



**INVESTMENT COMMENTARY**

**Market Review**

After a strong end to 2004, stocks generally weakened in January, rose in February, and then fell off again during March, resulting in negative returns for the first quarter of 2005. As expected, the Federal Reserve continued raising short-term interest rates, slowing growth of the money supply and signaling the Fed's commitment to restrain inflationary expectations. Longer-term rates finally began a moderate rise, as the yield on the benchmark 10-year Treasury bond rose from 4.2% to 4.5%<sup>1</sup>. As the table below shows<sup>2</sup>, total returns on bonds were flat to slightly negative. With corporate earnings continuing to increase and strong, cash-heavy corporate balance sheets, credit spreads, i.e. the yield premium over the comparable Treasury issue, narrowed during the quarter, making it difficult to find attractive value in the corporate bond market.

Comparative Performance Indices			3-Year Average		
Total Return for periods ending March 31, 2005 <sup>2</sup>			Quarter	Year	Annual Return
U.S. Stocks	Russell 3000		-2.2%	+7.1%	+3.7%
Foreign Stocks	MSCI EAFE		-0.8%	+12.5%	+9.2%
Taxable Bonds	Lehman Brothers Aggregate Bond		-0.5%	+1.1%	+6.0%
Municipal Bonds	Lehman Brothers Municipal Bond		-0.0%	+2.7%	+6.1%

The indices above are representative of investment asset classes. The Lehman Brothers Aggregate Bond Index is composed of U.S. Treasury, U.S. government agency, corporate bond, and mortgage-backed securities. The Lehman Brothers Municipal Bond Index is composed of general obligation (GO) and industrial revenue bonds issued by state and local governments. The Russell 3000 Index is composed of the 3000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market. The Morgan Stanley Capital International Europe, Australia and the Far East (MSCI EAFE) Index is a widely followed group of stocks from 20 countries, excluding the U.S. It is not possible to invest directly in an index.

During the quarter, the news flow was dominated by oil prices, which rose substantially from \$43 per barrel to \$55 per barrel<sup>3</sup>, the current account deficit, a.k.a. the trade deficit, and anticipation of higher interest rates, higher inflation, and a lower dollar. As explained below, we believe that many of these fears were (and still are) either overblown, misplaced, or both.

**Current Outlook**

We maintain our view that 2005 will be the third consecutive year of positive stock market returns (though probably the lowest of the three years). Here's why ... we expect that 1.) oil prices will fall substantially in the next year; 2.) inflation will rise moderately; and consequently 3.) long-term interest rates will not rise fast enough to significantly inhibit economic growth.

Oil prices will fall because perceptions, which drive speculative trading, do not match the market realities of reliable oil supplies, building inventories, and softening demand<sup>4</sup>. High prices have stimulated increased exploration budgets among cash-rich oil companies, leading to growing drilling activity around the world. The temporary disruption of oil supplies from Nigeria, Venezuela, Russia, and Iraq, which took place over the past few years, are mostly eliminated. On the demand side, demand will slow for several reasons. (*over*)

<sup>1</sup> Yahoo Finance

<sup>2</sup> Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, April 4, 2005.

<sup>3</sup> TFC Commodity Charts

<sup>4</sup> Bear Stearns, February 15, 2005



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The Strategic Petroleum Reserve will reach full capacity later this year<sup>5</sup>. High prices are already beginning to slow demand growth in China, the world's second largest oil consumer, India, and elsewhere. While oil demand is relatively insensitive to price among developed nations, consumers in developing nations actively reduce consumption when prices rise. Consequently, we believe, barring a major supply disruption from war, terrorist attack, or other geopolitical event, that oil prices are headed substantially lower over the next year. Is this a bubble? Perhaps. Moreover, we believe that "Wall Street" has overestimated the impact of today's high oil prices on corporate earnings. Based on this view of the oil market, we have reduced our holdings of oil stocks. We remain bullish, in the near-term, for other stocks.

Inflation will rise moderately, but for the right reason – domestic economic growth. Inflation, as measured by the Consumer Price Index, has already risen to an annualized rate of 3%, significantly higher than the 1-2% rates that we have experienced over the past several years<sup>6</sup>. The increase in inflation appears to be due to the rapid money supply growth of the past two years accompanied by the today's strong demand growth throughout the global economy. Nonetheless, inflationary pressures will moderate based on the Federal Reserve Board's clear shift from an anti-deflation to an anti-inflation policy and a strengthening dollar. We expect moderately increasing inflation to have a relatively benign effect on stock prices.

We expect nominal interest rates to continue rising at both ends of the yield curve. The Fed is driving short-term rates higher and inflation is driving long-term rates higher. However, real interest rates, i.e. nominal rates less inflation, should remain low as a result of high corporate liquidity and strong international flows into the U.S. Treasury market. The international flows represent the necessary offset to the current account deficit. Overseas capital from China, India, and other emerging markets continues to buy U.S. Treasury bonds, helping to keep U.S. interest rates low, as these countries prevent their currencies from rising and slowing exports and economic growth.

Professor Jeremy Siegel of the University of Pennsylvania states that current account deficits and capital account surpluses, rather than representing causes for alarm, are an inevitable consequence of demographics and, therefore, are likely to remain with us for many years<sup>7</sup>. As the largest and most affluent generation in U.S. history, a.k.a. the baby boomers, moves into retirement, who is going to buy their assets and produce the goods and services to support their retirement living? ... the younger populations in the developing nations. A recent study by McKinsey & Company reached a similar conclusion by analyzing the impact of foreign investments by U.S. multinational companies on the current account deficit<sup>8</sup>. We believe that the current account deficit is here to stay, at least for the next 10 to 15 years, and will neither cause a precipitous dollar decline nor a spike in interest rates.

Given this investment environment, assuming our expectations are accurate, stock market returns for 2005 should remain positive and bond market returns will be very low. We believe that we have entered a low return world, as compared with recent market history. Low investment returns to both stocks and bonds are likely to persist for several years ahead.

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<sup>5</sup> Tim Evans, IFR Energy Services, April 4, 2005.

<sup>6</sup> U.S. Department of Labor

<sup>7</sup> *The Future for Investors* by Jeremy J. Siegel, 2004.

<sup>8</sup> Wall Street Journal, April 4, 2005.