a boring, stagnant stock market. In fact, the opposite is true. The U.S. stock market began the quarter in dismal fashion, only to rebound in late April. The slide in stock prices in the early part of the quarter was due in part to fears of rising inflation. After a few benign pieces of economic data, however, inflation fears were doused and the equity markets rebounded.

Perhaps the biggest surprise in recent months for investors has been the trend in long-term interest rates in the face of nine straight 0.25% Fed Funds interest rate increases. The conventional wisdom has held that the effort of the Federal Reserve to bring short-term rates up would also cause long-term rates to rise. The opposite has happened. Long-term rates have moved lower despite the steady climb in short-term rates, flummoxing even Mr. Greenspan, who has called the phenomenon a “conundrum.” As investors, we must try to figure out what this peculiar behavior in long-term interest rates means. Typically, declining long-term rates signal a slowing economy on the horizon. Such an occurrence should take no one by surprise, however, as we are already more than three years into the economic recovery that began after the 2001 recession. A slowdown of some sort next year would have plenty of historical precedents.

When their second quarter results are reported in the next few weeks, corporations will likely post their slowest rate of earnings growth in more than three years. In fact, the last 12 quarters have all featured double-digit year-over-year increases in corporate profits, but the consensus estimates for 2Q profit growth is 7.1%—still a solid result if it comes to pass. Despite slowing growth, corporations are generally in excellent financial shape. Cash balances and profit margins are near their all time highs, while debt is down. The major issue facing companies with cash on hand is figuring out how to put it to productive use. Overall, companies have been extremely cautious with their cash over the past couple of years, content to let it pile up on their balance sheets. Right now more than \$630 billion sits in the coffers of the S&P 500 companies, up from about \$400 billion just two years ago. Equity investors may be disappointed at the lack of perceived growth opportunities for businesses, but they can expect to see an ever-increasing amount of that cash come back to them in the form of increased dividends or stock buybacks.

Across the Atlantic, economic and political difficulties abound. The 12-nation Eurozone is expecting a paltry 1.2% rate of economic growth this year. Italy is in recession. The European Constitution

appears to be dead in the water after voters in France and the Netherlands rejected it. With the above factors hanging over Europe, one might reasonably expect the markets there to be struggling. In fact, they are doing quite well and are handily outpacing the U.S. and Asian markets. The European bourses, as it happens, are dominated by global companies that do business all over the world. With the political problems in Europe weighing on the Euro, sales generated by these global companies in the U.S. and Asia are helping to boost corporate profits. Asia's growth, on the other hand, continues to be swift, but there are signs of cooling. While China's strong economic growth is likely to persist for many years, a slowing in the rate of growth could put pressure on the oil, metal, and basic materials companies that have been supplying that country's voracious appetite.

Overall, the U.S. economy appears to be on relatively solid footing. The major potential pitfall, in my view, has to do with a red-hot real estate market characterized increasingly by fancy, nothing-down mortgages designed to permit people to buy homes that they otherwise would not be able to afford. For many years now home owners and speculators alike have been enjoying above trend-line appreciation in their real estate assets. I believe this rate of appreciation is likely to slow considerably over the next couple of years. If this should happen, I think it is reasonable to expect some dampening of consumer demand for all sorts of products. Since the unwinding of the stock market bubble in 2000, many people have drawn great comfort from the rapidly increasing values of their homes and have continued to spend strongly. It remains to be seen how consumers will react to a leveling off or even (gulp) a decline in the real estate market.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

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