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Market Commentary

A Review of the Markets and a Look into the Future

Soft Patch or Downturn?

"You know, Hobbes, sometimes even my lucky rocketship underpants don't help. "

~ Bill Watterson, *Calvin and Hobbes*

The United States of America has a glorious long-term history of prosperity as a result of the grace of God and the hard work of freedom loving Americans everywhere who have continually strived to innovate and improve their lot in life. It is principally for these reasons that long-term investing in America has been so rewarding. The path to prosperity has not always been a straight one, rather a winding road as periodic cycles of recession and depression have impeded economic progress from time-to-time. These cycles of growth and contraction are referred to as the business cycle by economists (see Chart 1).

Business cycles are not always predictable, but they do tend to have a common pattern. There is first a peak in economic activity, contraction, a trough and then an expansion phase. There are different reasons why the economy cycles. Often businesses overestimate sales growth and have to cut back on inventory and/or capital expenditures to adjust for reduced demand, collectively causing an even more significant downturn. Sometimes

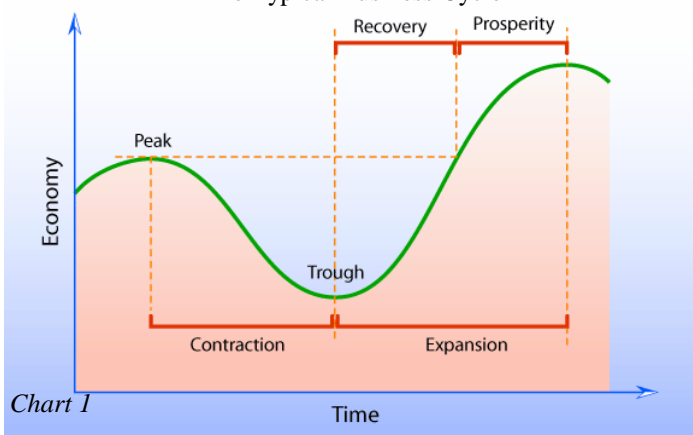
technological innovation can result in significant changes to consumption and demand patterns, thereby causing the economy to ebb or flow. Other times, external shocks like wars or commodity price spikes (sound familiar?) can result in economic disruption.

The movements of the financial markets are closely linked to the business cycle. Price trends in stocks, bonds and commodities are strongly influenced by investors' expectations – each peaking or bottoming at different points in the cycle. The difficulty of predicting the exact beginning point of each phase in the business cycle and the varied performance of each investable asset class within those periods is the precise reason why proper asset allocation is so important to investment success.

What Phase of the Business Cycle Are We In?

We have been in the expansion phase for some time. However, across the country economists are split over whether the economy is beginning to succumb to the effects of higher oil prices and interest rates or just merely experiencing a temporary soft patch. This question, while seemingly benign, is much more complex and has much broader ramifications than you might think. With inflationary pressures rising, a modest slowdown in economic growth would ordinarily be a welcome occurrence to the stock and bond markets – allowing the Fed to slow, or possibly conclude their monetary tightening sooner rather than later. This would give a green light to investors anxious to snap up bargains created by the recent uncertainty.

The Typical Business Cycle



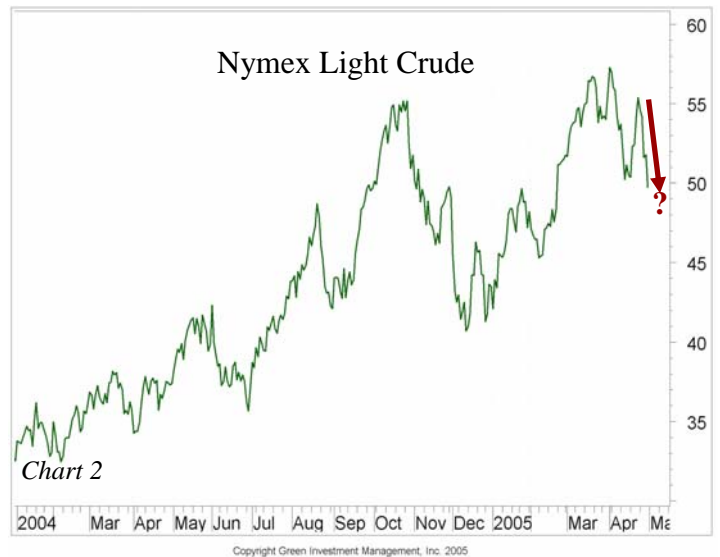
As often is the case, things are not quite as simple as we would like them to be. The 1st quarter's Gross Domestic Product (i.e., the most comprehensive measure of U.S. economic activity, "GDP") released on April 28th revealed an apparent softening trend in the economy. Real GDP (i.e., GDP adjusted for inflation) for the period increased at a 3.1% annualized rate compared with growth of 3.8% in the fourth quarter. That rate represented the slowest economic growth in two years. On the surface this seems to strengthen the argument the Fed should be able to conclude its tightening posture very soon. However, concurrent with that report was an increase of 3.3% in the chain-weighted price index. As Hamlet would have put it, "Ay, there's the rub". It is nominal GDP growth (GDP unadjusted for inflation) that matters most for monetary policy and it accelerated during the first quarter, up 6.4% versus 6.2% for the fourth quarter. This might imply the Fed still has a way to go before it is through with its tightening phase and therefore possibly a few more months before stocks gain any traction to the upside. However, keep in mind 1st quarter GDP data is backward looking (and subject to significant revision) and not necessarily indicative of what is happening now.

The Weekly Leading Index, a forward looking, high frequency index of U.S. economic growth produced by the Economic Cycle Research Institute (ECRI), suggests that growth will hold up in the second half of the year. This index generally provides about a three-month longer lead time than the Leading Economic Indicator produced by the U.S. Commerce Department tends to provide. The ECRI's Future Inflation Gauge remains strong and continues to reflect underlying inflationary pressures. The bottom line is even if economic growth is moderating, consumer inflation may not peak for a few more months.

So What Does This Mean For The Markets?

Rising core inflation should keep the Fed on a tightening path for a while longer. The market and the economy are facing a mid-cycle setback, but they are not likely to experience either a bear market or a recession. Slowing growth should eventually lead to weakening inflation expectations. After several months of moderate economic growth and a clear peak in core inflation data, the Fed will likely pause their rate hikes.

In the meantime, the combination of rising short-term interest rates and slower economic growth raise the potential for further weakness in both stocks and corporate bonds in the next few months. There is also the



risk the Fed may overshoot its target, as it sometimes does, and raise interest rates further than necessary. This could potentially slow the economy more than is currently anticipated.

Our portfolios are currently defensively postured while we await a clearer picture of the economic landscape. Our Guardian stock and balanced allocations have reduced their exposure to equities by an average of 25% in recent weeks. We have also substantially reduced our exposure to corporate bonds as the corporate market has responded negatively to concerns over recent difficulties at GM and Ford and an ambiguous outlook for the economy.

This environment has the potential to persist for a while longer. Nevertheless, we believe an opportunity for gains in equities will be forthcoming before the end of the year. As soon as the Fed hints that it is ready to pause, we are prepared to upgrade corporate bonds and equities in our portfolios. A significant further fall in oil prices (see Chart 2) could accelerate this opportunity. In the meantime, we will be monitoring the markets and the economy closely in order to respond to opportunities as they present themselves.

In closing, we send thanks to those of you that are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. 🐾

The views expressed are those of Byron Green as of May 2, 2005, and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.