**VICTOR LEVINSON** **NICK LEVINSON**

# MAY 2004 COMMENTS

## IMPORTANT NOTES:

### E-MAIL INFORMATION and TRANSMISSION

Starting this month, we will be E-MAILING the Comments, instead of mailing them, to everyone who has not previously received the Comments by e-mail, and for whom we have e-mail addresses. If you prefer receiving the Comments by regular mail, please advise Lynette at her email address, **lynettec@parkpiedmont.com**. Alternatively, if we do not have your e-mail address, and you would like to receive the Comments by e-mail, please provide your e-mail address to Lynette.

### REMAINING TRANSFERS to LSS/NFS: Related LSS/NFS Matters

As of now, only a few accounts remain to be transferred from Bear Stearns (BS) to LaSalle Street Securities (LSS)/National Financial Services (NFS). For these accounts, you will continue to receive BS statements until such time as the transfers are completed.

You will note the new statements for taxable accounts have a column for cost basis information (cost basis is not relevant for retirement accounts). We continue working towards providing this information to you before year-end 2004.

The new statements also provide added asset allocation information by dividing the mutual fund category into stock funds and bond funds. While this is extremely useful, there are certain investments that we may treat differently for allocation purposes, and therefore we continue to refer you to our quarterly billing report and its asset allocation information.

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*Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.*

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## COMMENTS: INDEX RESULTS, period ending MAY 31, 2004

| STOCKS | YEAR 1999 | YEAR 2000 | YEAR 2001 | YEAR 2002 | YEAR 2003 | YTD 2004 | CURRENT MONTH |
|---|---|---|---|---|---|---|---|
| Vanguard Total Stock Market Index Fund (1) | 23.8% | (10.6)% | (11.0)% | (21.0)% | 28.4% | 1.8% | 1.4% |
| S&P 500 Index (2) | 19.6% | (10.1)% | (13.0)% | (23.4)% | 26.4% | 0.8% | 1.2% |
| Vanguard S&P 500 Growth Index Fund (1) | 28.8% | (22.2)% | (13.0)% | (23.7)% | 25.9% | 1.9% | 1.9% |
| Vanguard S&P 500 Value Index Fund (1) | 12.6% | 6.1% | (12.0)% | (20.9)% | 32.2% | 1.0% | 0.9% |
| Dow Jones Industrial Average Index (2) | 25.2% | (6.2)% | (7.1)% | (16.8)% | 25.3% | (2.5)% | (0.3)% |
| NASDAQ Composite Index (2) | 85.6% | (39.3)% | (21.0)% | (31.5)% | 50.0% | (0.9)% | 3.3% |
| Vanguard Mid Cap US Index Fund (1) | 25.0% | 2.6% | (4.8)% | (16.3)% | 34.1% | 3.0% | 2.6% |
| Vanguard Small Cap US Index Fund (1) | 19.6% | (4.2)% | 1.0% | (21.6)% | 45.6% | 3.5% | 2.0% |
| Vanguard International (EAFE) Index Fund (1) | 25.3% | (15.2)% | (22.6)% | (17.5)% | 40.3% | 1.8% | 0.5% |
| **BONDS:** | | | | | | | |
| Vanguard Total Bond Market Index (1) | (0.8)% | 11.3% | 8.3% | 8.2% | 4.0% | (0.5)% | (0.5)% |
| Vanguard Interm. Tax-Exempt Bond Index (1) | (2.9)% | 9.2% | 5.0% | 7.9% | 4.4% | (1.0)% | 0.0% |
| Vanguard High Yield Taxable Bond Fund (1) | NA | NA | NA | 1.7% | 17.2% | (0.4)% | (1.7)% |

| % | 1999 1Q | 1999 2Q | 1999 3Q | 1999 4Q | 2000 1Q | 2000 2Q | 2000 3Q | 2000 4Q | 2001 1Q | 2001 2Q | 2001 3Q | 2001 4Q |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **S&P 500** | 4.1 | 7.6 | (7.7) | 15.6 | 2.0 | (3.0) | (1.3) | (7.8) | (12.1) | 4.8 | (13.8) | 8.1 |
| **NASDAQ COMP** | 14.6 | 10.0 | 0.0 | 61.0 | 12.4 | (14.8) | (7.2) | (29.6) | (25.5) | 12.9 | (26.7) | 18.3 |
| **BONDS Interm. Taxable** | 0.0 | (0.5) | 0.4 | (0.7) | 2.4 | 1.5 | 3.1 | 4.3 | 3.2 | 0.8 | 4.3 | 0.0 |

| % | 2002 1Q | 2002 2Q | 2002 3Q | 2002 4Q | 2003 1Q | 2003 2Q | 2003 3Q | 2003 4Q | 2004 1Q | 2004 2Q | 2004 3Q | 2004 4Q |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **S&P 500** | 0.0 | (13.8) | (14.1) | 4.5 | (1.8) | 12.8 | 2.2 | 13.2 | 1.3 | | | |
| **NASDAQ COMP** | (5.5) | (19.5) | (13.5) | 7.0 | 2.5 | 19.2 | 12.1 | 16.2 | (0.5) | | | |
| **BONDS Interm. Taxable** | 0.0 | 2.8 | 3.6 | 1.8 | 0.9 | 2.7 | 0.2 | 0.2 | 2.7 | | | |

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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## MAY 2004 COMMENTS

During the month of May 2004, most **STOCK PRICE** indexes posted modest gains, for the first positive monthly result since February 2004. For the month, the S&P 500 gained 1.2%, the Dow Industrials declined (0.3)%, and the NASDAQ Composite gained 3.3%. Year-to-date (YTD), the S&P 500 is now up 0.8%, the Dow down (2.5)%, and the NASDAQ down (0.9)%. Even with the flow of bad news reported in the media --about Iraq, inflation and interest rates-- stock prices advanced modestly. Since there was good news regarding the continued expansion of the US economy, signs of improved growth elsewhere, and strong US corporate earnings, the net gain for stocks seemed to have some basis in reality.

**BOND RETURNS** (price change plus interest) were negative again in May, but at a much lower rate compared to April. During May, high quality intermediate-term taxable bonds had returns of minus (0.5)%, compared to a minus (2.7)% in April, while intermediate-term municipal bonds (munis) broke even, compared to a minus (2.2) % in April. Taxable bonds are minus (0.5%) YTD, while munis are down (1.0)%. High Yield ("Junk") bonds continued to move without much connection to other bonds (or stocks), declining more in May, minus (1.7)% than in April, minus (0.7)%. This bond category is now down (0.4)% YTD.

When analyzing bond returns, it is extremely important to understand that the interest portion of the bond return is earned in small increments each month, whereas the price changes of bonds, up or down, can take place in short time frames, and can, at times, be quite substantial. Therefore, significant price changes early in the year can have a distorting influence on YTD bond returns, since the certain positive returns come from interest earned month after month for the full year. Also remember that in the liquid markets, there are two alternatives to bonds: Money markets and other cash equivalents that have stable prices but very low current interest rates; or stocks, which historically have had far more volatile prices along with their higher returns, and currently provide very little steady income flow.

While the media continues to stress the inflation risk, and the likelihood of Federal Reserve ("Fed") rate increases, the bond market appears to have already priced in an increase in the short-term interest rates the Fed controls. In a May 11th WSJ article (pg. C1 and continued), one analyst says that "bond prices reflect expectations of Fed rate hikes totaling _ to _ percentage point this year." This range seems appropriate given that the yield on the benchmark 10-year US Treasury is now at 4.65%, which is 3.65% over the 1% Fed Funds rate; historically, this yield spread is closer to 3%.

As we have discussed many times, maturities and credit quality are the key variables for bond prices in times of significant changes in market interest rates. To illustrate, we have set out below the 2004 YTD total returns (interest earned plus/minus price changes) of a variety of the bond and other interest-sensitive investments that we make in our client's portfolios. (Note: we do not use long term bond investments).

| | Short | Limited | Interm. | Long | Infl. Prot. | HiYld. | REITs |
|---|---|---|---|---|---|---|---|
| Treasuries | (0.2)% | NA | (0.8)% | (1.2)% | +1.7% | NA | NA |
| Corporates | +0.1% | NA | (0.8)% | (1.2)% | NA | (0.4)% | +2.3% |
| Mixed Govt/Corp | (0.2)% | NA | (0.5)% | (1.4)% | NA | NA | NA |
| Municipals | 0.0% | (0.6)% | (1.0)% | (1.7)% | NA | (0.5)% | NA |

1) Results for Vanguard funds include income and Vanguard fees, but not PPA fees

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Stock and bond investment results for May, for 2004 YTD, and for the five years 1999–2003 are set out on page 2. The stock market rally which began in March 2003 has raised the S&P 500 by 44% from the October 2002 low, even with the recent March-April decline. While these gains have made investors believe again that stocks do not go down in perpetuity (a view that was widely held during the depths of the bear market), the question of whether this recovery will continue is, as always, dependent on unknown future events. (Note also that after a price decline of 50%, it takes a gain of 100% to return to the previous price level).

In order to keep the current recovery in perspective, we continue to show the chart below, which sets out the extent of the declines measured from the highs of Q1 2000. The chart also puts these declines in the context of results since the end of 1994 (see also the figures on page 11). Note that the three indexes have positive average annual returns ranging from 9.9% to 10.9% for the 9.4 year period from the end of 1994 through May 2004, very much in line with long term stock returns going back to 1926. Further, as these returns converge more and more, the idea of "regression to the mean" seems quite applicable.

**The long-term investor therefore has a very different view of the stock market's returns than those measuring returns from the highest levels.**

| | **S&P 500 (1)** | | **DOW (1)** | | **NASDAQ (1)** | |
|---|---|---|---|---|---|---|
| 1st Qtr 2000 High | 1,527 | | 11,723 | | 5,048 | |
| Year End 2000 | 1,320 | (13)% | 10,785 | (8)% | 2,470 | (51)% |
| April 10, 2001 Low | 1,103 | (28)% | 9,390 | (20)% | 1,684 | (67)% |
| September 21, 2001 Low | 965 | (37)% | 8,235 | (30)% | 1,425 | (72)% |
| Year End 2001 | 1,148 | (25)% | 10,020 | (17)% | 1,950 | (61)% |
| October 9, 2002 Low | 777 | (49)% | 7,286 | (38)% | 1,114 | (78)% |
| Year End 2002 | 880 | (42)% | 8,342 | (29)% | 1,336 | (73)% |
| Year End 2003 | 1,112 | (27)% | 10,454 | (11)% | 2,003 | (60)% |
| May 31, 2004 | 1,121 | (26)% | 10,188 | (13)% | 1,987 | (61)% |

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999:

| | **S&P 500 (1)** | **DOW (1)** | **NASDAQ (1)** |
|---|---|---|---|
| End 1994 | 459 | 3,834 | 752 |
| End 1999 | 1,470 | 11,500 | 4,070 |
| Gain | 1,011 | 7,666 | 3,318 |
| Avg. Ann. % Gain, '95-'99; 5 years | 26.2% | 24.6% | 40.2% |
| May 2004 | 1,121 | 10,188 | 1,987 |
| Gain | 662 | 6,354 | 1,235 |
| Avg. Ann %Gain, '95-5/04; 9.42 yrs | 9.9% | 10.9% | 10.8% |

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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## I. Update of Key Economic Indicators

The strength of the overall U.S. and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. (Note: We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth). In any event, an understanding of the direction of current economic trends is useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators.

(1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the U.S. economy. (GDP figures are inflation-adjusted, annualized rates of growth). GDP for the first quarter (Q1) of 2004 was initially estimated at 4.2%, up slightly from the Q4 2003 figure of 4.1%, and well below the 8.2% for Q3 2003, which was a 20-year high. The most recent revision of Q1 2004 GDP, reported during the week ending May 28th, raised the growth rate from 4.2% to 4.4% (Vanguard Economic Week in Review, "VEWR," 5/24-28).

(2) Employment for April rose 288,000, following the March increase of 337,000. The WSJ article on this report (5/10, pg A2) stated that the first four months of 2004 showed employment gains of 867,000, "a sharp turnaround from the year-earlier period when the economy was losing jobs." Moreover, continued "strong employment gains suggest the US economy has entered a new self-sustaining phase of expansion…."

(3) Interest Rates increased during May, but at a much more moderate pace compared to April. The benchmark 10-Year US Treasury bond yield closed at 4.66%, up from 4.5% in April, which in turn had registered a huge 0.6% increase from the March level of 3.9%. This benchmark yield had increased to as high as 4.85% during May, before falling moderately to its month-end level. These April-May levels are the highest since the 4.45% reached in August 2003.

(4) Inflation increased in April. The Consumer Price Index ("CPI") "core" rate, which excludes the volatile food and energy sectors, rose 0.3%, increasing the inflation rate for the last twelve months from a historically low 1.2% to a higher 1.8% (VEWR, 5/10-14). Further, the Producer Price Index (PPI) core rate was up 0.2%, with the rate for the last twelve months now at 1.5% (VEWR, 5/10-14). The VEWR added that "prices for intermediate and crude goods rose at a faster rate than those for finished goods, which led some analysts to believe that inflationary pressures will only increase further down the road." Commenting on the same CPI report, the NY Times (5/15, Business page 1 continued), stated: "At its current level (1.8% annualized), the core inflation rate is approaching the 2% figure that many analysts describe as a limit, set by the Fed, that cannot be exceeded without forcing the central bank to raise the pivotal short-term interest rate that it controls." In a front page WSJ article (5/21) titled "Fed Shifts Focus From Job Growth to Rising Prices," the author writes that "An unexpected quickening in the pace of price increases in the past two months is challenging the Federal Reserve's plan to raise short-term interest rates only slowly from today's 46-year lows. The recent shift in prices is at odds with Fed officials' forecast that the combination of unemployment, unused industrial capacity and rapid growth in productivity would keep inflation very low for another year or two."

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(5) Sector Economic Activity was Strong

(a) Durable goods orders fell 2.9% in April, the largest drop since September 2002, following the largest two-month gains since 1992. Year-over-year gains remained strong (VEWR, 5/24-28; NY Times, 5/27, Business pg. 2).

(b) Industrial production rose 0.8% in April, "continuing the trend of strong monthly growth since mid-2003" (except for March 2004) (VEWR, 5/10-14).

(c) Retail Sales fell in April, attributed mostly to a drop in auto sales, but at a rate 8% higher than April 2003 (VEWR, 5/10-14).

(d) Housing sales for new homes fell sharply in April, but sales of existing homes rose (VEWR, 5/24-28; NY Times, 5/27). Increases in mortgage rates were cited as reasons for both results.

(e) Personal Income rose 0.6% in April, while personal spending, which accounts for two-thirds of U.S. economic activity, grew 0.3% (VEWR, 5/24-28).

(6) Consumer Confidence, as measured by the Conference Board's Index of Consumer Confidence, was flat in May, below analysts' expectations. "The board's survey found that rising energy prices, the weak stock market, increasing interest rates, and renewed rears of terrorism offset strong gains in the job market in the past few months (VEWR, 5/24-28).

(7) Corporate Profits for the first quarter of 2004 were strong. (There was no new news during May regarding previously reported first quarter profits). A WSJ article dated April 26th (pg. C1) discussed the rise in first quarter profits, which was strong enough that analysts are now increasing their estimates for the year, even to the point of projecting gains greater than last year's 18% gains. The article then goes on to question whether these highly favorable earnings can support stock prices that still approach 20 times projected earnings levels, compared to the historic price-earnings ratio of closer to 15.

While most of the economic news for May continued to be favorable, the ever-present question is whether stock prices are likely to respond, or have already responded, to all this news. Further, the media is full of stories indicating that all this good news on economic growth may lead to the not-so-good news of rising inflation and interest rates. And there is always the fundamental uncertainty as to the actual course of future economic developments based on actual events. As usual, only the unfolding of the actual events will determine the course of future price movements.

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## II. OIL PRICES, and Their Effects on Interest Rates, Inflation and Economic Growth; Also on Stock and Bond Prices

Oil prices have been in the headlines recently, having soared to record highs measured by nominal US dollars (before adjusting for inflation). Their impact is most obvious to people when they fill up the gas tanks of their cars. These high prices have potential high stake political implications as well (see front page WSJ article, 5/5/04, "Oil Prices Near $40 a Barrel, Casting Long Shadow," continuation page A6, in which the authors write: "The rise in oil prices also poses a political risk for President Bush, whose re-election campaign is suffering from public doubts about Iraq and the economy. Oil feeds directly into both concerns.") While the immediate reaction to these high prices is almost universally negative, their real impact on the economy, on interest rates and inflation, and indirectly on stock and bond prices, is quite complex. We are therefore devoting this month's Comments to a discussion of the issues raised by the current upward spike in oil prices.

To begin with, let's review some basic facts regarding oil and oil prices: Most important is the fact that the price of oil is really not that expensive when inflation is taken into account. During the mid 1970s, and again in the early 1980s, oil prices also went above $40 US dollars per barrel; that $40 price, when adjusted for inflation, would be closer to $100 per barrel in current dollars (see above cited WSJ article, front page, in which the authors write: "The last time oil prices broke significantly above the $40-a-barrel level was 1981, after the Iranian revolution curtailed exports from that country. That is equal to about $100 a barrel, if measured in today's dollars."). This thirty-year period has seen both high inflation rates (10-12% annually in the 1970s, which is high in the US economic experience) and low inflation rates (1-2% annually since 2001).

A second key fact is that the impact of oil prices is considerably less today than it was thirty years ago. A 5/27/04 NY Times article (pg. C1) discusses how less petroleum is used in factories today than was used in the 1970s, as the result of improved energy efficiency and energy conservation, so that "energy is a relatively small percentage of their (manufacturer's) costs." A 5/28/04 NY Times article (pg C1, continued on pg C6) states: "There are important differences between conditions today and thirty years ago….Energy is a smaller component of the overall economy now, prices are still fairly low in inflation-adjusted terms, and measures taken after the oil shocks of the 1970s provide some protection."

In spite of the apparently favorable impacts of these two facts, oil is still cited as having major impacts on the economy, inflation, interest rates, and, as a consequence, on stock and bond prices. In a signed article covering many of the impacts of oil prices, which appeared on page C2 of the May 27th NY Times, Princeton Economics Professor Alan Krueger writes that "sharp increases in the price of oil preceded four of the last five recessions…." But to emphasize the complexity of the impact of oil prices, the article continues: "Economists have not reached a consensus on the reason that oil price spikes depress economic activity – and probably never will because many aspects of the economy and economic policy change in tandem….While it is true that the share of oil dollars in the economy has declined…, there is little reason to believe that oil prices have become irrelevant for economic activity."

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The Krueger article continues: "Some economists argue that oil price increases matter because they make it more costly to produce a variety of products….Others argue that oil price increases cause a shift in demand across sectors, disrupting production….Still others argue that oil price increases act like a tax because most oil revenues flow overseas." And in another reference to the complex nature of the impacts of oil prices, Professor Krueger writes that "…Another question involves the extent to which the adverse effect of oil price shocks on economic growth results from the shocks themselves, or from the response of the Federal Reserve to those shocks, which is typically to raise borrowing rates to cool inflation." The author then cites a study indicating that "interest rate adjustments account for nearly all of the depressing effects of oil price shocks on the economy." The implication of this point, discussed at the end of the article, is that if the Federal Reserve does not raise interest rates in the face of this oil price spike, we might finally come to understand the real impact of oil price increases on the economy.

The Krueger article provides insights on all the pertinent interrelationships. Higher oil prices can have the effect of increasing costs, which in turn reduces the profitability of companies, which in turn would tend to lower stock prices. On the other hand, if companies can pass these costs along with higher prices, their profits may be maintained or even increase, which could result in higher stock prices but also trigger inflation. And if inflation becomes a problem, the Federal Reserve is almost certain to step in and raise interest rates in order to reduce inflationary pressures. And we know that rising interest rates result in lower bond prices, at least for some period of time. However, in another example of the multiple impacts involved, the same higher oil prices could be seen as putting a brake on the economy, thereby reducing inflationary pressures and the need to raise interest rates.

What lessons can we take from this discussion? Our view is that oil prices are but one of a number of factors that impact stock and bond prices, and that even in isolation, the impact of higher oil prices can cut in a variety of ways. Therefore, even if we knew how far and how fast oil prices are likely to rise during this economic cycle (which of course neither we nor anyone else knows for certain), it would still not be clear what action to take with regard to buying or selling stocks or bonds. While at first blush the higher prices would seem to be more negative than positive for both stock and bond prices, the higher prices do carry the seeds of economic slowdown, which would likely reduce the upward pressures on interest rates and would in turn have the usual mixed impacts on economic activity and stock prices.

Because of the importance of inflation and interest rates, and their connection to the discussion of oil prices, we are repeating a substantial portion of the following material from last month's Comments.

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What is the likely impact of increases in inflation rates on stock and bond prices? A look at history should provide some insight. (The following data, using 1949 as the starting point, comes from Ibbotson's 2002 Yearbook on Stocks, Bonds, Bills, and Inflation, pgs. 36-37):

| | Inflation Rate: | Intermediate Bond Returns: | S&P 500 Stock Returns: |
|---|---|---|---|
| 1949: | -(1.8)% | 2.3% | 18.8% |
| 1950: | 5.8 % | 0.7% | 31.7% |
| 1951: | 5.9% | 0.4% | 24.0% |
| 1952: | 0.9% | 1.6% | 18.3% |
| 1953-1965: | all years below 3% | | |
| 1966: | 3.3% | 4.7% | -(10.0)% |
| 1967: | 3.0% | 1.0% | 24.0% |
| 1968: | 4.7% | 4.5% | 11.0% |
| 1969: | 6.1% | -(0.7)% | -( 8.5)% |
| 1970-1972: | modest decline in inflation | | |
| 1973: | 8.8% | 4.6% | -( 14.7)% |
| 1974: | 12.2% | 5.7% | -( 26.5)% |
| 1975: | 7.0% | 7.8% | 37.2% |
| 1976: | 4.8% | 12.9% | 23.8% |
| 1977: | 6.8% | 1.4% | -(7.2)% |
| 1978: | 9.0% | 3.5% | 6.6% |
| 1979: | 13.3% | 4.1% | 18.4% |
| 1980: | 12.4% | 3.9% | 32.4% |
| 1981: | 9.0% | 9.4% | -(4.9)% |
| 1982: | 3.9% | 29.1% | 21.4% |
| 1983-1989: | not above 4.7% until 1990 | | |
| 1990: | 6.1% | 9.7% | -(3.2)% |
| 1991-1999: | not above 3.3%; | | |
| 1994 specific: | 2.7% | -(5.1)% | 1.3% |
| 2000: | 3.4% | 12.6% | -( 9.1)% |
| 2001-2003: | below 2% | 7.6%, 7.9%, 4.0% | - (11.9)%, -(23.4)%, 26.4% |

What lessons can we learn from this history?

1) When the media stokes people's fears about higher interest rates and their impact on bonds, they don't discuss where else to invest your bond money. Stocks have much more price volatility, up or down, than bonds. Cash generally has no price volatility, but its return these days is so low that it provides only downside protection, not a real investment return. In our view, managing maturities and quality (i.e., investment grade compared with high yield, or "junk", bonds) within a bond portfolio is the best way to handle interest rate risk.

2) Stocks have done very well during some periods of rising inflation; very poorly in other periods. Compare 1950-1951, very good years for stocks; 1973-1974, a horrible period for stocks; 1979-1980, another very good period for stocks; and 1990, a poor year for stocks.

3) In most times of rising inflation, bonds do not do well. Do not be fooled by positive returns in inflationary times; any return less than the rate of inflation provides negative "real" returns on investments. For example, in 1974 bonds rose 5.7%, but with inflation at 12.2% the after-inflation return in terms of "purchasing power" was negative (6.5)%.

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4) Low inflation does not guarantee favorable investment returns. Just look at the recent three-year (2000-2002) bear market in stocks for clear proof of this point. In 2003, bonds did not have a very good return even as inflation remained very low. But in most years, declining inflation does correlate with more favorable returns (see the examples of 1975 and 1976, 1982, and the bull market of the 1990s except for 1994).

5) Odd results also occur. For example, 1994 was the worst year for bonds since 1926, when the Ibbotson records were first compiled. But you would not have been able to predict this result from the inflation rate of 2.67%, which was right in line with the average figures for the entire decade. During 1994, the Federal Reserve saw fit to raise interest rates six times as it sought to keep what it perceived to be an inflationary surge from becoming an actual problem. It is noteworthy that the five years following 1994 witnessed an historic bull market for stocks and significant "real" average annual returns for bonds as well.

An April 19th WSJ article (pg. C1) also discussed the history of interest rate increases on stock prices, citing firms which provide long term data on market price changes. Steven Leuthold of Leuthold Weeden Capital is quoted: "The fact is that the stock market tends to continue going up after the first Fed rate increase." As a follow up to this point, an analyst with Ned Davis Research is quoted: "One rate hike alone isn't enough to derail a bull market. Usually it takes two or three or even four." One reason investors are concerned is that low interest rates have been one of the justifications for the broad S&P 500 stock index to trade at 23 times its companies' earnings for the past year, well above the historical average of about 15." The article also points out that "the real issue will be the risk of future rate increases and the ability of companies to keep posting robust earnings, not the small increase in base rates…" and "whether the economy has to face serious inflation, or just a mild dose." In a discussion of the 1950s and 1960s, the article notes that "when inflation and interest rates were similar to what they have been lately, investors didn't react that dramatically to Fed rate increases. There were four cycles of Fed rate increases during those two decades, and on average, one year after the Fed started raising rates, the broad market was up 21%."

Given all this information, the final question for our clients is whether you should change your current allocations to bonds. In general, we think not, for the following reasons:

(1) The impacts of rising interest rates were taken into account at the time the allocations were developed. This preparation involved a focus on short- and intermediate-term bonds, which have smaller price declines than longer term bonds in times of rising interest rates;

(2) As always, there are too many unknowns as to the number and extent of future rate increases to justify what we would consider an overreaction to the current news we do know;

(3) Your asset allocations are designed to achieve your objectives over extended time periods, not to be changed based on the short term movements of stock and bond prices; and

(4) The choices in the liquid markets continue to be stocks, bonds and cash. Stocks are likely to continue to be far more volatile than bonds, while cash continues to provide very low returns. Therefore bonds should continue to play an important role in your portfolio. Maintaining bond portfolios with short- and intermediate-term maturities continues to provide stability, income, and the opportunity over time to earn reasonable positive returns in excess of inflation rates.

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1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

**I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)**

| | S&P 500 (1) | | DOW JONES (1) | | NASDAQ (1) | |
|---|---|---|---|---|---|---|
| **Start of 2000** | 1,470 | | 11,500 | | 4,070 | |
| **End of 2000** | 1,320 | (10.1)% | 10,785 | (6.2)% | 2,470 | (39.3)% |
| **Sept. 21, 2001 Low** | 965 | (34.3)% | 8,235 | (28.4)% | 1,425 | (65.0)% |
| **End of 2001** | 1,148 | (21.9)% | 10,020 | (12.9)% | 1,950 | (52.0)% |
| **Oct. 9, 2002 Low** | 777 | (47.1)% | 7,286 | (36.6)% | 1,114 | (72.6)% |
| **End of 2002** | 880 | (40.1)% | 8,342 | (27.5)% | 1,336 | (67.2)% |
| **End of 2003** | 1,112 | (24.3)% | 10,454 | (9.1)% | 2,003 | (50.8)% |
| **May 2004** | 1,121 | (23.7)% | 10,188 | (11.4)% | 1,987 | (51.1)% |

**II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)**

| | S&P 500 (1) | | DOW JONES (1) | | NASDAQ (1) | |
|---|---|---|---|---|---|---|
| **Start of 1995** | 459 | | 3,834 | | 752 | |
| **End of 1999** | 1,470 | | 11,500 | | 4,070 | |
| **5 Year Gain; Annualized %** | 1,011 | 26.1% | 7,666 | 24.6% | 3,318 | 40.2% |
| **End of 2001** | 1,148 | | 10,020 | | 1,950 | |
| **7 Year Gain; Annualized %** | 689 | 14.0% | 6,186 | 14.7% | 1,198 | 14.6% |
| **End of 2002** | 880 | | 8,342 | | 1,336 | |
| **8 Year Gain; Annualized %** | 421 | 8.5% | 4,508 | 10.2% | 584 | 7.5% |
| **End of 2003** | 1,112 | | 10,454 | | 2,003 | |
| **9 Year Gain; Annualized %** | 653 | 10.3% | 6,620 | 11.8% | 1,251 | 11.5.% |
| **May 2004** | 1,121 | | 10,188 | | 1,987 | |
| **9.42 Year Gain; Annualized %** | 662 | 9.9% | 6,354 | 10.9% | 1,235 | 10.8% |

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