



ECONOMIC OVERVIEW

As winter approaches, most economic projections have been revised downward in the short run as the country deals with the economic and political implications of the damage along the Gulf coast brought on by hurricane Katrina. The magnitude of the economic impact of Katrina is unprecedented not only in terms of human suffering but also in terms of the extent of lost production and jobs, damaged or destroyed private property and public infrastructure, not to mention the resulting impact of escalating energy prices on the national economy.

Our prior projection of 3.5% real GDP growth for the full year will likely now shrink to the area of 3.2% based on revised projections of fourth quarter GDP growth of perhaps 2% or less depending on the lasting effect of the lost production impact of Katrina and Rita. This near term weakness, however, is likely to be followed by an increase in projected GDP growth in 2006 as the magnitude of the government and private sectors' economic recovery spending packages are implemented. Our preliminary projections for 2006 GDP growth have been modestly raised to approximately 3.1% from our previous growth target of 2.9%. This rate of economic growth, while moderating from recent trends, continues to be viewed as relatively healthy given that we are entering the fifth year of the current economic recovery that began in the fourth quarter of 2001.

Prior to hurricane Katrina, the economy was continuing to transition from the cyclical growth phase experienced in 2003 to the more moderate but sustainable growth phase of the economic cycle during the first half of 2005. Corporate balance sheets had experienced a marked improvement over the past four years as a good deal of long-term debt had been paid off and the carrying cost of the remaining debt had been reduced by refinancing within the current low interest rate environment. While corporate investment spending had shown renewed growth over the past two years, corporate liquidity has remained at unusually high levels. The sharp increases in both private and public reconstruction expenditures should more than offset the near term negative effect of the lost production and consumption growth.

Consumer confidence was weak in September as the two benchmark surveys, the University of Michigan index and the Conference Board, each reported falling numbers. No doubt that higher interest rates and energy prices are largely to blame. While some store sales figures were mixed on the retail front, there was no sign that consumer spending was unraveling.

Over the next year, the inflation rate, as measured by the Consumer Price Index (CPI), should show a gradual acceleration to the area of 3.0% as higher commodity prices and a return of pricing power are no longer substantially offset by productivity gains.

FINANCIAL MARKETS

In recent months, the market has begun to show increasing selectivity in market leadership based on the potential for sustainability of current earnings momentum and underlying valuation levels. These disparate market trends experienced to date were initially created by concerns over higher energy prices and rising short-term interest rates.

During the third quarter of 2005, the total return of the S&P 500 was 3.5%, and 2.7% on a year-to-date basis. During the first nine months of this year, the dispersion of sector return results was unusually wide with the Energy and Utilities sector each recording gains of 41% and 23% respectively. Basic Materials, Information Technology, Industrials, Consumer Discretion and Telecommunications were all down for the same period. Healthcare and Consumer Staples returned 5.3% and 4.1% respectively. This sector performance profile is somewhat predictable given higher energy prices across the board.

Based on consensus earnings figures, the market is currently being valued at 17x estimated 2005 earnings and less than 16x preliminary 2006 projected earnings of \$76 for the S&P 500. Earnings growth will likely slow from the projected 12% in 2005 to 10% in 2006, still above the long-term average of 7%. This valuation level, while no longer historically inexpensive, is in line with past market average valuation levels, especially given the relatively low inflation and interest rate levels. While the market's consolidation over the past nine months has created a degree of nervousness within the financial community, it is our view that this respite has been normal following the significant market appreciation of the preceding eighteen months. Although earnings growth may slow in 2006, the fact that companies are in sound financial health means that corporate spending growth should continue.

The outlook for continuing earnings growth extending through 2006 coupled with the gradually increasing inflation and interest rate trends will likely make equities the asset class of choice for the time being.

Incremental investment performance from current levels will most likely be generated by the investors' outlook for potential sustainability of individual company earnings growth over the next twelve to eighteen months given the maturity of the current economic cycle and the financial pressures and opportunities that have been created by the recent Katrina hurricane disaster.

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INTEREST RATE TRENDS

The Federal Reserve is expected to continue its tightening of the discount rate with at least one more increase by year-end 2005. At press time, the Fed Funds futures market is pricing in 99% odds that short rates will rise another .25%. The boost in energy costs has not only created a dampening effect on consumer spending trends, but it has also added to the potential for inflationary pressure over the year ahead, especially considering the \$200 billion estimate of capital infusion from the federal budget as the Gulf coast re-construction begins in earnest.

Relatively low treasury yields should persist over the near term. Domestic interest rates are in large part the result of the current international flow of funds and the relatively attractive yields offered by the United States within the global financial community. Over the next twelve to eighteen months, however, moderating international demand for treasury bonds is likely as the growing trade and budget deficits place more U.S. debt in the hands of foreign entities. The main reason behind the low long-term interest rate environment has been the lack of supply of long-term debt in the market place. Corporate balance sheets have been strengthened over the past four years and much of the high grade corporate debt has been paid down or refinanced. The Treasury Department, which historically has been a primary source of high quality long-term debt securities, stopped issuing 30-year Treasury Bonds several years ago because of the declining deficit and has not reinstated the long bond in spite of the more recent deficit increases. While the supply of long-term debt in the United States is currently depressed, demand for these high quality long-term instruments has shown real growth.

The flattening of the yield curve has created a degree of near-term concern, but the reissuance of the 30-year Treasury bond in the first quarter of 2006 should begin to alleviate the current supply/demand imbalance that has suppressed the long bond interest rate levels.

While these current factors have thus far combined to hold longer term interest rates at historically low levels, the underlying cyclical and secular pressures should begin to move longer term rates higher as we move through 2006. Inflation rates have

Nominal Interest Rates
3 month and 10 year



Last Obs: 9/05 Source: Federal Reserve Board; Clarion Inv. Research, Inc.



moved up over the past two years and energy costs will likely remain at relatively high levels. The governmental budget deficit has increased and given the combined pressure on governmental spending created by our international commitments, the domestic spending needs created by hurricane Katrina, as well as already budgeted entitlement spending increases, current federal deficits are likely to continue to show significant growth over the foreseeable future, likely pushing interest rates higher.

AT THE FIRM

In a continuation of our efforts to enhance client services, we have adopted a new statement format. The new format is similar to our current statement, but is simpler with an improved summary page containing a cash reconciliation which many of our clients have requested. Account statements are an important communication of financial activity. Clients will receive a letter and sample statement explanation in the mail over the next several weeks.

We would like to congratulate our Investment Associate, Wayne LeSage, and his wife Stacey on their recent marriage. We wish them a long, happy and healthy life together!

We look forward to seeing you soon.

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

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