



www.dcmol.com
20 Northwest First Street
Fifth Floor
Evansville, IN 47708

Tel. 812.421.3211
800.321.7442
Fax 812.421.3214

January 15, 2005

Barnyard Forecast

At least annually for many years, we have made our Barnyard Forecast. We usually offer it at our client gathering in November here in Evansville. Since this year that gathering was an open house at our new offices, and not very suitable for speechmaking, we are offering it as a part of our regular quarterly letter. For the benefit of those who are new to Donaldson Capital Management, the Barnyard Forecast does not take its name from the fact Evansville lies in the heart of farming country, or that some of us are from farming families; neither does it predict agricultural prices. The Barnyard forecast is the nickname derived from the acronym for its components: Economy + Inflation + Earnings + Interest rates = Oppportunity (E-I-E-I-O). Old MacDonald and his menagerie would be proud that their lyrics might possess predictive powers for the capital markets. The Barnyard Forecast's longevity, which dates to the early 1990s, is a testament to its value in offering a simple filter through which to evaluate the prospects for stocks in the coming year. As a reminder, we rate each of the four components as creating a positive, neutral, or negative environment for stocks. We then combine the ratings for an overall Opportunity score for the year ahead.

In the End, It's the Fed

In our opinion, the Barnyard Forecast works as an indicator of the stock market because it frames the economic landscape the way we believe the Federal Reserve looks at it. Since there is a high correlation between the actions of the Federal Reserve and, ultimately, the actions of the stock market, by checking the pulse of the Fed; so to speak, we can also find the pulse of the stock market.

As you will see, our predictions for the EIEIO components in the coming year differ from the consensus. We often disagree with the consensus. A year ago we were not in agreement with most strategists who were predicting that long-term interest rates were going higher. Our belief then was that Alan Greenspan and the Federal Reserve would start raising rates on the short end of the yield curve, which would allay building, inflationary fears and keep long rates low. That is what, essentially, happened in 2004. The Fed raised short-term rates from 1% to 2.25% during the year, but the 10-year US Treasury Bond (T-bond) ended 2004 with a 4.25% yield, nearly the same as year-end 2003.

Ironically, the main reason we are at variance with the consensus in the coming year is the same as it was in 2004 – the actions of Mr. Greenspan and the Federal Reserve. Let's just call it the "Greenspan Effect." Investors have become so confident in Mr. Greenspan's ability to do the right thing for the economy and inflation that, as we will show, current long-term interest rates are ignoring the recent uptick in inflation. We, too, believe Mr. Greenspan has been brilliant in his leadership of the monetary policy of this country. Indeed, we believe his actions in the years immediately after 9/11 will likely be remembered as the most astute actions by any Federal Reserve in history. His record of success; however, has bred a sense of confidence in his capacity to control inflation that may be hindering his ability to do so. This is what we are calling the Greenspan Effect.

In our judgment, investors' overconfidence in Mr. Greenspan has pushed interest rates below where they should be relative to inflation, which is making his job tougher. Furthermore, we believe Mr. Greenspan agrees with us. In a recent speech in Germany, he made it clear that interest rates were going higher, and the minutes of the most recent Federal Reserve Board meeting contained surprisingly tough language about the inadequacy of current interest rates to fight inflation. In short, we believe Mr. Greenspan is giving us another "irrational exuberance" warning, this time about bonds; and investors who ignore him do so at their own peril.

Economy:

On an inflation-adjusted basis, the US economy has grown at an average annual rate of just over 3% for the last 80 years. As we traverse the remainder of the Barnyard Forecast, you will see that the 3% level plays a prominent role in many of the components. History shows us that 3% real economic growth is a kind of tipping point. Growth below 3% has led to a rise in unemployment, and sustained growth above 3% has pushed up inflation. For this reason, economists have labeled 3% the "optimal level" of non-inflationary growth.

It truly boggles the imagination to think that just 60 days ago the media and the presidential contenders were debating the "weakness" of the economy. We hope that our October quarterly letter laid to rest the wacky notion that the economy is weak. The economy is strong – so strong that a sublime moment is near. The media will soon start trumpeting the woes of an overheating economy without ever having admitted that it wasn't still on its deathbed.

The table below shows quarterly GDP growth on a year-over-year basis for the last four years. The shaded part of the table shows that the last six quarters of GDP growth have exceeded the optimal level of 3%, averaging just over 4.3%.

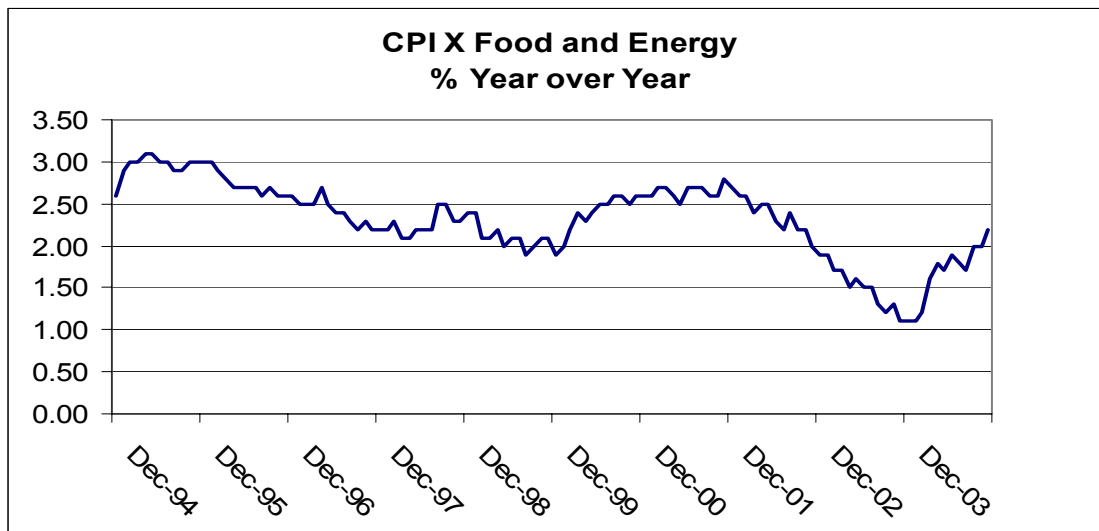
**GDP 2001-2004
%Year over Year**

| 2001 | | | | 2002 | | | | 2003 | | | | 2004 | | | |
|------|-----|-----|-----|------|-----|-----|-----|------|-----|-----|-----|------|-----|-----|------|
| Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| 1.9 | 0.6 | 0.4 | 0.2 | 1.2 | 1.5 | 2.5 | 2.3 | 1.9 | 2.3 | 3.5 | 4.4 | 5.0 | 4.8 | 4.0 | 3.9E |

We believe GDP growth in the coming year will again approach 4%. Growth of this magnitude will keep the Fed on high alert for inflation and keep interest rates rising. As we will explain later, this strong growth is sure to put pressure on bond prices, but its impact on stocks is a tougher call. Strong economic growth will be good for corporate earnings and dividends, which would normally be good news for stocks. The problem is if interest rates rise too much, stocks may start looking past the strong earnings and dividend growth and focus on the slower, long-term growth that sharply rising interest rates would likely bring. The higher than optimal level of growth has the potential to bring both good news and bad news for stocks in the year ahead. For this reason, we rate the economy Neutral for stocks in the coming year.

Inflation:

The long-term average rate of inflation in the US has been about 3% (there's that number again), however, that includes the period of double-digit inflation in the 1970s and early 80s. We have stated before that we believe Alan Greenspan and his Federal Reserve colleagues are now targeting an average of 2% inflation. The chart below shows the "Core" Consumer Price Index (CPI X), which excludes food and energy. The Fed has made it clear that it prefers the core reading of inflation because it is less volatile than the regular CPI.



This shows that the CPI X currently stands at 2.2%. This is a safe level, but its trend since the end of 2003 is worrisome. Remember, this version of CPI excludes food and energy; thus, the \$10 a barrel fall in the price of crude oil since the election will not materially affect it in the coming months. Although the trend is worrisome, the level is not in the danger zone, and therefore, we rate inflation as Neutral for stocks. As you will see in our conclusions, we consider inflation the dealmaker for stocks in 2005.

Earnings:

Corporate earnings in 2004 were nothing short of sensational. The earnings for the average company in the S&P 500 rose by over 23%, and that was on top of the nearly 15% growth in 2003. The consensus estimate for corporate earnings growth in 2005 is just over 9%. Based on our optimism for the economy, we think it will be better than that. Our earnings growth target for the coming year is 12%. The biggest contributors to the above-consensus earnings growth will be the stronger economy, a weak dollar, and improved pricing power. The strong economy will have obvious, positive effects on corporate sales and earnings. The effects of the weak dollar and increased pricing power are less obvious. To bring them into focus, it is important to remember that almost 35% of S&P 500 company earnings are generated abroad; therefore, international sales are very important. The weak dollar causes goods produced in the US and sold abroad to be less expensive and more competitive. Additionally, the weak dollar makes the goods that foreign producers sell in the US more expensive and less competitive. In this way, the weak US dollar has the effect of putting some extra bounce in US companies' sales and earnings. We also expect the top US companies to gain some modest pricing power in the year ahead. US companies have not been able to raise prices much since 1999. The combination of a strong US economy and a continuing weak dollar will allow many of the more powerful brand name companies to lift prices and profits in the coming year. We think 2005 will be a surprisingly good year for corporate earnings, and we rate this Positive for stocks.

Interest Rates:

Because of the Greenspan Effect, we believe interest rates are too low relative to inflation to slow the economy, and with continued economic growth above 3%, they will rise. Mr. Greenspan's predecessor, Paul Volker, taught us a valuable lesson about inflation fighting during his term in the early 1980s. When inflation is on the rise, the Fed must raise rates in a leading fashion, rather than a lagging fashion. The key to the leading strategy is for the Fed to raise interest rates above the rate of inflation when the trend of inflation is persistently higher. The lagging strategy, in which rates are raised only enough to meet inflation, was a disaster in the 1970s, when inflation soared.

Mr. Greenspan has shown through many interest rate cycles that he not only understands the leading strategy but he is also a master at executing it. But, we think the recent election forced him into a lagging strategy. As you may remember, the first President Bush widely criticized Mr. Greenspan for his defeat by Bill Clinton. Mr. Bush, Sr. complained that Mr. Greenspan had not cut interest rates quickly or sharply enough, following the Savings and Loan Crisis of the early 1990s, to allow economic growth to become firmly rooted by the 1992 election. With the economy still stumbling along, Bill Clinton coined the famous slogan, "It's the economy, stupid," and rode it to an upset victory over the incumbent president.

In the recent election, Mr. Greenspan and the second President Bush were in danger of dancing the same dance. The difference was in 2004 the question was how fast Mr. Greenspan would raise rates, rather than how fast he would lower them. With 2004 economic growth at 4% and inflation at 2.2%, a leading strategy would have the Fed Funds rate near 3.25%, rather than the current rate of 2.25%, which is clearly lagging. For this reason, we believe the Fed has some catching up to do and they know it.

In the current inflation environment, we would expect 10-year T-bonds to be yielding 5.25%, instead of 4.25%. There are hundreds of studies showing that investors normally demand a 3% premium above inflation on long-term bonds. So why is the current inflation premium only at 2%? There are two answers: either investors are right and inflation will soon fall to 1.25%, or they are wrong and interest rates will soon rise. In the face of a strong economy, the odds of inflation returning to 1.25% in the year ahead are very low. Thus, we must deduce that bond investors are paying too much for long-term bonds. The reason they are doing so is easy: the Greenspan Effect. Bond investors are targeting the lagging actions of Mr. Greenspan, instead of the rising trend of inflation. Based on what we see and the comments of Mr. Greenspan and other Federal Reserve members, we believe their tactics are about to change, and we think this means both higher short-term and long-term interest rates. That leads us to give interest rates a NEGATIVE rating for stocks in the year ahead.

Opportunities:

With our ratings of the Economy and Inflation coming in at NEUTRAL, that leaves Earnings and Interest Rates to make the call on this year's Barnyard Forecast. Normally, higher interest rates are not good for the stock market, but we believe in the coming year that high quality, dividend-paying stocks will post solid gains. There are two reasons for our optimism:

- (1) The better-than-expected earnings and dividend growth will provide lift for stocks.
- (2) The Fed's shift to a leading strategy will keep inflation under control and will turn it into a positive sometime during the coming year.

As we said earlier, inflation will be the dealmaker for stock performance in 2005. The reason for this is because stocks are more highly correlated to inflation than they are to interest rates. Thus, even though we are forecasting higher interest rates, if inflation remains under control, stocks will ultimately be driven more by the strong earnings growth we expect than rising interest rates. We believe this will be made easier because stocks are currently much more fairly priced than bonds.

The following is our computation of the Dow Jones Industrial Averages' (DJ 30) fair value:

It will come as no surprise that there is a 3% relationship between stocks and inflation. By adding 3% to the projected rate of inflation, we can compute the expected Price to Earning (P/E) ratio of the DJ 30 in the coming year. Then, using our estimate of 2005 DJ 30 earnings, we can calculate our 2005 target for the DJ 30.

| | |
|--|------------------------------|
| Constant Inflation Premium | 3.0% |
| Projected Inflation | <u>3.0%</u> |
| Total Earnings Yield | 6.0% |
| | |
| Expected Price - Earnings Ratio | $1.0 \div 6.0\% = 16.7X$ |
| | |
| 2005 Projected Earnings for the DJ 30 Companies | \$700 (12% over est. 2004) |
| | |
| Projected DJ 30 Price | $\$700 \times 16.7 = 11,690$ |

Working backwards in this way, we project that the Dow Jones Industrials should rise by 8.4% in the coming year and adding in the current 2.2% dividend yield produces an expected total return of 10.6%. That is higher than the consensus but sounds about right to us.

Fixed Income Strategy

There is another big opportunity in the coming year – preserving capital in fixed income securities (bonds and preferred stocks). Since we believe fixed income prices are likely to fall in the coming year, it will be important to reconfigure fixed income portfolios to minimize loss. Even though bonds and preferred stocks are different from common stocks in that they mature at a predetermined price and losses are not usually a big consideration, we believe there is much work to do in our portfolios in 2005. This is because most of our fixed income portfolios have sizeable gains. That means that the bonds and preferred stocks we hold in our typical portfolio are now worth more than what we paid for them, and more than they will be worth at their maturity or call date. Thus, by selling selected fixed income securities that we believe are most likely to fall in price -- under the scenario we are forecasting in the year ahead -- we can accomplish two good things: We can capture a profit that may not be there in a year, and we can reposition the proceeds in bonds and preferred stocks that we believe will be less affected by the rise in interest rates.

The following are some of the tactics we will employ to protect your fixed income portfolios:

1. Sell long, fixed income securities that we believe will not be called and may be at significant price risk to rising interest rates.
2. Sell fixed income securities whose credit quality is likely to suffer from rising interest rates.
3. Buy fixed income securities that are highly likely to be called, particularly, if the yield to the call is more attractive than yields currently available in that maturity.
4. Buy securities whose interest rates are variable and will be relatively immune to rising interest rates or inflation.
5. Buy preferred stocks that qualify for the 85% dividend exclusion.
6. In some portfolios, consider reducing the percentage of bonds we hold.

The above to-do list will increase the activity in most bond accounts. It may also result in our holding more cash in accounts while we shop for secure alternatives to bonds we are selling. There is much work to do, but we have wonderful research tools, technology, and staff to accomplish our goals of preserving capital in bonds.

Blessings,

Greg Donaldson

Mike Hull

