

May '05 Newsletter – Stock Market Update

Corporate earnings vs. the health of the overall economy is the tug of war on Wall Street these days. High volatility in recent weeks has been due to the conflicting data regarding rising inflation numbers and higher than expected corporate profits.

The bad news for investors is, we have had lighter volume on up days and heavier volume on the down days...a clear sign of institutional selling which accounts for 80% of market direction. This tells me, large money managers are more concerned about the economic data than corporate profits. Let's look at some inflation facts:

- Core CPI (consumer price index - inflation) which measures the cost of goods excluding food and energy, rose 0.35% in March. Nearly double Wall Street's forecast and the most in any one month since late 2002.
- Inflation, including food and energy, rose 0.6% last month. Energy prices alone are up 12.4% vs. a year ago. (Note: Core CPI data is generally used to measure inflation change because it ignores the volatile food and energy categories and is believed to be a true measure of the pace of prices in our economy.
- Core CPI is up 2.3% in the last 12 months. Below the last 15 year average of 3.1%.
- Wages are not keeping pace with the price of goods: -0.5% vs. one year ago.

Lower wages and rising prices, especially at the pump, means less disposable income. This could slow consumer spending which reduces future corporate profits...I'm sure you can see the developing pattern. Wall Street is mainly concerned with the future – the stock market is a "leading indicator" of the health of the economy.

Rising CPI data indicates the Fed may continue to raise interest rates...also a drag on the economy. When it costs companies more to borrow money, they are less likely to do so and this could slow future growth.

Should inflation be a worry? It is my assessment, no. We are still at historic low levels and the main driver of higher prices has been the world's increased demand for oil, specifically from China and India. Fed policy can't do anything to change the price of oil. Higher oil prices should eventually lead to conservation, development of alternative energy technologies and new oil discoveries to help keep pace with long term demand.

What does all this mean for you? Year to date the S&P 500 is down 4.9% and the NASDAQ 11.2%. At this point, we are in an intermediate correction. We need to focus on diversification and being in the best investments in each sector. This will reduce the drawdowns...which I like to call the "Ulcer Factor" in our portfolios and have us well positioned for the next bull market rally.

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