Sather Financial Group, Inc.

Registered Investment Advisor

2004 Year End Commentary

The past year might have gone down as one of the dullest years ever for U.S. stocks if not for a strong fourth quarter. Despite the war, the election, low interest rates and a surge in corporate profits, the financial markets produced rather slim returns. ***The S&P 500 index managed a gain in the high single digits while the Dow Jones Industrial Average yielded less than 4%***.

Although the results posted by the financial markets were not too amazing, they were expected. Furthermore, we expect few fireworks again in 2005, so ***don't be surprised if the stock markets only produce another 6% in '05***. This is especially true given an environment of decelerating profit growth and rising interest rates.

This year, the stock market's gains have been capped by sluggish job growth, limited wage gains and concerns about a slowing economy. The price of oil hit $56 a barrel (before retreating to the low $40's), which bit into companies' profits and consumers' pockets. The U.S. dollar fell faster and further relative to other world currencies than most expected, rekindling fears about the nation's gargantuan trade and budget deficits and the willingness of foreign central banks to continue bankrolling our spendthrift ways. And, let us not forget, the tough race for the White House dragged on until the final hour, against the daily drumbeat of violence overseas.

On the upside, however, stocks were bolstered by corporate-earnings growth of 19%, above the 12.7% analysts had forecast a year ago. While '04 earnings gave the market a reason to rally, ***we expect profit growth to fall to 10% in '05***. Based on these numbers, the S&P 500 trades for 17.9 times '04 estimates and 16.5 times '05 profit predictions. Although these price/earnings multiples aren't cheap in relation to historic norms, they are not the most expensive we have seen.

The S&P 500 produced decent returns in '04, however, we have concerns over many of the stocks producing these returns. Names like Google, eBay and Amazon have returned to the forefront of the financial news headlines with speculative behaviors. ***Amazon is a relative bargain at a mere 60 times earnings, while eBay trades for 110 times earnings and Google is truly outrageous at a whopping 258 times earnings***. We have not seen blind speculation of this variety since the peak of the tech boom and it makes us wonder if investors have completely lost all comprehension of the tech bust.

Low interest rates prevailed for yet another year, despite the Federal Reserve's move to lift short-term rates four times in '04. ***While we incorrectly expected the rate on 10-year Treasury bonds to top 5% by year end we are once again predicting 5% yields for '05***. One of the biggest changes in '04 was the Fed's decision to start tightening credit. The federal-funds rate, or interbank overnight lending rate, now stands at 2.25%, and likely will be increased to 2.50% in February of 2005. ***Many economists predict Fed Chairman Alan Greenspan will raise short-term rates to 3.5% by the end of 2005***.

If interest rates rise, however, price/earnings multiples on stocks will come under pressure. One of the biggest threats to the stock market continues to be the bond market. For every ½% point increase in the 10-year Treasury yield, approximately one percentage point should be subtracted from the fair-value earnings multiple of the S&P 500. Because rate-sensitive financial stocks now account for 20.7% of that index, the impact of higher rates arguably could be even more dramatic.

A potential back-up in interest rates is one reason we continue to predict restrained gains for stocks next year. As rates move higher they create a headwind. The equity market can tolerate rising interest rates as long as the rise is gradual and inflation is not problematic. We do think inflation will drift upward, but hopefully it will not go dramatically higher. In assessing inflation, despite recent increases in labor costs, one of the biggest corporate expenses, inflation as a whole remains tame.

Job growth could improve sharply next year, along with the economy and the trade deficit. Consumer demand in the U.S. has been growing at a far faster rate than gross domestic product because Americans are buying so many foreign-made goods. This continues to add to the current account trade deficit. The dollar's decline traditionally has led to an improvement in the trade deficit, however, there is usually a two-year lag. If history repeats, ***the trade deficit could narrow to 5% or 5.5% of GDP next year from the current 6%.***

Under this scenario the economy would grow faster than domestic demand if U.S. and foreign buyers purchase more U.S. goods and services and the U.S. exports more. A 1% improvement in the trade deficit could result in GDP growth of 4% to 5%, compared with the 3.5% growth rate Wall Street expects. While this would be nice, ***we are preparing for a 3.5% increase in GDP***.

If the economy and GDP begin to heat up, and unemployment falls to 4%, bond yields would rise and the Fed likely would find itself behind the rate-increasing curve. Unfortunately, such a robust environment would lead to a much tougher second half of the year.

Corporate America's large cash balances, built up over the past several years, should provide the market with a secure underpinning. ***Net debt to capital among the S&P 500 companies averages 33%, compared with 48% fifteen years ago***. Being flush with cash provides corporations with far greater flexibility.

What will companies do with all that cash? The preferred route would be increasing or initiating dividends. Dividends will become a much bigger part of total returns going forward.

Developments in Washington could cast a lengthening shadow over Wall Street in ‘05. At some point we need to show we can make some progress on the budget deficit. The U.S. had a budget deficit of $375 billion last year, which the Congressional Budget Office projects will increase to a record $422 billion this year, before declining (hopefully) to $289 billion in ‘06. Sadly, we are skeptical on this issue also.

The markets are likely to keep close tabs on the Bush administration's dollar policies. One U.S. dollar today will buy only 75 Euro cents, compared with €1 just two years ago. The U.S. currency also has fallen in value versus the yen.

If the dollar continues to decline, interest rates eventually will have to rise to offset greater inflation and satisfy foreign creditors. Among the biggest creditors is China, which is widely expected to cease pegging its currency, the yuan, to the dollar, and let it float in a narrow band against the dollar or a basket of currencies.

The president's plan to privatize a portion of Social Security could prove both a boon and bane for the market. Adding individual retirement accounts to Social Security could cost as much as $2 trillion over 10 years, because the money going into accounts can no longer be used to fund payments to retirees today. The White House has said it would pay for such expenses through additional borrowing, not tax increases, which could put additional pressure on interest rates. We’ll believe it when we see it.

The nation's debt, incurred by consumers, corporations and the government, is growing at a reckless pace, and inflating GDP by several percentage points a year. The ability to borrow and spend could be curtailed as the Fed continues to raise rates, with unhappy consequences for many. ***You can sustain very high levels of consumer debt when rates are falling, but not when they're rising. Consumer spending is now about 75% of GDP (up from 65% historically).***

Escalating housing prices have played a key role in supporting consumer spending in recent years. In 2003 and 2004 combined, U.S. homeowners borrowed a total $600 billion against the value of their homes. The so-called housing bubble could be another casualty of higher interest rates. Although we may not see as much of this in Texas, it is certainly a truer statement when assessing housing on the east and west coasts. ***Homeowners nationwide should not expect the value in their homes to continue to fund their excessive spending***.

Any restraint on consumer spending could curb corporate earnings growth in '05. ***We are starting to see the beginnings of this slowdown in spending in the retail sector***. Corporate spending is likely to grow at a more measured pace, in part because a tax break granting companies accelerated depreciation on capital expenditures expires at the end of this year. Purchases of large equipment have been pulled forward into ‘04, to the detriment of '05's results.

One event that could spark greater volatility is the impending retirement of Fed Chairman Greenspan. His board membership ends on Jan. 31, 2006 and uncertainty about his replacement will challenge investors. All of these things will add uncertainty to the market. Investors are complacent right now, assuming it's business as usual. Next year will probably be more volatile and there will be more unexpected events.

If you have any questions or comments please give us a call or stop by. Also, if you would like a copy of our most recent Form ADV please let us know. And finally, ***we wish you a safe and prosperous 2005 and thank you for all of your support in the past and the years to come.***

Sincerely,

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™