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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

October 2004

POLITICS VERSUS THE ECONOMY

How Will Each Impact The Stock Market?

President Bush and Senator Kerry move into the final stretch of the campaign with the President ahead in the polls, but not with a commanding lead. Since 1900, there have been 25 presidential elections. When the incumbent party prevailed, the Dow-Jones Average increased 88% of the time between the end of the last convention and the election. The average increase was 9.6%. When the challenging party won, the stock market did not fare as well. It fell 78% of the time with an average decline of 3.0%. So far, there has been no discernable change in the Dow Average.

While politics plays an important role in the economy and the stock market, the health of the economy plays an important role in politics. A healthy economy normally bodes well for the incumbent party.

In 2004, the health of the economy is controversial. Different participants have a different perception of the progress of the recovery. Corporate management, which is inclined to Republican administrations, perceives the economy quite favorably and continues to support the current administration. They focus on economic growth over the last several years and the sharp rise in corporate profits — more than 27%.

The average worker, on the other hand, has not fared as well. Employment is still weak. Gains in average hourly wages failed to keep pace with the rise in inflation as the American worker faced competition from lower wages overseas. While the employment picture is improving (over one million jobs added so far this year), there are still one million less jobs today than peak levels achieved in early 2001. As a result, this group feels slighted and is

likely to seek a change in the White House this November.

Retirees, as a whole, may also be somewhat disenchanted in spite of a reduction in capital gains and dividend income tax rates. Those tax benefits did little to mitigate the financial “squeeze” they experienced over the last several years as their wealth continued to suffer from less than a full recovery in the stock market while low interest rates curtailed retirement income. On the other hand, their children, who do have mid- and upper- income jobs, have done better. They used low interest rates to re-finance higher home values, which in turn generated extra funds for discretionary spending.

As a result of these dichotomies, the outcome of the election, and which party controls the White House in 2005 – 2008, will be quite sensitive to and dependent upon minor changes in the economic outlook between now and November 2nd.

Overall though, the economic recovery is intact, even if the pace is not as robust and as widespread as many would prefer. Growth averaged 4.8% over the last four quarters, assisted by last year’s tax cuts. Deceleration from that pace is occurring. The recently completed quarter registered just 3.3% growth.

Going forward, the economy will no longer benefit from last year’s fiscal stimulus. In addition, corporate profitability will be impacted by rising short-term interest rates and extraordinarily high crude oil prices. Projected growth is expected to continue at a more subdued 2.5% - 3.5% pace.

INVESTMENT STRATEGY

During the third quarter, intermediate- and longer-term bonds ignored the Federal Reserve's three successive increases in the Federal Funds rate. Those bonds rallied in reaction to decelerating business conditions, and their yields declined as much as a half of one percent, reversing a good portion of their second quarter rise. On a year-to-date basis, bonds generated low single digit returns.

The recent decrease in longer-term interest rates is viewed as temporary and associated with the recent slowing in the economic recovery. Once the economic recovery broadens, particularly in the capital intensive industrial sectors, upward pressure on interest rates should resume. Thus, fixed income purchases should be deferred.

For stocks, the third quarter felt like the "summer doldrums". The major stock indices declined 2% -3%. Year-to-date, the Dow-Jones Average is down 2.1%, while the Standard & Poor's Index has a marginal return of 1.5%.

of its 14-year valuation range and appears reasonably valued in today's interest rate environment. It discounts the near-term economic risk of a slowdown in the economy, the election, high oil prices, and Iraq.

Nevertheless, stock market returns over the next several years will be limited to a combination of dividend yield and earnings growth for an investment return in the 7% - 12% range. Price-earnings ratios are already at reasonable levels, and rising interest rates should inhibit a return to higher price-earnings levels such as occurred in the late 1990s.

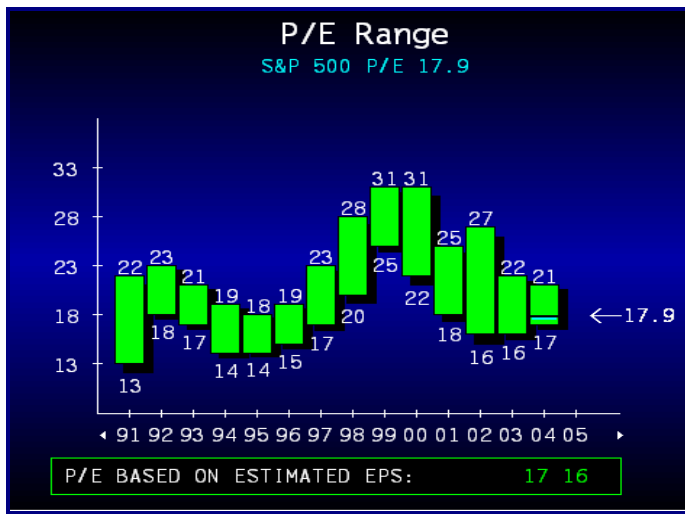
The contribution of dividends to stock returns will be modest. The current yield on the Standard & Poor's Index is 1.7%. However, most dividends are taxed at a favorable 15% rate.

The dividend return will be supplemented by earnings growth. The acceleration in earnings gains at a double digit rate during the last few years benefited from lower interest rates and taxes. That caused corporate profit margins to expand. Further expansion in profit margins is unlikely, and profits are more likely to see gains in the 5% - 10% range, in closer alignment with underlying revenue growth.

Within the stock market, three sectors should benefit from the maturing economic recovery: first, multi-nationals that benefit from the translation of strong foreign currencies into weaker dollars; second, industrials which should experience better profitability as the recovery broadens and there is fuller utilization of our manufacturing capacity; and third, the depressed technology sector which is expected to improve as firms start to cope with rising capacity utilization in a more efficient manner.

CHART I

STANDARD & POOR'S PRICE-EARNINGS RATIO 1991-2005E



Source: Baseline

The "silver lining" to the first three quarters of this year is an orderly adjustment to excessive valuation through a process of rising earnings and a stagnant stock market. The price-earnings ratio for the Standard & Poor's Index declined from 20 times trailing earnings at the beginning of this year to 17.9 currently, 17 times calendar 2004 earnings, and only 16 times estimated 2005 earnings (Chart I). At current levels, the market is in the lower half

TABLE I

YEAR-TO-DATE MARKET PERFORMANCE*

(Including Interest and Dividend Income)

MARKET INDEX	12/31/03	9/30/04	Return
Standard & Poor's 500	1,112	1,115	1.5%
Dow Jones Average	10,454	10,080	-2.1%
NASDAQ	2,003	1,897	-5.3%
EAFE Index	1,289	1,309	2.2%
3 Month U.S. Treasury Bill	.9%	1.7%	0.7%
10-Yr U.S. Treasury Bond	4.3%	4.1%	4.2%
10-Yr AAA Tax-Exempt	3.5%	3.3%	2.6%

*Estimate

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