Second Quarter 2005 Commentary

As we close out the month of June the only thing hotter than the Texas summer has been the price of oil. Fortunately, the costs of many other commodities are moderating, helping to alleviate some of the worst inflationary fears.

For the quarter, ***the broad stock market finished about where it started, but remains negative year to date***.

Although we correctly anticipated a drop in the price of oil early in the quarter, ***we did not foresee the recent jump to $60 per barrel***. ***We continue to question this short term pricing***. Last quarter we reported that Exxon's CEO stated that oil is no longer trading based upon supply and demand economic fundamentals and is overpriced. Now the CEO of Valero (the largest refiner) has also made comments of this nature. As such, we think that at some point in the near term the price of oil will drop. Even so, we continue to think that as India, China and other emerging markets develop a greater thirst for oil, the long term price for the black liquid will increase.

While we may have to wait and see how accurate we are in assessing the energy market, one thing is for sure—***high oil prices will lead to inflationary pressure***. We have been very fortunate so far in that much of the pressure put upon our economy by oil prices has been offset by decreases in technology and other costs. However, we should not be lulled into believing everything the government tells us about "official" inflation figures. Their version of Consumer Price Index math leaves much to be desired as it understates the true cost of goods and services.

The Federal Reserve has continued raising short term interest rates in an effort to combat inflationary concerns. After raising short rates nine times since June of 2004, Alan Greenspan and company now have ***the Fed Funds rate at 3.25%.*** Look for the Fed to continue with its rate increases at its August meeting at which time rates should be 3.5%.

With Greenspan scheduled to retire in January of 2006, his final economic decisions may be some of the most difficult. Although he accurately sees inflationary pressures, the economy itself is not growing at a breakneck pace. This puts the Fed in a difficult situation as they battle inflationary worries while trying not to stifle corporate growth. Of further concern is the fact that ***corporate growth appears to be slowing*** to single digit increases after twelve straight quarterly double digit increases.

Conventional wisdom typically assumes that if short term rates are increasing, then so should longer term rates. Although conventional wisdom held true in the first quarter, ***longer rates have now reversed course resulting in the 10 Year US Treasury Bond dropping back below 4.0%***. This is the "conundrum" that Alan Greenspan has spoken of recently. We now have ***overnight Fed Funds rates at 3.25% and a 10 Year US Treasury earning a mere 4%.*** That is not much of a difference for tying your money up for an additional ten years.

Why have longer rates dropped? There are a couple of schools of thought on this matter. One is that ***the bond market may see economic weakness on the horizon***. If this is the case, the bond market is anticipating that the Fed will reverse course and begin lowering short term rates to stimulate a sluggish economy. This is certainly a possibility.

A second answer lies in the current account trade deficit, which has gotten a fair amount of notoriety lately. For several years the U.S., as a whole, has bought more foreign goods and services than they have sold. Over time, this imbalance grows which results in American consumers having lots of toys and other stuff while the foreigners who sold us that "stuff" build up a larger and larger stockpile of U.S. dollars.

The people outside the U.S. don't just sit there and hold our green dollar bills. Instead, they take that money and invest it in U.S. Treasury bonds. The net effect of this transaction is that ***increased demand for treasuries increases prices and decreases the yield on treasury bonds***. Remember that there is an inverse relationship between the price of fixed income investments and the yield on these bonds.

No matter what the actual reason(s) are, long term bond yields are very low which makes it a great time to get a fixed rate mortgage, but a tough time to be a fixed income investor. Given these low bond yields, many ***investors continue to find dividend paying stocks more and more attractive*** in terms of cash flow. Not only are these dividends usually taxed at a maximum of 15%, but companies also can increase their dividends over time making that income stream that much more valuable.

Also, it is worth noting that with short term rates increasing, ***we are content (but not thrilled) to hold cash/cash equivalents until better alternatives become available***.

As mentioned previously, now is a great time to get a fixed rate mortgage. ***What is not great is the demand for adjustable rate mortgages and interest only mortgages***. Currently, these mortgages comprise the majority of new mortgages. Worse yet, they often are funded with zero money down. The net result is maximum, if not dangerous, leverage with substantial interest rate risk.

These new mortgage products, accompanied by lax lending standards, have in our opinion provided high octane fuel for the real estate fire. While we are admittedly conservative in our approach, we fear that ***many people are setting themselves up for a variety of stumbling blocks***. These stumbling blocks will come in the form of higher insurance, higher property taxes, higher utilities and higher costs to furnish their new mansions.

Too often the price of entry can be obtained, but the long term carrying costs of these real estate fantasies are lethal. Sooner or later this roller coaster will stop going up and the downside will most likely be painful. Despite the multitude of warning signs too many people are now treating real estate as they did internet stocks in the late '90's—it's different this time, there's no end in site, I want to be where the action is, etc. ***Whatever the logic (or lack thereof), there is tremendous froth in the real estate market which will substantially curtail any positive rate of return potential.***

While we continue to like affordable homes to live in we think that ***the better investment strategies will involve good long term stock market holdings and high liquidity***. While this strategy is downright boring, it should prove to be consistent and successful long term.

Finally, ***we wish you a happy and safe 4th of July holiday***. Please take the time to appreciate the freedoms and opportunities we all enjoy in our great nation. While the U.S.A. is far from perfect, it is the greatest nation on the planet.

Please call or stop by with questions.

Sincerely,

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