



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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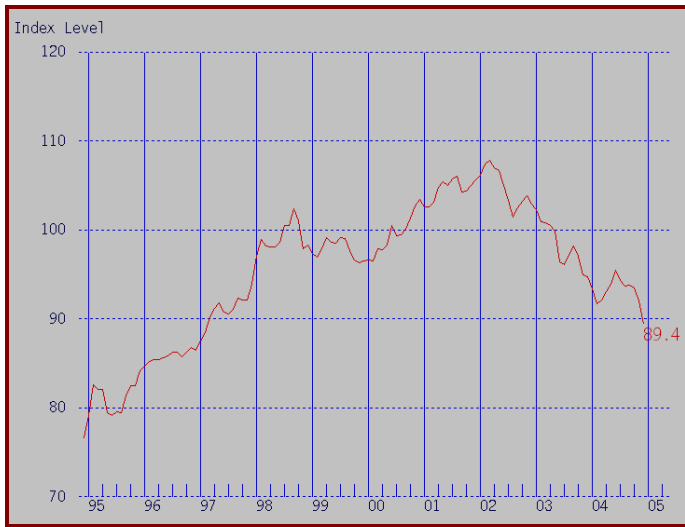
PROSPECTS FOR THE STOCK MARKET

Impact of Crude Oil, Interest Rates, and the Dollar

The stock market faced a number of hurdles in 2004. On the economic front, it contended with escalating crude oil prices, rising interest rates, and a plummeting dollar. Geo-politically, there was uncertainty regarding the outlook for post-war Iraq and what many thought would be a close presidential election at home.

as its 35% drop against the Euro. It is now 17% below its 2002 peak and approaching its lowest levels since 1997. Moreover, the dollar decline is moderating. Its 2004 decline subsided to just 4.3% in contrast to an 8.7% drop in 2003. This deceleration bodes well for improved stability in 2005.

CHART I
Trade Weighted US Dollar
12/31/94-12/31/04



As the year concluded, some of those risks abated. Political uncertainties subsided with the conclusion of the election. While challenges to the economic recovery remained, they became less onerous. Crude oil prices retreated from an astonishing \$55 a barrel to the \$40 - \$45 range and consumers started to see some relief at gas pumps. Interest rates rose as expected, but in a measured and gradual manner that did not derail the recovery.

On the other hand, the trade weighted dollar continued to weaken in foreign currency markets, but not as dramatically

The stock market absorbed these events with normal volatility during the first three quarters of last year, but rallied during the last two months. It concluded 2004 with a 3.3% price gain for the Dow Average (5.5% total return including dividends) and a 9.1% gain for the Standard & Poor's Index (10.9% with dividends).

Last year's appreciation can be attributed to three principal factors. First and foremost, corporations were able to grow earnings in spite of higher energy costs. Growth in consumer spending and corporate productivity gains more than offset the negative impact of higher crude oil prices. The earnings gain for the Standard & Poor's 500 Index exceeded 15%. The Dow Average, which did not rise as much, also did not have as strong earnings performance. In 2005, both stock market indicators are expected to have mid-single digit earnings growth.

Second, the rise in interest rates has been modest. Short-term rates increased about one and a half percent as the Federal Reserve instituted five quarter point increases in the targeted Federal Funds rate. But, those increases came from extraordinarily low levels and did not translate into the longer maturities. For example, the ten year Treasury yield was virtually unchanged between the beginning and the end of 2004. Thus, interest rates had only a mild impact on the stock market.

Third, the impact of a weak dollar has been mixed. The weak dollar helped multi-national company profits by converting their overseas earnings into more dollars.

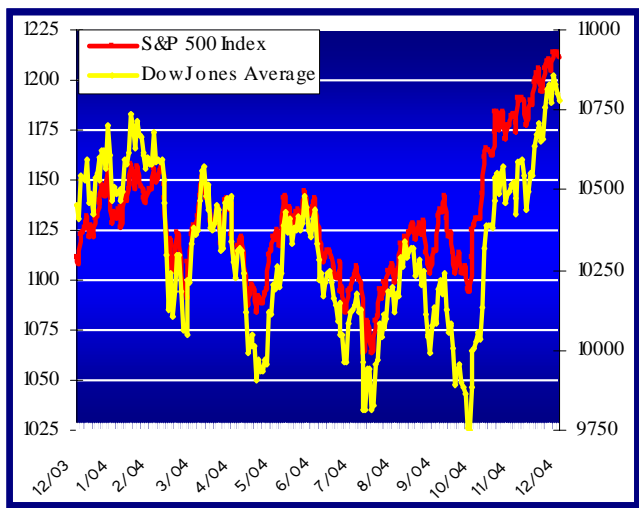
Another positive, but slower developing benefit, is that a cheaper dollar reduces the price of American made goods and services in the world economy. A depressed dollar should eventually cause our exports to improve and help prevent further deterioration in our trade balance. This can be quite significant; the deterioration in our trade balance last year cost the economy \$100 billion in growth.

On the other hand, if the dollar declines too much, which has not yet happened, it can have adverse repercussions in our financial markets. Foreigners holding dollar denominated investments suffer a currency loss and could withdraw investment capital from our economy if they fear too much of a decline. With so much of our debt foreign owned, such a reaction could be ill-afforded. To prevent that from happening, the Federal Reserve may be induced to raise interest rates more aggressively than domestic economic considerations would warrant. Thus, to some extent, the sustainability of the economic recovery will be dependent on stability of the dollar.

INVESTMENT STRATEGY

Until the election, stocks traded in narrow range of 1,000 points for the Dow Average and 100 points for the Standard & Poor's Index. Investors appeared to be biding time while corporate earnings caught up with 2003's sharp stock market recovery. After the election, investors focused more on the broadening economic recovery and growth in corporate profits.

CHART II
Stock Market Indicators
12/31/03-12/31/04



The economy is expected to expand at a 2.5% - 3.5% pace in 2005 with a strengthening capital spending sector and

rising employment. In this environment, corporate earnings are expected to expand at a rate more than double that of the economy. Even though earnings growth is slowing from much higher rates over the past two years, it still remains at a healthy pace. Corporations should continue to benefit from productivity gains associated from fuller utilization of plant and equipment.

On this basis, the return/risk prospects for stocks are more favorable than for bonds. Rising earnings and dividends on stocks should more than offset the impact of a modest rise in interest rates. However, rising interest rates are unlikely to permit an expansion in valuation parameters. Thus, stock appreciation in 2005 should primarily be associated with earnings growth.

Within the stock market, the capital intensive areas of the economy are favored. This includes the industrial, materials and technology sectors, which should continue to benefit from a pick-up in business spending. In addition, weak stock performance in the healthcare sector over the last several years has led to attractive valuations that ignore the long-term growth potential that many of these companies have.

Exposure to the financial sector of the stock market should be limited at the outset of 2005. Further increases in interest rates, even if it continues to be gradual, will make earnings growth in this sector challenging and subject to increased risk.

The fixed income markets will be challenged by rising interest rates, and caution is still warranted. Additional interest rate increases can be expected to provide support for the dollar. While the impact on longer-term rates was minimal last year, it could become more pronounced in 2005. Therefore, bond returns could be disappointing.

TABLE I
MARKET PERFORMANCE COMPARISON
(Including Interest and Dividend Income)
Year to Date*

MARKET INDEX	12/31/03	12/31/04	Return
Standard & Poor's 500	1,112	1,212	10.9%
Dow Jones Average	10,454	10,783	5.5%
NASDAQ	2,003	2,175	8.6%
EAFE Index	1,281	1,515	18.3%
3 Mth U.S. Treasury Bill	.9%	2.2%	1.1%
10-Yr U.S. Treasury Bond	4.3%	4.2%	4.5%
10-Yr AAA. Tax-Exempt	3.5%	3.6%	3.0%

*Estimate