Sather Financial Group Inc.
Registered Investment Advisor

# Third Quarter 2004 Commentary--Four Hurricanes & $50 Oil Are Not Our Biggest Problems

Since making our June 9, 2004 predictions we are batting two for three and are thankful not to live in Florida. We were correct on stock market weakness and rising short term interest rates, but misjudged long term interest rates.

Going forward, we are faced with an interesting, and difficult, investment climate. Corporate earnings continue to be shaky. The ***stock market is still fully valued with the S&P 500 at a 19 price to earnings ratio*** (15 is its historical average) and there are limited opportunities currently. Patience will be a virtue. Third quarter corporate earnings are expected to increase 14%. While this sounds great in isolation, it is a decrease from the second quarter and signals slowing profitability.

***In the past quarter we have seen the broader indices down a few percentage points***. The S&P 500 fell 1% and the Dow Jones Industrial Average slipped 2%. Additionally, the average large cap mutual fund has dropped 3% for the year. However, those betting on technology and semiconductors received bruising results. The NASDAQ dropped close to 6% in the quarter while the semiconductor index plummeted a gut wrenching 18%. We are thankful to not have exposure to these troublesome areas.

Alternatively, the fixed income market does not offer much brighter opportunities as ***interest rates are still at very low levels*** historically. As we expected, the Federal Reserve ***raised short term interest rates three times and the Fed Funds rate now stands at 1.75%*** (up from 1.00%). However, ***longer term interest rates (ie: the 10 year US Treasury yield) have actually fallen from about 4.88% down to 4.12%.*** This would indicate that bond traders are ***anticipating continued economic weakness***. While this may be a good time to get a mortgage it is a difficult time to be a long term fixed income investor.

The Fed continues to monitor increased pressure upon commodity prices, as well as the US dollar. We have seen strong demand for everything from cotton and wood to steel, oil and gold. And while the price of oil made a bit of a retreat, it has increased near $50. The Saudis state they support oil prices in the low to mid $30 range as prices much higher than this spur development of alternative fuels. So far this has not occurred. Issues of terrorism and violence in the Middle East and hurricane activity in the Gulf of Mexico have curtailed oil production which has resulted in prices challenging $50 per barrel.

The only positive we can find with oil pricing is that our ***current reliance upon oil relative to gross domestic product is about one half of what it was in 1980***.

The economic boom in China continues to affect commodity pricing world wide. This boom, coupled with the relatively cheap US dollar, has created strong demand for a wide variety of commodities. The result has been broad inflationary pressure upon commodity prices. ***Industrial commodities have increased 15% in 2004 and have increased 63% since the market bottom in November of 2001***. At the same time, we have seen ***deflation in the tech sector*** as technology pricing has slipped by 7% this year.

Typically, ***raising interest rates will slow demand for commodities*** and reduce, or stabilize, their prices. Furthermore, raising interest rates will make the US dollar more attractive when compared to other currencies. Despite a somewhat weak economy, we think the Fed will continue to ***increase short term rates to 2.00% by the end of the year***. This will affect people borrowing money based upon the Prime Rate, lines of credit and credit cards. All of these borrowing structures have reacted quickly to the Fed and raised their rates accordingly. This also presents us with some opportunities in the fixed income market.

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We continue to evaluate a variety of different stocks to continue holding or add to portfolios. Even though we have pulled money out of the stock market since June there continue to be some opportunities. We are now waiting for them to be priced at attractive levels.

The ***presidential election does not concern us much.*** At this point we give the Bush re-election bid a slight advantage. If Kerry does win, however, we do not anticipate immediate changes to our tax code or other issues for that matter. Like many politicians, Kerry's claims for raising taxes on dividends and capital gains are mainly campaign promises. Kerry will still have to get these ideas through the Republican controlled Congress.

Longer term, however, ***whoever wins the presidency will be faced with raising income taxes***. Our budget deficit has gotten out of control and there is very little opportunity to manage this situation without a tax increase of some sort. Compounding the issue further is the fact that we have an aging work force that wants to retire earlier. This removes productivity from our economic base and adds additional strain upon our financial system. This is obviously a difficult proposition to fulfill and still pay down our national debt.

Our aging work force and massive personal and governmental debt may be crushing us already without us fully understanding it. In the 12 months ending March 31st, ***consumer debt grew by $1 trillion, or 11%***. That pace is unsustainable whether interest rates are flat or rising, given that ***incomes are only increasing by 3%.***

Additionally, ***home prices have been rising 8% annually***. This, also, is far faster than income growth, and ***at some point homes will no longer be affordable***. Making matters worse, ***consumer spending has been bolstered by homeowners refinancing or using their equity like an ATM machine***. Higher interest rates or lower house prices will stop consumers in their tracks. The economy remains dependent upon consumer spending, which accounts for about 70% of GDP. With consumer spending comprising such a large portion of our economy it is quite unlikely that anything will offset weaknesses in consumer spending. ***This will result in substantial economic problems.***

Further compounding matters is the fact that our trade deficit continues to worsen. Essentially ***we, as a nation, continue to buy more stuff from other countries than we sell and we purchase these items with debt***. This has caused our second quarter GDP figure to be revised downward and has put additional downward pressure on the value of the US dollar relative to other world currencies. The revised second quarter GDP was 3.3% (down from 4.5% in the first quarter).

A final thought was offered by ***former Fed Chairman Paul Volker. Volcker has already uttered a grim prediction that there is a 75% chance of a Third World-style debt crisis in the United States in the next five years***. These are not the words of a politician or newspaper trying to generate excitement to sell a product. These are the words of one of the world's greatest economists and also a man with no economic benefit for stating his views. Given this, it is time that Americans wake up to the fact that we are living on borrowed time. ***We must pay down our personal and governmental debts or else we face a far more dire future than most can imagine***.

Now that we have shared that bit of sunshine, please give us a call to discuss or with questions.

Sincerely,

Dave

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™