



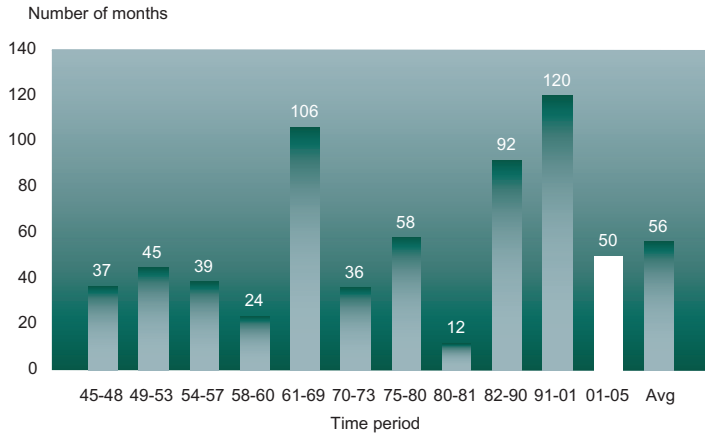
ECONOMIC OVERVIEW

The economy is expected to continue to show well-balanced economic growth despite the continuing steady increase in the Federal Reserve's Discount Rate and the recent economic shock created by hurricane Katrina.

Gross Domestic Product ("GDP") growth for 2005 is expected to come in at 3.6% representing a gradual decline from the 4.2% recorded in 2004 but still modestly ahead of the longer term average rate of growth. During 2006, GDP growth is expected to continue to grow at a decelerating rate in the area of 3.1%. Incremental growth should be characterized by a slowdown in consumer spending partially offset by continuing job growth, inventory building, foreign demand and continuing solid growth in corporate spending. During 2006, Real Consumer Spending growth is expected to moderate to the level of 2.7%,

while Real Business Investment Spending should continue to record strong gains in excess of 6%.

US Business Cycle Expansions



Last Obs: 1/06  
Source: National Bureau of Economic Research; Clarion Inv. Research, Inc. CYCL300A

Throughout 2005, awareness of the economic cycle and the degree to which current expectations were built into the valuation of the general equity market proved to be critical to investors. The current economic recovery that began in the fourth quarter of 2001 has entered its fifth year of positive growth. The initial recovery was driven by aggressive monetary and fiscal stimulus by the

government coupled with relatively strong consumer spending trends. Beginning in the second half of 2003, continuing positive growth became more balanced as corporate spending showed significant improvement from what had been depressed levels. Based on an average economic recovery of 4.7 years in the post World War II period, the current cycle should be judged on its capability to generate continued growth well beyond the historic average duration of an economic recovery that will be reached at mid-year 2006.

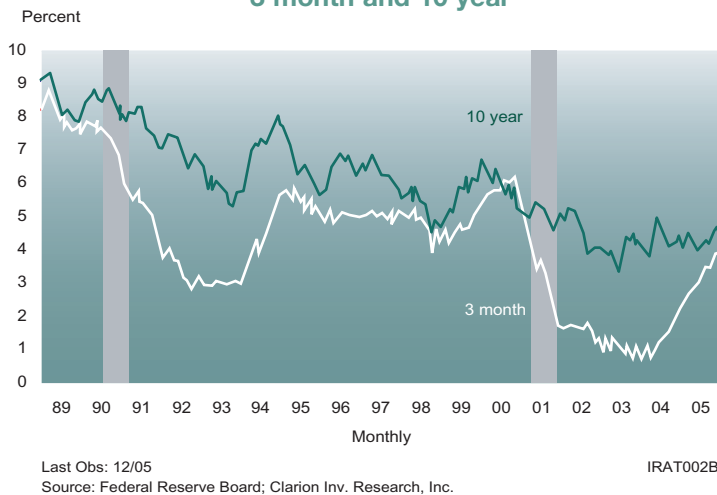
INTEREST RATES AND INFLATION

Over the course of the last eighteen months, the Federal Reserve has conducted a measured withdrawal of monetary stimulus through a program of thirteen quarter-point increases in the Federal Funds Rate

from 1% in mid 2004 to 4% at year-end 2005. This gradual tightening has had little impact on continued positive economic growth or longer term interest rates due to the general environment of low corporate sector loan demand and heavy international demand for domestic debt instruments.

Inflationary trends have remained relatively subdued over the past year as measured by the Core Consumer Price Index (“CPI”), ex food and energy, increase of 2%. The all inclusive CPI, however, has increased by over 3.5% during the past year and the Producer Price Index is now up by over 4.4% during the same period. Manufacturers are no longer holding back on passing along their increased

### Nominal Interest Rates 3 month and 10 year



costs to the consumer. It has become an industry standard to see gas surcharges on everything from trash hauling bills to shipping receipts. To date, increasing fuel and raw material costs have been largely offset in finished goods pricing by continued productivity gains. However, as these gains moderate in the later stages of the recovery, inflationary pressures may gradually become more apparent.

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Over the next few months we expect the Federal Reserve to continue to increase the Federal Funds rate to the area of 4.5%. As the short end of the yield curve continues to move up, we believe that the longer rates will eventually follow. The ten-year Treasury bond is currently artificially depressed by technical factors to yield 4.5%, a rate that has not increased materially over the last year. There are several technical demands on this particular bond that have held its yield down which include: hedge fund activity; portfolio duration management; pension actuarial balancing; foreign demand; and the relatively modest longer term Treasury bond supply. As several of these pressures moderate over the next year, we expect to see the ten-year Treasury reflect a more realistic interest rate level closer to 5% by year-end 2006.

## BOND MARKET

To say that 2006 should be a very interesting year would be an understatement. The bond market is not only focusing on when the Federal Reserve finishes raising interest rates, but is also keeping a keen eye on inflation, new issue supply, total US debt, liquidity and geopolitical risks. None of these issues point to a true yield curve inversion traditionally indicative of an impending recession.

**T**he housing market is a big swing factor in this equation. Will housing prices hold or give slightly resulting in a soft landing? Will home owners continue to extract cash from their homes? 70% of GDP in 2004 was related to household spending. \$600 billion of this cash came from home equity! The housing affordability index is falling. Spreads have widened on ARM's in anticipation of a wave of refinancing into 30-year mortgages. As a firm we have wisely maintained light positions in mortgage securities. This means a lot of 15-and 30-year supply to come.

Another concern affecting interest rates is the US debt load. Foreign accounts hold 50% of US public debt. This number was a mere 33% in 2000. China and Japan hold the most US securities. We are confident that we will not see dollar dumping or US securities flooding the market from other countries. However, the market is expecting to see an additional \$300+ billion of net new US Treasury debt in the marketplace. Large supply with heavy foreign demand and a steady dollar should translate into a more positive sloping curve by year-end. Expectations are for the 10-year to hit 4.75%-5%.

## EQUITY MARKET

During 2005, the general market averages showed little in the way of broad appreciation. Many individual companies posted strong appreciation for the year, however the appreciation was not broad based and only two economic sectors recorded double-digit growth. During the year, the Energy sector recorded a gain of over 30%, while the Utility group increased by 17%. The Consumer Discretionary group and Telecommunications sector were down for the period while most of the remaining sectors posted low single-digit gains or losses with the broad market, as measured by the S&P 500, recording a total return of less than 5%.

The reported earnings from the S&P 500 composite are expected to post an increase of approximately 11% in 2005, which represents an all-time high absolute earnings level and an incremental growth rate that remains well above the market's long-term average. Preliminary projections for 2006 call for an incremental earnings gain of 8%, which is slightly above the 7% long-term trend line.

As for the market's valuation after four years of economic recovery, the average price/earnings multiple is 17 times earnings, representing a valuation that is in-line with the average valuation level for the market over the longer term. While current valuation levels are no longer undervalued from a historical perspective, the increased quality of reported corporate earnings that has resulted from the last three years of close regulatory scrutiny, coupled with the outlook for continuing growth leads us to be relatively positive on current values within the market. But as was the case in 2005, individual stock fundamentals and earnings growth potential will continue to be the differentiating factors in determining the stock's incremental appreciation potential. The market is likely to become increasingly selective in rewarding companies that have the ability to show solid earnings gains while the economy's overall momentum slows and cyclically based earnings gains become less certain.



## OUR PERSPECTIVE

In spite of the economic and geopolitical uncertainties being expressed at the beginning of 2005, our published forecast for the year was for a relatively positive outlook for the year ahead.

*“While economic growth is projected to moderate in 2005, the prospects of continued gains remain strong based on growth in consumer wages coupled with increasing real investment spending from the corporate sector. The estimated 4.1% real gross domestic product increase in 2004 should moderate to 3.1% in 2005. The earnings from the S&P 500 are expected to post an increase of 9% in 2005, which is slightly above the 7% long term trend line. As for the market’s valuation, the average price/earnings multiple is no longer undervalued based on historic levels. However, considering the current inflation rates, these valuation levels are not materially overvalued either. Therefore, the maturity of the economic rebound will likely dictate that a stock’s appreciation potential will be more closely focused on a specific companies’ potential for fundamental growth as the general economic trends moderate.”<sup>1</sup>*

While there is certainly risk in any forecast, most of what we expected in 2005 did indeed occur. Interest rates moved up and are expected to move up further in 2006. Earnings were strong and while expected to decelerate from here, are still above trend line growth. And finally, appreciation potential, while certainly present, should continue to be specifically tied to the fortunes of the individual companies and not materially captured by the broad market indices.

1. Davidson Capital Management Quarterly Review, December 2004

## AT THE FIRM

We are pleased to announce that **Wayne LeSage, Jr.** earned his CFA designation in the fourth quarter. This is a terrific accomplishment, as it takes a tremendous commitment to pass all three levels of the examination. *Congratulations Wayne!*

**Bruce K. Bauder** and **Joseph J. Costigan** have accepted invitations to join the partnership. Both men have made important contributions to our firm’s clients during their tenure with Davidson Trust Company. We are proud to add both names to the partnership roster.

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

DAVIDSON CAPITAL MANAGEMENT

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