



ECONOMIC OVERVIEW

**THE US ECONOMY CONTINUES TO EXPAND AT A VERY HEALTHY PACE.** The first quarter, GDP rose at a revised upward 4.4% annualized rate, as corporate profits and consumer spending remained strong. At the time of this writing, the second quarter of 2004 is expected to come in at better than 4% annualized.

On the jobs front, we continue to see employment growing. Over the last year, the US economy has added almost 1 million new jobs. However, over the last three years, 2.4 million jobs were lost indicating more room for employment growth.

While there is ample good news on the economic front, energy prices, interest rates, and election year uncertainty are all concerns that may affect equity share and bond prices. During the 2nd Quarter of 2004, the price of a barrel of oil hit an all-time high of over \$42. Consumers have undoubtedly experienced the dramatic increase in gasoline prices at the pump this year. Gas prices across America have gone up from \$1.40-\$1.60 to \$1.95-\$2.35 this year alone.

The volatile situation in the Middle East region creates uncertainty for the future of energy prices as a disruption in the supply of oil is a major concern. We do believe, however, that the existing price of oil is unsustainably high and has been affected by speculation in the energy markets. Look for energy prices to settle

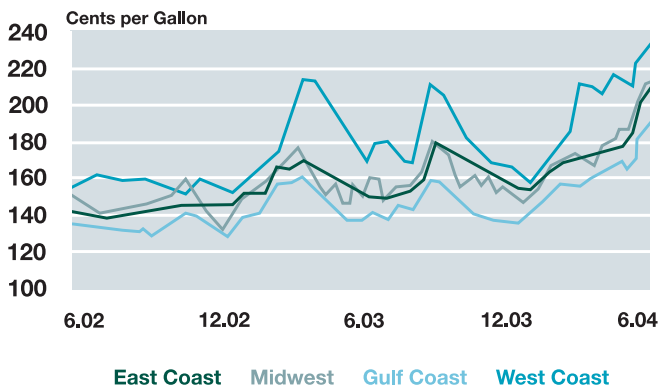
down in the low \$30's during the summer months as the speculative excess works its way out of the market for oil.

While we have been writing about a gradual rise in interest rates during 2004, the Fed has still pegged the overnight lending rate at 1%. Perhaps by the time you receive this edition of Davidson Quarterly Review, Alan Greenspan will have already made his first move with an increase of .25-.50%. We believe the odds of an increase are fairly high at the June

30th Federal Open Market Committee Meeting (FOMC). As long as the rate increases are gradual, we do not think equity prices will be negatively affected.

The Bush vs. Kerry presidential election rhetoric has been somewhat quite of late. As we move through the third quarter of 2004, we expect it to heat up with the candidates attempting to define and contrast their platforms for the American people. It seems the main question will likely be, can George W. Bush overcome the political turmoil that is the result of the Iraq conflict? At the time of this writing, the polls show the race is a dead heat. The financial markets are taking a "wait and see" attitude toward it.

Retail Reformulated Regular Gasoline Prices



## THE DEMAND SIDE

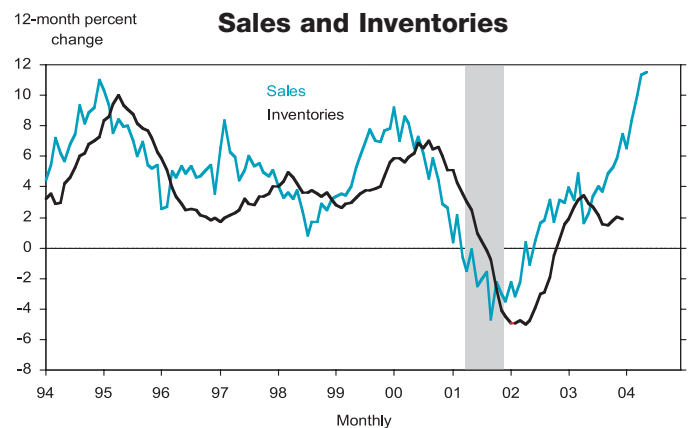
Consumer spending remains strong. Although spending was hurt by higher gasoline prices and slightly higher mortgage rates, employment and wage increases continue to show strength.

Consumer balance sheets have been bolstered by increasing home values, as well as a rising stock market. After-tax cash flows have also improved with the rise in employment, modest wage growth and the tax cuts of 2003. Total net worth climbed by 11.5% (or \$5.5 trillion) in 2003 and remains at a historically high level compared to income. (Source: BCA Research)

## THE SUPPLY SIDE

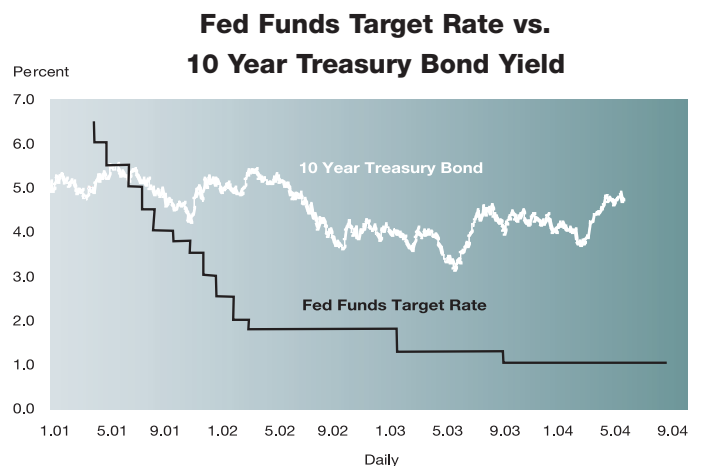
Historically, trends in sales tend to lead to changes in business inventory levels such that in good economies, rising inventories tend to prolong GDP growth and in falling economies, inventory reductions tend to follow business declines. This is clearly evident for all but the most recent periods, as seen in the accompanying chart.

Recently, the relationship between the 12-month percent change in sales and the 12-month percent change in inventories has become exceptionally large. While some people have written that permanent changes in technology and information processing have allowed companies to improve their control on inventories and production, we do not believe that the current gap between the change in sales and inventories can be fully explained by “better business practices.” Importantly, we expect that the gap will narrow as businesses restock their shelves. If this view is correct, we should see inventory stocks build at above average rates as the inventory liquidation that occurred during the recession is partly reversed. We view this increase in business spending as a positive for the economy and for equities in general.



## INTEREST RATES + INFLATION

All market participants are focused on the risk of rising inflation this quarter. The Consumer Price Index (CPI) will be the truest representation of inflation as prices begin to more heavily influence the speed of our economy. The current market forecast for interest rates has priced in approximately 70 basis points in anticipation of FOMC movements. Street estimates are for overnight lending rates to increase between 75 to 150 basis points through the end of this year.



Factoring out the price of houses in reaction to several years of strong demand, we are not at the verge of runaway inflation. CPI at its last reported year-over-year rate of 2.3% (1.8% excluding food and

*“The greatest discovery of my generation is that human beings can alter their lives by altering their attitude.” William James*

energy) is pretty much on target with the FOMC expectations. However, the Fed does need to recapture some of its liquidity tools, namely the ability to ease in an emergency situation such as September 11th.

In just a matter of three months, the 5-year Treasury bond has moved from a yield of 2.78% to 4.06%. Keep in mind that the Treasury has increased the overall amount of its debt this quarter, as has the corporate bond market. June is also a very heavy month for municipal bond issuance. This injection of supply translates into cheaper prices. Add the increase in supply to the expectations for the Federal Reserve to raise interest rates and the result is a yield curve ready to shift upward.

## EQUITIES OVERVIEW

With the initial rebound now behind us, the market has been locked in a rotational trading range since the first of the year. We would expect that stock market performance will be much more selective and tied directly to specific companies and their ability to record solid fundamental growth on a continuing basis even as the general economic momentum slows and the future peak in economic activity begins to be contemplated.

The S&P 500 Index recorded earnings per share in the area of \$55 during 2003 and current projected results for 2004 are in the area of \$64, representing a new high for the market following the sharp decline that began in 2000. Based on these consensus figures, the market is currently being valued at 17 times 2004 estimated earnings and less than 16 times preliminary 2005 estimated earnings of \$68. This valuation level, while no longer historically inexpensive, is in line with past market average valuation levels, especially during periods of low and relatively stable underlying inflationary trends.

## OUR PERSPECTIVE

As we enter the second half of 2004, the economic recovery continues to show an increasingly balanced and therefore sustainable growth trend. The current expectation of an increase in the discount rate should not be viewed as a negative but rather a sign that the economy is now returning to a healthier, more normal condition that no longer requires the lowest interest rates in forty years and constant stimulation to offset the underlying fears of deflation that gripped the country just two years ago.

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In 2003, uncertainty and skepticism were running high based on the lackluster economic trends and the threat of mid-east conflict and terrorist threats. Looking ahead to the second half of 2004, the uncertainties are different this year but still certainly in place. The ultimate success of the transfer of power in Iraq is yet to be determined. Terrorist attacks have become a constant international threat that will be present for the foreseeable future and only amplified by the Olympic games in Greece and the approaching elections in the United States. While the economy is currently much healthier, this is a Presidential election year and the political rhetoric and alternative political priorities will create additional uncertainty as we move through the election process. While short-term rates remain at historically



## OUR PERSPECTIVE (continued)

low levels, the only question remaining as it relates to the direction of interest rates is how quickly the Federal Reserve Board will raise rates not whether or when they will raise them.

While the outlook for the economy is much improved over the past year, the financial markets have already discounted a great deal of the improvement. The major equity markets have all recorded strong rebounds from their lows of March 2003. To date, the dramatic increases recorded have been the result of a shift of investor psychology from gloom and doom to renewed hope and optimism. During the initial period of rebound most companies were lifted by the rising tide of a return of confidence with many companies that were most vulnerable to economic weakness receiving the greatest lift. With the initial rebound now behind us, we would expect that the market's performance going forward will become much more selective with incremental appreciation tied directly to specific companies and their ability to record solid fundamental growth on a continuing basis even as the general economic momentum slows and the future peak in economic activity begins to be contemplated as we move through 2005. Within this type of environment, sound fundamental analysis and a focus on individual security valuation levels will be increasingly important in providing attractive relative investment returns.

### AT THE FIRM

We are pleased to announce that Wayne G. LeSage joined our firm in April as an investment analyst. His past experience includes time with White & Case, LLP in New York and Valley Forge Asset Management in King of Prussia. Wayne is a graduate of Notre Dame and a Level III Candidate for the CFA Charter. He is a welcomed addition to our Investment Management & Research team.

The new statement package is here! Our team worked diligently to bring our clients the best statement package in the industry. We hope you find them easy to read and helpful.

Please check out our website ([www.davidsoncapmgt.com](http://www.davidsoncapmgt.com)). It's new and improved with more comprehensive descriptions of our services, and pictures of the DCM team!

Robert Lodge | *Managing Director* | Davidson Quarterly Review is a publication of Davidson Capital Management.

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