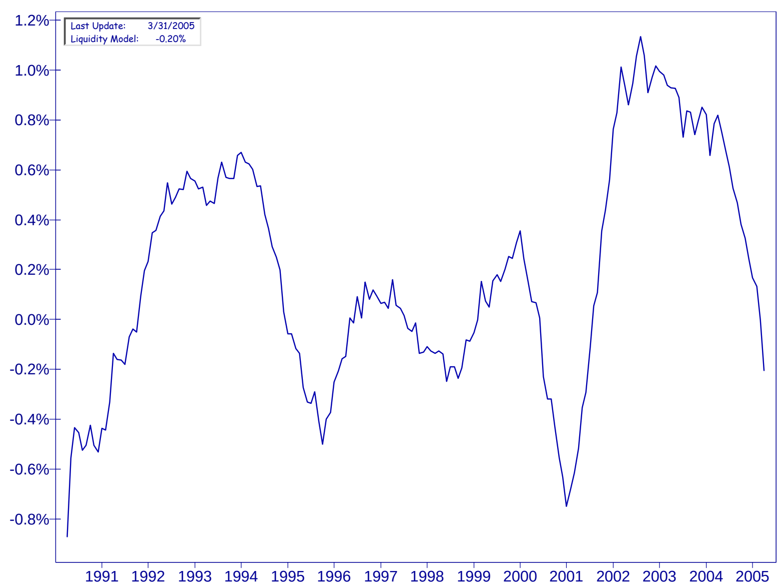
May 2005

DAVIS HAMILTON JACKSON & ASSOCIATES

Slowing Profit Growth

For many years we have been using a proprietary leading economic indicator developed by John Lohman, Director of Quantitative Strategies at Davis Hamilton Jackson & Associates. This indicator essentially measures the amount of monetary liquidity in the economy and takes into account both monetary variables and the shape of the yield curve.

We all know that the Federal Reserve has been gradually and consistently raising short-term interest rates for many months. With long-term rates remaining in a narrow trading range, this has resulted in a flattening of the yield curve. That is, short-term rates are now quite close to long-term rates. At the same time, all measures of the money supply show very little growth on a twelve month rolling basis. With these two factors indicating a significant contraction in monetary liquidity, our economic indicator is forecasting a sharp contraction in growth in the economy over the next six to nine months.



Source: Bloomberg, DHJA Research

This indicator is not predicting a recession, but is certainly suggesting a significant slowdown in real GDP from current levels to 1-2%. Consensus expectations are for growth to moderate to 3-4%.

If the model's forecast is correct, stocks may have several more quarters of churning before they resume an uptrend. Slower than expected growth would mean that current expectations for earnings are too high and profit margins, which have been at record levels, are unsustainable. Until expectations are set at more reasonable levels, disappointments are likely.

In fact, we are already seeing some evidence of falling expectations with the current earnings season. Company after company has reported excellent earnings generally in line or higher than Wall Street expectations. However many have tempered their forward guidance slightly, and investors have generally reacted negatively to these reports.

Slowing of economic growth, the costs associated with Sarbanes-Oxley reporting, and higher raw material costs, especially for energy, means that companies and analysts will have to lower their earnings expectations even more over the remainder of the year.

Since the market looks forward, investors will not be comfortable until this process is over. Expect the stock market to be negatively biased and range-bound for the next several months. Once the Federal Reserve feels that they can stop tightening, and the monetary factors begin to improve, we would expect a better trend for the equity market.

On the other hand, longer term bonds have been performing well in this environment as the market adjusts to slowing growth, and we would expect that to continue.

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May 1, 2005

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