November 2, 2004

THIRD QUARTER COMMENTARY

" 'Doubt' is not a pleasant condition, but 'certainty' is an absurd one."

Francoise Marie Arouet
"Voltaire", 1694-1778
French Author and Philosopher

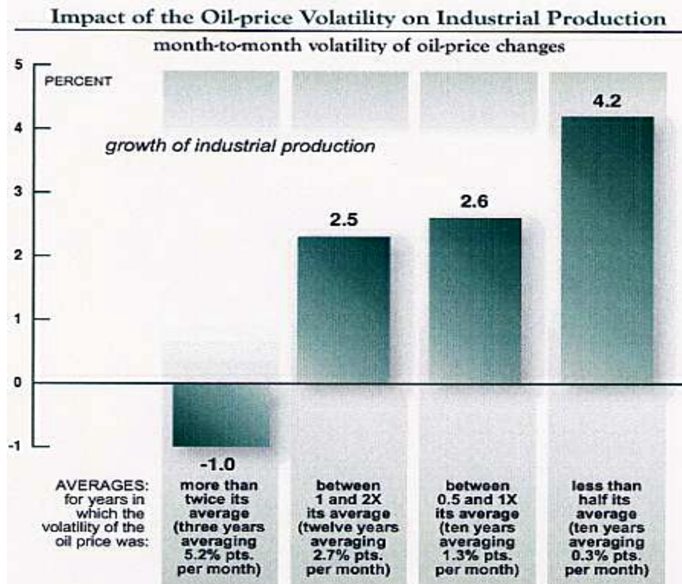
Voltaire died in controversy as he had lived. He was imprisoned in the Bastille, was exiled to England, took up residence in the Prussian Court of Frederick the Great in Berlin and Potsdam, and died in Paris. His corpse was seated upright in a horse-drawn carriage at night, held in place by a sympathetic passenger, and secretly spirited away to a Champagne abbey for interment. Thirteen years later his remains were removed to a resting place of honor, the Pantheon in Paris.

Voltaire's quip could have been used verbatim in the second presidential debate by the President's opponent. But we settle for what did transpire in the second debate, dumbed down for the masses as, "But this issue of certainty…………certainty sometimes can get you in trouble". But back to Voltaire.

Unbeknown to authorities, Voltaire's bones were stolen following Napoleon's defeat at Waterloo and dumped in a garbage pit. But it took fifty years for French authorities to verify that the sarcophagus in the Pantheon was in fact empty. But somehow his heart and brain had been salvaged. Today his heart rests at the Bibliotheque Nationale in Paris. His brain had apparently been put up for auction and lost in history. Nevertheless, we expect it to resurface some day on eBay, so we are ever alert for jars of formaldehyde bearing French labels.

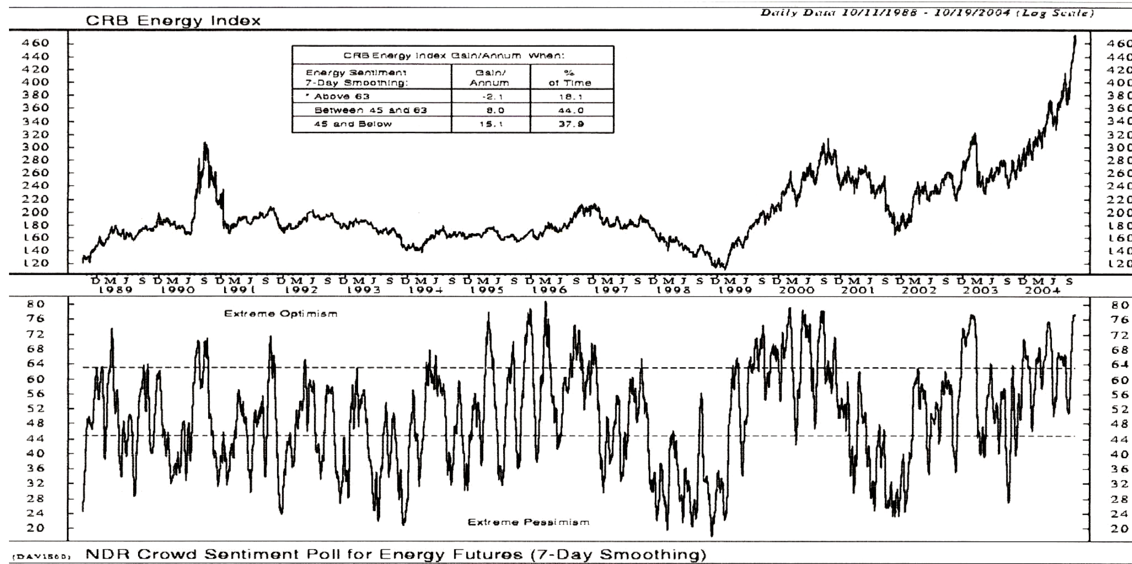
It would be a mistake to trivialize the contributions Voltaire made to the course of western civilization; he was the philosophical conscience of the Enlightenment, thereby connecting him to the American Revolution, and an unrelenting champion of the downtrodden. His observations regarding "doubt" and "certainty" we find appropriate to investor mindsets, if not presidential politics.

The price of oil has taken center stage in what appears to be an exponential rise. This much is clear: from this point forward, a further rise in oil price will curtail economic activity in the U.S., resulting in lower long-term bond yields. It has recently been persuasively argued that it is not a high oil price per se that dampens economic activity, but rather volatility itself which is a damper on business planning and spending. This can be seen in the chart at right. Although inflation flow thru will occur from higher prices, this will take time, and be overwhelmed in the short-run by deflationary forces unleashed by uncertainties created by price volatility. We judge it could be difficult for the stock market as a whole to make upside progress in such a scenario.



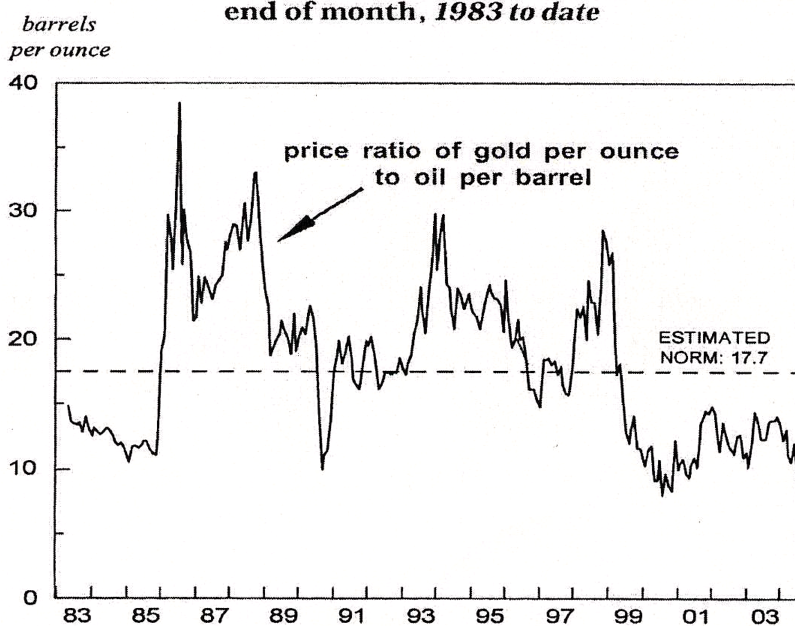
We also judge that time-wise the oil price spiral is very close to upside exhaustion. In fact, it may already have occurred. Nevertheless, a rapid spike up of 25% or so remains a possibility, abetted by hedge fund speculators starved for exploitable momentum trends. It does not take a large percentage of the $900 billion hedge fund industry so speculating to overwhelm fundamental forces short term. However, we believe investors would be well served to begin leaning against the wind, anticipating the higher GDP growth inherent in a declining oil price and lower volatility. Should such occur, we believe the U.S. equity market will respond positively. Longer-term of course, American dependence upon oil imported from unstable Islamic regimes is itself economically destabilizing and raises the equity risk premium that in substantial part determines stock prices. Nevertheless, we believe the stage has been set for a resumption of a market with an upward bias. We know many investors "doubt" this to be the case and judge the current environment not a "pleasant condition".

It seems that the price of oil, $55 so far as of this writing and having corrected to $48, could be headed even higher. Also it seems that both bond and stock market directions are now being exclusively dictated by the price of oil. The higher the price of oil, the stronger the bond market and the weaker the stock market, so it would seem.



However, as can be seen in the CRB Energy Index chart here, the index appears to be preparing for a climactic upside blowoff.

In an attempt to get a handle on "how high is high", we might first look at the inflation adjusted price of oil.



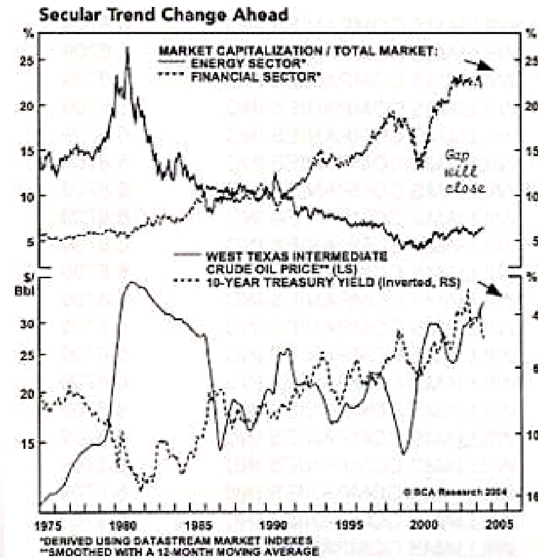
Investors may recall that oil got to $40 per barrel in 1979. That equates to about $80 per barrel in today's dollars. Since it is in the low-50's at present, $80 represents substantial upside headroom.

Another way to look at this is to ask, how many barrels of oil historically has it taken to buy an ounce of gold? As can be seen here, over the past 22 years it has on average taken about 18 barrels to buy an ounce of gold. Now it takes less than 8 barrels to buy an ounce of gold. This gold/oil ratio is about as low as it has ever been in the timeframe shown here.

It is possible both oil and gold could go up or down together but at different rates causing this ratio to move to its longer term relationship of 18 barrels per ounce. We can only conclude gold is cheap relative to oil.

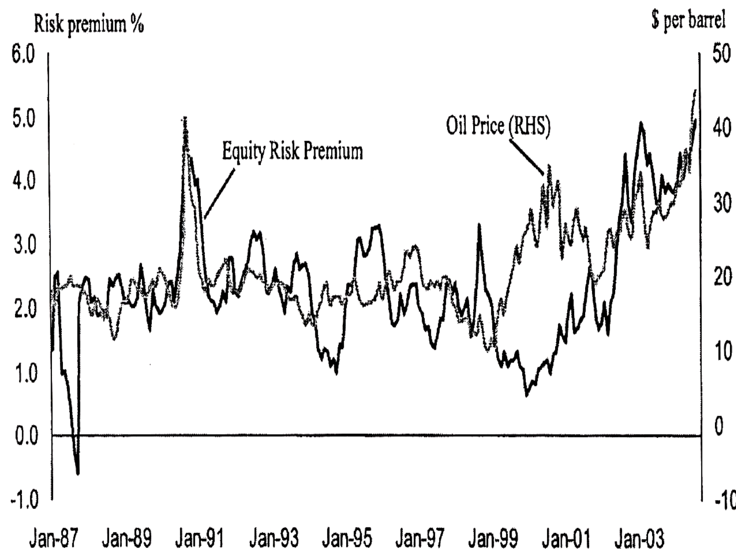
Yet a third way of looking at this is to make a judgment as to how heavily weighted the energy sector might become relative to its relationship to the S&P 500. As can be seen in the chart on the next page, the energy sector was once 26% of the S&P 500. Currently it is about 8% of the S&P 500. However, although this might seem low at 8%, one must bear in mind that GDP output per barrel has doubled since 1979 meaning that an equivalent extreme today would be for the energy sector to be 13% instead of 26%. If market capitalization maintained proportionality to GDP, then perhaps 8% energy market sector cap to total S&P 500 market cap could become 13% under a runaway bullish scenario for oil. Again, significant upside.

As can be seen in this chart, the past quarter-century of disinflation has been very kind to financial stocks as they have gone from 7% to 23% of the S&P 500 while energy stocks are almost an exact mirror image, dropping from 26% to as low as 4% of the S&P 500. Therefore, at 8% today, although having doubled from trough lows in 1998-9 when oil got down to $10 per barrel, there is a possibly of an upward spike akin to the 1978-1983 experience, but at lower percentages of the S&P 500 as alluded to earlier. Moreover, as seen in the bottom panel of this same chart, since the mid-80's, higher oil prices have generally been accompanied by lower 10-year treasury yields, defying the notion that higher oil begets higher inflation which begets higher interest rates.



Most importantly, not only have higher oil prices been associated with lower interest rates, they have also been associated with higher equity risk premiums. As seen here, the current equity risk premium has risen to 5%, extraordinarily high by historical standards. This means that equity prices are currently depressed by the high hurdle rate relative to other investments, and means that investors expect 5% greater return from stocks than from 10 year treasuries, currently yielding about 4%. Therefore, stock prices should be discounted in the current environment to provide,

Figure 1: World Ex-Japan Equity Risk Premium and the Price of Oil



Source: IBES, Bloomberg, Datastream, Lehman Brothers

eventually, 9% total returns. As can be seen in the previous chart, the equity risk premium normally runs about 2 ½ %. Therefore, the stock market may be poised to rise solely from a shrinking equity risk premium which would most likely be accomplished by a falling oil price. This is serious food-for-thought for all those bearish on the stock market.

Table 2: Equilibrium Fed Funds (%)

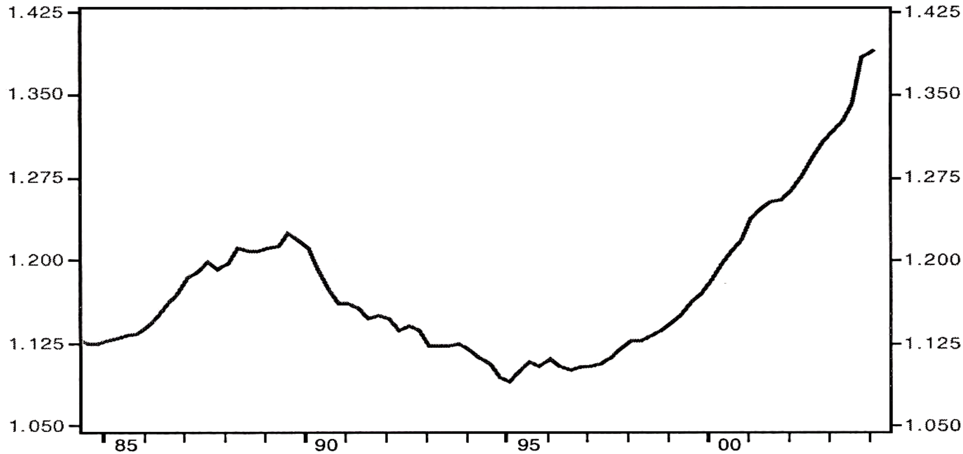
Core Inflation (%)	Real GDP Growth (%) 1	2	3	4	5	6
1	0.0	0.4	0.9	1.4	1.8	2.3
1.5	0.7	1.2	1.6	2.1	2.6	3.1
2	1.4	1.9	2.4	2.9	3.3	3.8
2.5	2.2	2.7	3.1	3.6	4.1	4.6
3	2.9	3.4	3.9	4.4	4.8	5.3
3.5	3.7	4.2	4.6	5.1	5.6	6.1
4	4.4	4.9	5.4	5.9	6.3	6.8
4.5	5.2	5.7	6.1	6.6	7.1	7.6
5	5.9	6.4	6.9	7.4	7.8	8.3

Source: Merrill Lynch, our calculations.

As for Fed policy, the world knows short-term rates are headed higher, as, in the words of Fed-speak "policy accommodation is being withdrawn". This chart shows that given 3% real GDP Growth and 2% core inflation, that the equilibrium Fed Funds level is 2.4%, higher than the present 1.75%. Should either real GDP growth or core inflation be higher than these numbers, interest rates will have to be going yet higher. Although taken in a vacuum, this is not friendly to the equity markets, it may be that a contraction of the equity risk premium as a countervailing and positive factor will overwhelm rising Fed Funds as a negative factor. We regard this as "the" critical issue facing investors.

Lastly, as we look at other asset classes, we still find the equity markets looking fairly good. Since 1995 the P/E ratio for "housing" has risen almost 35% whereas the P/E ratio for the S&P 500 has gone nowhere at 15 times trailing earnings (adjusted for inventory valuation and capital consumption).

Extended Valuation — This Is The P/E Ratio for Housing (Look Familiar?)



Source: Bureau of Labor Statistics, Office of Federal Housing Enterprise Organization. Note: In our calculation we assumed that rent prices would edge up by 3.1% per year (the 10-year average) and the average ratio between the two series is 1.15 (average from 1983 to 2000).

Like Voltaire, we accept uncertainty as the ever present condition in which we operate.

We thank each of our clients for their patience during a year of irregular progress. Irrespective of a controversial Bush Administration re-election, we continue to believe the stock market is poised to deliver yet another surprise to the plurality of investors by going……………………………up!

Very truly yours,

Alan T. Beimfohr **John G. Prichard, CFA**