WEALTH MANAGEMENT GROUP

Market Scorecard

Late-Cycle Market Conditions

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- Reported fourth-quarter earnings climbed almost 19% over year-ago levels, besting expectations of 15% at the beginning of this year. Aggregate growth rates were carried by the Energy and Materials sectors, which surged 100% and 89%, respectively. Excluding those commodity industries, S&P 500 earnings advanced around 10%. For all of 2004, S&P operating earnings rose 21%. For 2005, however, Wall Street analysts have been adjusting expectations lower. Current 2005 projections stand at 9.9%, with strongest earnings growth still anticipated in Materials (22%). Analysts are counting on only 2% growth in Energy earnings, but, just like last year, upward revisions in the sector will likely persist at least through the first half of this year. In addition to Energy, bottom-up earnings projections for 2005 mark meaningful slowdowns in Information Technology and Consumer Discretionary.
- As indicated in earlier communications, slowing profit growth is a headwind for equity performance particularly when the monetary tightening cycle is in full swing. The Federal Reserve's rate-setting committee will meet next on March 22 and we expect the seventh "measured" hike in overnight lending rates in a row. So far, equity markets have avoided incurring meaningful damage mainly because long bond yields have defied the Fed's intentions of liquidity constraint by staying at remarkably subdued levels. In addition, corporations have become cash-rich in the aggregate and equity valuations are undemanding. As a result, 'big-money' institutional investors are not rushing for the exit.

Key Market Indicators

Parameter	***Observation***	***Equity Impact***
Corporate Earnings	Slowing profit growth	On yellow
Monetary Policy and Liquidity	Fed rate-hike cycle in upswing	On red
High-Yield Bond Spreads	Still narrowing versus investment-grade bonds	On green
Absolute Valuations	P/E in 'fair-value' zone	On green
Relative Valuations	Favoring stocks over bonds	On green
Crude Oil Prices	Continued upward pressure, over $50 per barrel	On yellow
Economic Cycle Direction	Leading indicators point to stable growth	On green
Manufacturing Activity	Solid growth but below peak momentum	On green
Services Activity	Solid growth but below peak momentum	On green
Buying Power vs. Selling Pressure	Reluctant institutional accumulation	On yellow
Chart-Technical Picture	Rally in slow gear, consistent with late-cycle market	On yellow

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- Instead, they are stepping up the pace of sector rotation. In the first two months of the year, the S&P 500 index failed to make any headway, but the Energy sector surged no less than 22%. In contrast, Technology stocks as well as the Consumer Discretionary sector declined about 5% in the aggregate.
- It is understandable that investors have certain reservations about the sustainability of firm global growth in the current macro-economic environment. In this regard, persistent upward pressure on crude oil prices and higher rate-hike expectations are not very helpful. Hence, investors continue to exhibit a value bias and preference for relatively defensive industries in their equity allocations. Still, solid business confidence and a favorable outlook for U.S. capital spending suggest that stable growth conditions may prove sustainable longer than consensus expectations. Cautious investor sentiment about the economic outlook and lagging performance of cyclical sectors and industries outside the commodity complex suggest that at least a counter-trend wave favoring Cyclicals may develop in the weeks ahead. Still, we would use such an upward push to new cycle highs to incrementally shift exposure into non-cyclical areas of the market. Late-cycle market conditions and developing pressures on earnings growth rates still suggest to us that upside in the major market averages is contained and that a plateau phase in a possibly wide trading range could develop soon thereafter.

Valuation Parameters

Parameter	Mar 1	Jan 27	Observation
S&P 500 index	1210	1174	Market testing cycle highs
S&P 12-Month Forward EPS	$75.16	$74.04	Rising
S&P 12-Month Forward P/E ratio	16.1	15.9	In 'Fair-Value' zone
S&P 12-Month Forward P/E (ex Tech)	15.1	14.9	At historical average
S&P 500 Consensus EPS Forecast 2005	9.9%	10.2%	Decelerating from 2004; revised lower
S&P 500 Actual Long-Term EPS Growth	5.9%	5.9%	Below analyst expectations
Fed Funds Rate	2.50%	2.25%	Overnight lending rates in uptrend
Fed Funds Futures August ' 05	3.42%	3.22%	Rate expectations tightening
2-Year T-Bond Yield	3.58%	3.28%	Rising short-term yields
10-Year T-Bond Yield	4.37%	4.14%	Long-term yields firming
Baa Corporate Bond Yield	5.12%	4.84%	Corporate spreads holding near cycle lows
Earnings Yield (12-Mth Forward)	6.21%	6.31%	Smaller advantage over corporate yields

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