



<u>3rd Quarter 2005</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	10,568.70	↑2.86%
Standard & Poor's 500 Index:	1,228.81	↑4.08%
10-Year Treasury Yield:	4.33%	

Investment Outlook **September 30, 2005**

Dear Investors,

The third quarter of 2005 was something of a roller coaster for the U.S. stock market: up in July, down in August, up in September. The major equity indexes are mostly trading water year-to-date, with the Dow down 2%, the S&P 500 up 1.39%, and the NASDAQ down 1%. Bonds suffered their worst quarter so far this year as the interest rate on the benchmark 10-Year Treasury note climbed 41 basis points to 4.33%.

The performance of the U.S. stock market was impressive in the third quarter. But hold off on the celebrations: as I write this, on October 12th, the S&P 500 has already given back all of its gains from the third quarter and then some. October is historically the second worst month for stocks (behind September), and so far it is living up to its reputation. It seems that the market, after having weathered the destruction wrought by Katrina and Rita so well, is finally starting to buckle under the pressure of high oil prices, rising interest rates, and a slowing consumer.

When they report their third quarter results in the next few weeks, U.S. companies will likely post reasonably solid numbers but offer tepid outlooks for 2006. With oil prices above \$60 per barrel and natural gas prices around \$13 per thousand cubic feet, consumers have begun to pull back on their spending. Gasoline prices remain very high due to the refinery disruptions on the Gulf Coast, and consumers are bracing for what could be a more than 50% rise in the cost to heat their homes this winter. On top of that, the Federal Reserve is beginning to make more hawkish noises about inflation and seems to be committed to taking short-term interest rates higher over the next several months.

Across the Atlantic, economic and political challenges linger. Germany's economic future remains uncertain as Angela Merkel becomes Germany's first female chancellor. To be sure, tough measures will be needed to fix an economy that is barely growing and hampered by high unemployment and high labor costs. While the Europeans appear to have made little tangible progress in reinvigorating their economies, their stock markets have done surprisingly well this year. Germany's DAX is up 9%, as is France's CAC-40. London's FTSE-100 is up 7%. Much of the improvement in Europe's corporate sector has come from restructuring and merger activity.

One of the brightest spots overseas so far this year has been Japan. It appears as though a new dawn is breaking for Japan, which has endured 15 years of grappling with deflation and economic stagnation. Prime Minister Junichiro Koizumi's resounding victory in a snap election has given him a strong mandate to continue his economic reforms. International investors have taken notice; they have driven the Nikkei 225 Index up 17.2% year-to-date. Other Asian markets have also performed well: India's Sensex is up 20% and Korea's Kospi Index is up 21%.

Looking ahead, the U.S. economy appears to be on more tenuous footing than three months ago. The combined effects of rising interest rates and high energy prices along with a slowing real estate market are headwinds that will, in my opinion, be difficult for the economy to plow through unscathed. This economic environment is good for neither bonds nor stocks. The main difficulty is that things have been so good for so long on a number of economic fronts that trouble is likely to arise when these trends slow or reverse. For instance, consumer spending has been remarkably strong and will likely slow. Long-term interest rates have been bouncing off generational lows and will likely rise over time as the Federal Reserve increases short-term rates. The recent rises in energy prices are likely to stick. A positive note for investors, however, is that U.S. corporations are in virtually the opposite financial position of the average debt-laden American consumer. Companies are hoarding record levels of cash, are reluctant to spend on equipment upgrades, new ventures, or new hires, and have put into practice operational and financial disciplines that have allowed their profit margins to rise to record highs. Stock valuations remain above their historical averages, but relative to their chief competitor for the affections of investors—bonds—they remain reasonable values and a better long-term hedge against inflation as well.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

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