

July 7, 2005

THIS ISSUE

"Our doubts are traitors and make us lose the good we oft might win by fearing to attempt."

– William Shakespeare, *Measure for Measure*

The Stock Market

DEAR CLIENTS:

The U.S. equity market extended its first calendar quarter slide into April due to a myriad of ongoing concerns, including the reality of rising oil prices, the prospect of continuing Fed interest rate hikes and the possibility of higher inflation. Warnings of weaker than expected earnings from bellwethers General Motors Corporation (GM), International Business Machines Corporation and Wal-Mart Stores, Inc. added to investors' malaise.

The skies began to clear and the market rose in May and into early June amid overall corporate earnings that came in ahead of expectations and more positive indications on the inflation and employment fronts. The rally faltered towards the end of June, leaving the major indices with second quarter gains, but mostly still lower for the first half of 2005.

Interest Rates and the Bond Market

Periods ending June 30, 2005
 (Total Returns-Cumulative-Bloomberg)

	S&P 500 Index	NASDAQ	Russell Midcap Index
3-months	1.37%	3.08%	4.18%
6-months	-0.81%	-5.12%	3.92%
1-year	6.32%	1.10%	17.12%
3-years	26.93%	42.84%	55.53%
5-years	-11.32%	-46.98%	42.53%

Summary

We thought at the beginning of the year that 2005 would be a year of modest returns, with the possibility of slipping into negative territory. Thus, although we're not particularly happy sitting at the mid-point of 2005 with client equity portfolios mostly "flattish," neither are we surprised. Although our outlook for the balance of 2005 hasn't

changed, we thought it would be helpful to discuss what we think will happen *beyond* the next six months and the positive implications for the market, if those come to pass.

THE STOCK MARKET

The risks are well known. The U.S. trade deficit is at record levels and growing. Because of this, the U.S. is increasingly beholden to its trading partners to finance this deficit, which runs the risk of a shift in the economic balance of power. The American consumer has driven the economic recovery, but sky-high debt levels and soaring energy prices could cause the engine to sputter. Real estate has experienced extraordinarily rapid price appreciation in a number of markets. We are reminded that the selling price of a house/condominium depends on not only what a buyer is willing to pay, but also on the amount a lender is willing to finance and on what terms. Lenders have been adept at creating loan products, such as 0% down, interest-only, adjustable-rate mortgages that enable buyers or refinancing homeowners to borrow the maximum amount to finance new home purchases or turn their "equity" into cash. The implicit "bet" being made by both the lender and borrower is that property values will keep rising and interest rates remain low, a risky proposition. Crude oil remains in the headlines as it broke through the "psychologically important" \$60/barrel level and continued to move higher. Finally, the Federal Reserve marked the one-year anniversary of the current cycle by raising the federal funds rate to

3.25%, the ninth consecutive 0.25% increase, and indicated increases will continue at a "measured" pace.

These risks are all very real and will continue to weigh upon the market. We don't minimize their importance. However, when we look at the last two items on the above list, we find reason for a more sanguine outlook on the U.S. equity market for 2006 and beyond. Our friends at International Strategy & Investment (ISI) looked at market performance following peaks in crude oil and the final Fed tightening in a cycle. There have been seven peaks in the price of crude oil since 1981. In the six months following the peak, the average S&P 500 performance was +5.8%. Similarly, there have been five cycles of Fed tightening since 1987. In the six months following the final tightening in the cycle, the S&P 500 has averaged a +8.9% gain. These are just *historical averages* and we obviously don't know when crude oil will peak or the final tightening in this cycle will occur. However, we think the probabilities favor both of these occurring sometime within the next 6-12 months and the historical averages are useful in framing the potential, positive subsequent outcome. Finally, we expect gains in corporate earnings to continue into 2006 and beyond. If the overall market remains flattish for the rest of 2005, this means the price-to-earnings ratio on 2006 expected earnings will be lower, which should improve the prospects for a better market ahead.

We continue to focus on individual stocks and used the market's early swoon to purchase a number of new names and subsequent recovery to sell stocks approaching or meeting our price targets. We are working diligently to identify new attractive opportunities, but it's difficult in the current environment.

INTEREST RATES AND THE BOND MARKET

The bond market staged an impressive rally, as the yield on the 10-year U.S. Treasury bond declined from 4.49% at the start of the second quarter to finish at 3.92%. Given this decrease in long-term yields occurred within a backdrop of increasing short-term yields, presumably the "conundrum" in Mr. Greenspan's mind, which we referenced in our most recent letter, is larger than ever. There are a number of theories why long-term yields have tumbled and may move lower still. Among these are the Chinese are using U.S. dollars accumulated with their trade surplus to buy U.S. Treasury bonds, there is a worldwide glut of savings that is finding its way to bond markets, the bond market is forecasting a dramatic economic slowdown and there is a shortage of long-maturity bonds developing. These reasons for low long-term interest rates all appear plausible, but what we know is the yield curve (the yield on various maturities of U.S. Treasury securities, from shortest to longest) has flattened (the difference in yield

between shorter maturity vs. longer maturity has been compressed) to the point where it made sense for us to shorten maturities (clients weren't being properly compensated for moving out on the yield curve). The absolute yield we're able to earn in fixed income remains unexciting, but given capital preservation is the name of the game, we thought it prudent to take advantage of the rise in shorter-term yields.

On the corporate side, Standard and Poor's cut the credit ratings of GM and Ford Motor Company to "junk" status in early May, which roiled the market. The cut in credit ratings themselves should not have surprised a small child, but the timing was sooner than investors anticipated. This was a contributing factor to spreads continuing to widen, which we welcome. If this widening trend continues, our plan is to re-deploy funds from short-term U.S. Treasury securities to individual corporate securities with attractive risk/reward characteristics.

SUMMARY

Although we see tough sledding ahead for the balance of 2005, we see reasons for optimism for 2006 and beyond. This morning's terrorist attack in London, which followed last year's attack in Madrid, is a stark reminder the world will be a dangerous place for the foreseeable future. Our charge is to cast aside our doubts and fears and invest your precious assets as if they were our own, for the long-term. We thank you for your business and the trust and confidence you've placed in us.



Regards,

Kirr, Marbach & Company, LLC