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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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RISING INTEREST RATES

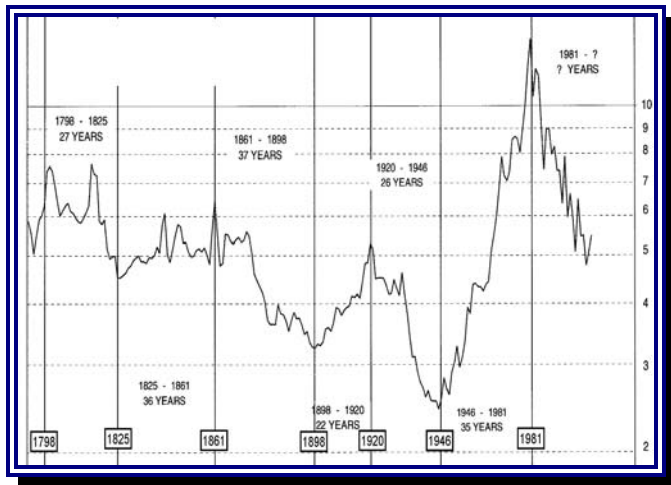
What Can We Expect?

Interest rates rose during the second quarter in anticipation of the long-awaited increase from the Federal Reserve. A strong economy accompanied by improving employment data, an escalating Federal deficit, positive earnings growth, and rising inflationary pressures laid the foundation for the Federal Reserve to initiate a policy of “measured” increases in interest rates on June 30th. This was their first increase in four years, and appears to be the first of what may become a succession of increases.

The advance in the 30-year U.S. Treasury yield from 4.8% to 5.3% during the last three months had a direct and negative impact on the bond markets. With no indication of an imminent slowdown in the economy, rates could continue to rise in the near-term with bonds continuing to decline in value.

The impact on the stock market, however, is less obvious because interest rates normally rise when the economy is expanding and corporate profits are growing. Thus, the positive effect of economic growth often offsets the negative impact of rising rates.

CHART I
LONG-TERM INTEREST RATES
1798 - 2004



Source: Smith Barney

Historically, interest rates have had extended periods of expansions and contractions, each lasting between 22 and 37 years (Chart I). Long-term rates dipped to a historical low of 2.5% following World War II, and advanced to a peak of 14% in 1981. It has been twenty-three years since the 1981 peak, and within this period there have been shorter periods of rising and declining rates.

CHART II
STOCK MARKET RETURNS AFTER AN
INCREASE IN THE DISCOUNT RATE
(1973-2000)

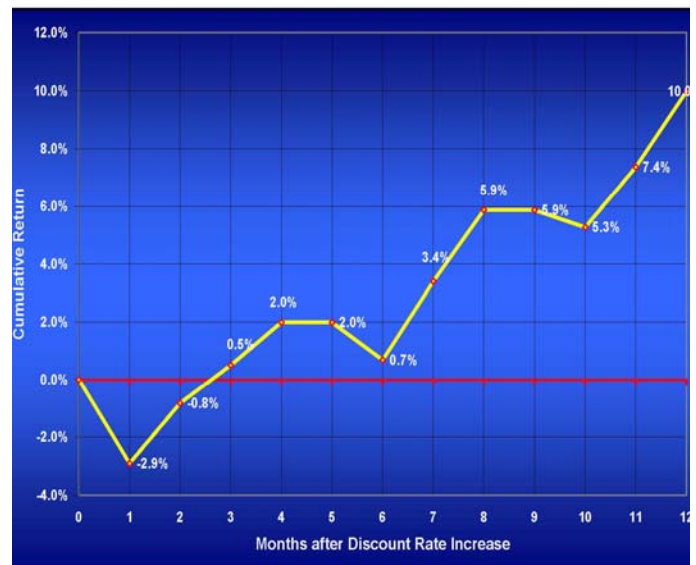


Chart II traces the cumulative monthly performance of the Standard & Poor's Index following an initial increase in the

Federal Reserve's discount rate, a definitive indication of monetary restraint that often accompanies a succession of increases, such as the one instituted on June 30th. In the last 35 years, there have been six discount rate hikes, with the first beginning in 1973. The initial impact during the first month is as one would expect; stock prices declined in five out of the six occurrences. But after the initial decline, stocks tended to move higher. In the second month, stocks rose in four of the six occasions. The two exceptions were 1973 and 1977. In both cases, the Federal Reserve increased the discount rate yet again before the second month was completed. On average, stock prices were relatively strong, particularly 6 - 12 months after the initiation of monetary restraint. By then investors were looking forward to a subsequent easing in monetary policy. On average, the Standard & Poor's Index enjoyed a 10% return in the twelve months following an initial increase in the discount rate.

INVESTMENT STRATEGY

During the second quarter, bonds suffered one of their weakest periods in ten years. While yields rose considerably from earlier in the year, it is still too early in the economic and interest rate cycle to add to bonds. Investors should wait to see if yields move even higher before committing funds to the fixed income markets.

Stocks performed better than bonds during the second quarter, assisted by strong earnings growth, but tempered by rising interest rates and political uncertainty with the upcoming election. Nevertheless, the Standard & Poor's Index advanced 1.4% (1.7% with the reinvestment of dividends). Within the stock market, the energy and industrial sectors fared better with the maturing economic expansion, while the consumer discretionary and financial stocks were weak in anticipation of those sectors slowing during the second half of the year.

At current levels, the Standard & Poor's Index is conservatively valued in relation to existing interest rates. This is apparent by comparing the reciprocal of the price-earnings ratio, a concept that defines earnings relative to stock price (the earnings yield). A higher earnings yield relative to interest rates, such as currently exists, implies conservative stock valuations.

Chart III shows the difference between the earnings yield and the 30 year Treasury bond since 1990. Normally, the earnings yield for stocks is less than the bond yield because investors are paying a premium for growth while the return from bonds is fixed. The wide spread between the two

yields during 1999-2000 shows the "bubble" that developed in the stock market at that time. Since then, bond yields continued to decline, while the stock market underwent a three year correction. Now the earnings yield is actually greater than the bond yield. Presently, stocks are more conservatively valued than they have been for some time and already discount a further increase in interest rates.

CHART III
STANDARD & POOR'S EARNINGS YIELD AND
THE 30 YEAR TREASURY
(1990-2004)



Interest rate and political risk are likely to persist and could dampen stock returns in the near-term. Even so, stock valuations continue to improve, not from corrections in the market, but from rising earnings. At the beginning of the year, the price-earnings ratio for the Standard & Poor's Index was 20 times trailing 12 month earnings. In spite of price gains during the first half, the ratio declined to 18.5 times by mid-year. Stocks should rise further by year-end, supported by a broadening economic expansion and double-digit earnings growth.

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

MARKET INDEX	12/31/03	6/30/04	Return
Standard & Poor's 500	1,112	1,141	3.4%
Dow Jones Average	10,454	10,435	.8%
NASDAQ	2,003	2,048	2.2%
EAFE Index	1,289	1,331	3.9%
3 Mth U.S. Treasury Bill	.9%	1.3%	.4%
10-Yr U.S. Treasury Bond	4.3%	4.6%	-.8%
10-Yr AAA Tax-Exempt	3.5%	4.0%	-1.9%

*Estimate