

**VIEWPOINTS**

3<sup>RD</sup> QUARTER 2004

ADVISORY NEWSLETTER

**MARKET COMMENTARY**

FRED WILLIAMS

*Black Gold, Texas Tea...and Interest Rates*

With all due respect to Jeb and his family, the third quarter of 2004 was dominated by news about both crude oil prices *and* domestic interest rates. In addition to the volatile petroleum market, we also saw the F.O.M.C. nudge short-term rates higher by 25 basis points twice since their initial move at the end of the preceding quarter. In a contrast of extremes that bracketed the 3<sup>rd</sup> quarter, interest rates we're coming off of multi decade lows, while crude oil prices were hitting record highs, not seen in the 21 year history of the NYMEX. With the Fed funds rate creeping toward 2% and petroleum futures flirting with \$50 a barrel, to say nothing of the continued unrest in Iraq and the seasonal storms that battered the southeastern U.S., the popular media had plenty of material that compelled investors and consumers to remain largely on the sidelines most of the summer.

The final revision to 2<sup>nd</sup> quarter G.D.P. was bumped upward from 2.8% to 3.3%, with Q3 '04 estimates ranging from 3.7% to 4.5% given the expectation for inventories to build from their current levels, corporate cash hordes to be put to use in renewed business investment, and modest income growth to get mall parking lots filled back up again. As is often the case in the battle between half-filled and half-empty glasses, interpretation is in the mind of the beholder:

*"Spoilsports, ourselves very much included, who troubled to pry into the details of the better number might be inclined to feel the enthusiasm it evoked was a mite exaggerated. For the main contributors to the revised increase were exports, housing and inventories. All three are somewhat problematic -- housing continues to look topky, exports might easily slacken even while imports mount, and we have a hunch that a large chunk of that higher inventory was not intentionally accumulated.*

*Meanwhile, final sales in the quarter were flat, as was disposable personal income. And consumers, alas, far from spending with their old gusto, displayed an unwonted reluctance to part with their money. In other words, on closer inspection, the bright spots in the latest version of June-quarter GDP seemed transitory or only superficially bright, while the key readings remained rather glum."*

*Alan Abelson, Barron's; October 4<sup>th</sup> 2004*

Continuing to contribute to this confusion was a raft of end-of-quarter economic statistics that convincingly played both sides of the fence. August core-CPI was only up 0.1%, while core-PCE [Personal Consumption Expenditures] increased at a more brisk 1.7% rate, personal incomes grew at a 2.4% and the savings rate remained near all time lows at 0.9% of disposable income. With our July trade balance reading over \$50 billion in the hole and leading indicators declining for the 3<sup>rd</sup> month in a row, it's no wonder that September sentiment and confidence readings dropped, all of which were manifest in a growing reluctance on the part of the consumer to part with their hard earned currency. We many times find this myriad of data, such as the "official"

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inflation data (the Consumer Price Index), to be out of touch with the real world costs and their impact on the economy, to say nothing of the disparity that these measurements seem to imply:

*"The CPI as calculated may not be a conspiracy but it's definitely a con job foisted on an unwitting public by government officials who choose to look the other way or who convince themselves that they are fostering some logical adjustment in a New Age Economy dependent on the markets and not the marketplace for its survival. If the CPI is so low and therefore real wages in the black, tell me why U.S. consumers are resorting to hundreds of billions in home equity takeouts to keep consumption above the line. If real GDP growth is so high, tell me why this economy hasn't created any jobs over the past four years. High productivity? Nonsense, in part – statistical, hedonically created nonsense. My sense is that the CPI is really 1% higher than official figures and that real GDP is 1% less."*

*Bill Gross, PIMCO; October 2004*

One of the significant contributors to the spending-driven growth in our economy over the last few years has been the home-refinancing boom, which fattened up wallets with heretofore-illiquid cash. Except for those inhabitants of the dark side of the moon, it would appear that the re-mortgaging craze has run its course, thereby leaving personal balances sheets a bit more indebted and consumer spending challenged by higher energy costs. Should interest rates trend higher over the next few years, and the national savings rate climb with more baby boomers moving into retirement, it becomes problematic that an already burdened consumer sector is going to have the disposable income that would allow it to continue as the driving force in our economy.

In the midst of these cross currents, the capital markets produced a wide variety of results during the most recently completed quarter, with the emerging markets outpacing the developed world. The Dow dropped 3.4%, leaving it with a decline of 3.57% through the first three quarters of the year, while the S&P 500 was off 2.3% (+0.24% YTD) and the NASDAQ gave up 7.4%, leaving it off 5.32% in 2004. Overseas the weak 2<sup>nd</sup> quarter was followed by some relative stability in the 3<sup>rd</sup>, with London's FTSE up 2.4%, the Paris CAC off 2.5%, Frankfurt's DAX declining 3.9%, and the only weak spot being Japan, where the Nikkei dropped 8.7%. As noted, the emerging markets from Brazil to Indonesia and Chile, saw increases, in local currency terms, of 10-13%, thereby continuing to reinforce the asset allocation argument on a geographical basis.

The domestic bond market provided a contradiction to the commonly assumed relationship between bond prices and interest rates during the July to September time period. Rather than bond prices declining as interest rates rose, we saw bonds climb in price despite the F.O.M.C.'s move to increase the Fed funds rate three times in just over three months. At the end of the quarter the 10-year Treasury note's yield had declined to 4.125%, thereby providing a three-month total return of 5.23%. Although pleased by the outcome of the "abnormality", we continue to expect higher interest rates to adversely impact the long end of the bond market, as we noted in previous market commentaries. To this end we will continue to shorten bond portfolio durations, while adding exposure to floating rate, and other inflation indexed, debt that can offer a hedge against rising rates.

As indicated at the start of the year, we have viewed 2004 with a bit of trepidation given our geopolitical concerns. From domestic political conventions, to the Olympics and the upcoming U.S. elections, we were concerned that there would be ample opportunities for emotional incidents emanating from the war on terror. Strategically, relative to portfolio structure, we chose to increase our cash positions, continue to focus on equity holdings that produced significant cash flow, and move to hedge our dollar denominated investments via increased overseas allocations. From an "event" standpoint, we're happy to point out that, thus far, we've been off the mark, however we feel compelled to maintain our prudently defensive posture until we get through the

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upcoming elections. As always, we feel that our value orientation to portfolio management requires a discipline that affords us the opportunity to proactively react to situations, regardless as to their near term emotional interpretations.

## **WEALTH MANAGEMENT OVERVIEW**

TRACY ROGERS

As we enter the last quarter of the year, one of the planning details that's often time overlooked is review of your retirement plan contributions to make sure you are maximizing your tax deductions, deferrals or employer matching contributions. Traditional and Roth IRA contribution limits are \$3000 this year with a \$500 catch up provision for those age 50 or older, while 401(k) and 403(b) plans have deferral limits of \$13,000 in 2004, with a \$3,000 catch up clause for those over age 50. In certain circumstances, depending on the summary plan description on your employer's plan, you may be able to defer up to as much as 100% of your compensation, which could be of value in unusual tax planning or savings situations. Looking to next year, Traditional and Roth IRA contributions will increase to \$4,000 in 2005, and we will see the limits for 401(k) and 403(b) plans increase to \$14,000 for deferrals and \$4,000 for catch up contributions.

For those with children in college, it's not too early to start think about filling out FAFSA forms in anticipation of an early filing in 2005. Remember that this may reflect the maximum funding for retirement plans, as well as any tax planning strategies you may want to consider now, such as scheduling capital gains or losses in investment portfolios. If you have had children graduate from college in 2004, you may also want to look into consolidating any outstanding student loans as the rates are at historically low levels right now. The same may be said for home mortgages, given the recent easing in rates, for those that are still contemplating a refinancing option.

As we noted in our cover letter, these and may other issues are fodder for year-end planning throughout the 4<sup>th</sup> quarter – we look forward to speaking with you between now and year-end.

## **IMCG NEWS**

We're please to announce a number of changes and additions to the firm as we continue our expansion:

TRACY W. ROGERS – *PORTFOLIO MANAGER & DIRECTOR OF OPERATIONS*; Joining us from the financial services industry, Tracy's Denver based management experience will be of great value as we continue to expand our infrastructure and personnel. In addition, he brings his clients and portfolio management experience, along with a planning background that includes a specialization in risk management product analysis.

STEPHANIE KELLEY – *RESEARCH & PLANNING ASSOCIATE*; Continuing her growth at IMCG, Stephanie is migrating to the more analytical aspects of our work and will be assisting portfolio managers in the numbers crunching necessary for both the investment management and planning disciplines to work in an integrated fashion.

SCOTT WHYTOCK – *RESEARCH & PLANNING ASSOCIATE*; An entrepreneur who has also had experience in management and as a fund accountant, we're looking forward to Scott's combined talents within our analytical work and our office infrastructure.

ANGELA FORRESTER – *ADMINISTRATIVE ASSISTANT & RECEPTIONIST*; With experience in the insurance, securities and legal professions, we feel Angela will be an invaluable additional to our client support and operational activities.

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