



ECONOMIC OVERVIEW

The economy is expected to show a well balanced and sustainable positive growth trend.

Following a 4.4% growth in real Gross Domestic Product (GDP) in 2004, the economy is expected to record GDP growth of 3.8% in the first quarter of '05 and complete the year with a gain of 3.5%. This rate of gain, while moderate, is viewed as very positive given that we are in the fourth year of an economic recovery. The economic recovery that began in the fourth quarter of 2001 was initially based largely on positive spending by the consumer and increased liquidity provided by the Federal Reserve. Economic growth is now composed of moderating positive growth by the consumer coupled with significant improvement in capital spending that has developed in response to the last two years of solid corporate profits expansion and healthier balance sheets. The impressive growth in corporate spending is taking place in spite of the fact that many of the interim tax incentives expired at year-end 2004 and energy prices have moved up significantly over the past few months. Current expectations of a seventh increase in the discount rate should not be viewed as a negative at this point in the cycle but rather a sign that the economy has now returned to a healthier, more normal condition that no longer requires the lowest interest rates in forty years to foster positive growth. Preliminary projections for 2006 call for a further GDP gain of 2.9%.

Over the next three quarters, the inflation rate as measured by Consumer Price Index should show gradual acceleration to the area of 2.8% as higher commodity costs and a return of pricing power are no longer substantially offset by productivity gains. The Federal funds rate is expected to increase to 3.5-3.75% by the end of 2005, while the ten-year Treasury yield should reach 5%.

Finally, while the outlook for the economy has continued to improve over the past year, the financial markets have already discounted a great deal of the improvement. The major equity markets have all recorded strong earnings rebounds over the past year with 2004 earnings, as measured by the S&P 500 Composite, recording a gain of 19% to over \$66. This earnings level represents an all time high for the S&P and a rate of gain that is over twice the market's long-term average rate of growth. Current projections for 2005 call for an incremental gain of 9%, a rate of growth slightly higher than the longer term average of 7%.

As 2005 unfolds, we would expect stock performance to become much more selective with incremental market gains tied directly to the 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.

Based on consensus earnings figures, the market is currently being valued at 17 times 2005 estimated earnings and less than 16 times preliminary 2006 estimated earnings of \$76. This valuation level, while no longer historically inexpensive, is in line with past market average valuation levels, especially during periods of relatively low and stable underlying inflationary trends.

INFLATION AND INTEREST RATES : THE LONG AND SHORT OF IT

the long... During the past three years as the economy has shown a solid recovery, inflationary expectations have remained relatively low. Factors that are frequently cited for this relatively benign outlook include: the outsourcing of manufacturing and production to relatively inexpensive labor markets in Asia during the 1990's; an accelerating increase in manufacturing productivity in the United States due to technological improvements and the experience of the work force; artificially low interest rates on both a real and nominal basis; limited domestic pricing power within many industries during the initial economic recovery; and relatively modest wage increase pressure experienced to date. Three years ago, in fact, one of the major investor concerns was not the eventual reemergence of inflation but rather the perceived threat of deflation.

This investor perception was to a large degree a function of the preceding twenty-year experience when the underlying economic trend was for gradual disinflation following the previous long-term inflationary peak levels experienced in the early 1980's. The accompanying chart shows the long term trend of inflation and interest rates over the past fifty years. As can be seen by this chart, the recent inflation and interest rate environment has been as benign as anything that the United States economy has experienced since the late 1950's

What investors should be aware of is that many of the same factors that caused a gradual but continuing period of disinflation over the past twenty years may reverse course and reemerge to create increasing inflationary pressures going forward. Operating efficiencies created by international outsourcing over the past decade will likely be lessened going forward by the impact of accelerating wage gains within the Asian countries as well as the weakening value of the dollar. Domestic productivity gains are also likely to slow going forward based on the aging and gradual retirement of the domestic "baby boomer" labor pool. In addition, the absorption of the technology produced sharp productivity gains introduced during the 1990's are now largely built into the manufacturing base. The economic overcapacity that had been created by the recession of 2001 has largely been absorbed by the recovery of the past three years and monetary and fiscal policies are continuing to be highly accommodative. Finally, artificially low real interest rates combined with continuing budgetary and trade deficits are likely to eventually result in increasing inflationary trends and expectations, especially when coupled with the recent increase in energy prices.

During the next few years, as the growing recognition emerges that inflationary pressures continue to pose a potential risk to the economy and the investment community, the emphasis on future income growth, as well as current income levels, will increasingly be the focus of both individual and institutional investors.

and the short... Based on the data points during the first quarter of 2005, with the exception of commodities and the cost of energy, inflation does not appear to be roaring through the US economy. The Consumer Price Index (CPI) and the Producer Price Index (PPI) excluding food and energy have risen only 2.3% and 2.7%, respectively, year-over-year. Inclusive of food and energy, the PPI is up 4.2% annually. CPI should gradually accelerate towards 2.8% by year-end.

Producers appear to be willing to continue absorbing a certain amount of costs and, perhaps, retailers are equally willing to accept slightly less profit in an effort to draw the consumer in and keep him there. Two

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important questions arise at this point; when will these price increases finally be passed to the consumer? And will the increasing cost of transporting foreign goods to our shores help increase domestic or South American manufacturing?

Retailers are rethinking their sources. The U.S. has done an excellent job of exporting our inflation to Asia over the last 10 years or so. South American trade has picked up significantly, suggesting that this may be our next “volume” trading partner to keep us from feeling the looming pains of inflation in the short run.

Interest rates will continue to move up 25 basis points at a time, following the measured pace that the Federal Reserve began last June. We will see another three or four rate increases before the fall, bringing overnight lending rates to a neutral 3.50% - 3.75%. Some forecasters are even predicting a possible 4.0% rate by year-end. We do not believe these rate hikes are indicative of a tightening cycle eluding to inflation, but rather an attempt by the Federal Reserve to get back to a solid footing in case of future emergencies.

Unfortunately, as short rates move up, so will the Prime rate and mortgage rates. There has been a significant drop in weekly mortgage applications, particularly those accessing home equity, commonly referred to as “cash out” refinancing. Twenty-five percent of outstanding mortgages are adjustable rates, well above historical levels. Credit card, auto loan and other consumer interest rates will continue higher. A rising interest rate environment could spell definite trouble for the housing and consumer markets. We anticipate that the ten-year Treasury bond will yield 5% by year-end, 78 basis points higher than where it closed out 2004.

In anticipation of rising rates this year, we have shortened durations, laddered maturity schedules and filled in under the two-year sector with several floating rate instruments where possible. Another viable strategy has been to add callable bonds which will “naturally” tighten as rates rise. This will help to deflect any falling market values as the yield curve continues to shift upward.

OUR PERSPECTIVE

With the economic recovery now in its fourth year and the stock market recovery now in its third year, earnings growth within the general market is expected to slow significantly. As it does, earnings quality and sustainability will become increasingly important to specific investment valuation levels. Within this environment we would expect relative performance to strengthen for those established companies who have demonstrated the capability to generate solid earnings performance during all phases of the economic cycle.

Since the peak of the technology bubble in March of 2000, stock market gains in every market capitalization strata have been dominated by “value” stocks. Value investors seek stocks that have been overlooked by other investors which may have “hidden value” and trade at a low multiple of their earnings. These companies may have been beaten down in price because of some bad event, or may be in an industry that is looked down upon by most investors. The classic value sectors are basic materials, such as chemicals and steel, utilities and financials, to name a few. These sectors are closely tied to the economic cycle, commodity prices and interest rates and subsequently offer cheaper valuations over the long-term due to a sales and earnings profile that is cyclical in nature and less predictable over the long run.



Value stocks typically have a strong performance profile during the early stages of an economic cycle. This is intuitive, as one would expect the prospective earnings and revenue growth of an economically cyclical company to be strongest at the early to mid points of a recovery.

Why do we care about this now?

As noted earlier in this newsletter, we are in the fourth year of the economic recovery in the US. We know that historically, the average business cycle expansion is approximately 55 months or just under five years. Looking back, value stocks, regardless of market capitalization, have outperformed high quality, growth oriented stocks since the market peak in March of 2000.

At Davidson, our equity investment conviction lies in the following two tenets of our philosophy: first, purchase companies that have a dominant market position which offer sustainable and consistent earnings and revenue profile, and two, purchase them at reasonable prices. For us, these successful companies offer better-than-average growth that tends to be predictable over the long run. Furthermore, these companies make excellent long-term investments enabling us to reduce trading costs and manage capital gains effectively as the holding period tends to be three to five years.

The implication of this is that our equity investment strategy is well positioned for the period ahead as growth stocks tend to outperform later in the market cycle when investors begin to pay a premium for companies that exhibit consistent and predictable revenue and earnings growth.

As for valuation, the P/E to growth rate for the Russell 1000 Value, a popular value index, is currently trading at 1.67x compared to 1.54x the Russell 1000 Growth. This means that investors are paying on average less for a growth company than a value stock. In other words, growth stocks offer compelling value currently.

AT THE FIRM

We are pleased to announce two new additions to the DCM team!

Peter J. Niedland, CFA has joined the partnership roster of the firm. Peter will be leading our small- and micro-cap efforts in order to expand our product offerings. He brings with him over twelve years of experience at Pilgrim Baxter & Associates where he was a small-cap growth portfolio manager and research analyst, managing over \$600 million in assets.

Jacqueline Pasquarello will be managing the operations team. Jackie's background includes portfolio accounting with Chartwell Investment Partners, LLP and fourteen years with Morgan Stanley Investment Management (formerly Miller, Anderson & Sherrerd) where she was involved in operations management and trading.

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