



Quarterly Update

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Financial Markets - Second Quarter Commentary & Outlook

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After a terrific 2003, in which stock investors saw the S&P 500 gain over 28%, the markets have stalled out this year, with the S&P gaining approximately 3% through June 30th. So why, with all the great news about strong economic growth and record corporate profits have the markets not produced better results? The reason can be summed up with one word: fear.

Over the last few months, investors have been bombarded with negative news. The continued turmoil in Iraq, high oil prices, the upcoming presidential election, and the specter of rising interest rates have cast a shadow over the market. There is also a fear of recession in China as it tries to manage a soft landing, and the impact that may have on the already poor U.S. trade deficit.

We think investors have lost sight of the underlying strong fundamentals. Economic growth and corporate profits are surging. The label of a "jobless recovery" is gone as U.S. firms have created 1.4 million jobs over the last nine months, taking up just over half the jobs lost since the start of the recession. Equity valuations have become more attractive as the market starts to discount the effects of any boosts in short term interest rates by the Fed.

Investors received answers to two very important questions during the last week of the quarter. On June 28th, two days before it was expected to occur, the United States handed over sovereignty of Iraq to its new government in what turned out to be a very quiet ceremony.



On the final day of the quarter, the Fed announced that it would raise the federal funds rate by a quarter percentage point to 1.25%. In its announcement, the committee eased concerns about inflation, stating that they felt "a portion of the increase (in inflation) in recent months appeared to have been due to transitory factors." This should allow the Fed to continue its "measured" campaign of moderating economic growth. These two events should decrease the noise in the marketplace and allow investors to focus on the fundamentals.

With the fireworks of July 4th comes the beginning of yet another earnings reporting season. The consensus earnings growth forecast for the second quarter is 19%, with some believing that it could come in as high as 25%. We expect that the sectors that will exhibit the strongest earnings growth will be the more cyclical sectors such as materials, information technology and industrials. We currently recommend overweighting the materials and industrials sectors, along with the energy, healthcare and consumer discretionary sectors.

Eventually the labor market will tighten, interest rates will have risen significantly, productivity growth will slow, and along with that, profit margins will be squeezed.

But we do not believe that this will happen until late 2005 or the beginning of 2006 at the earliest. By that time, we could be looking at S&P earnings that are 30% to 60% higher than they were at the end of 2003.

While we remain bullish on the stock market, we believe that the bull market for bonds is over. Bonds suffered one of the worst three month periods in a decade. The 10 year treasury saw its yield increase from 3.85% to 4.59% during the quarter. Since bond prices and bond yields move in opposite directions, this meant that its price fell almost 5%. One area of the bond market that performed well was TIPS, or Treasury Inflation Protected Securities, as investors sought protection from rising inflation. We recommend that investors keep their bond investments in securities with short maturities.

Investors are also concerned about the impact of the presidential election on the market. We believe that no matter who triumphs, a recovering economy and strong earnings suggest that the real winners will be stock market investors, at least for the short term.



Colleague Profile

Chris Chapman

Chris Chapman is one of the 40% of us at TCV who is a native, unlike the rest who must dwell here for several generations before we can be called Vermonters. Why doesn't he have to wait? He claims genuine native status because his mother's labor was triggered by a scald on her hand from boiling maple sap. That archetypal experience qualifies him.

His dad, a noted Brattleboro lawyer and Probate Judge, would hold forth dinner table conversations on such topics as Shakespeare's genealogy. Consequently, Chris was better equipped than most when at the age of 16 he went to work after school for the Brattleboro Reformer as a researcher.

Taking to the business, he became a part-time reporter and photographer and returned during college breaks. Newsroom work often involved 18-hour workdays. As he anticipated a career of long days in the business, he decided he should do something completely different before graduating from Northwestern. We can't explain this quirk of character, but he chose to ride to Alaska on a 12,000 mile motorcycle trip before his senior year.



After graduation, he found disappointment in his full-time work as a reporter in the Berkshires. Long troubled by the nation's Vietnam experience, he was drawn in a different career direction

when a haunting Newsweek cover picture of "boat people" kindled a desire to make a difference on the world stage. A job opened up in NYC with the National Council of Churches in its overseas division. They needed someone who could put publications together.

Two events changed his life again. While living in the city, he met his wife, Alison, an accomplished flutist. Then, the National Council introduced the desktop computer into the workplace. Drawing on computer science coursework, he automated key financial reporting procedures that so impressed his colleagues that he was drafted into the business office. That was the turn in the road that led him to the trust business.

Now a supporter of the arts by marriage and looking ahead to children and a mortgage, he realized he was going to have to make another change. He took great satisfaction at having helped the National Council raise \$50 million in its efforts to respond to disasters, but he could not see himself supporting a family as a professional church mouse.

On a trip home to Brattleboro, he interviewed with the former Vermont National Bank, which was looking for an administrator in its trust department. They needed someone who would learn a business involving investment management, estate-planning, and fiduciary taxation. The comprehensive nature of the work greatly appealed to him. It also involved helping others, which he valued.

Alison's career took the helm after the birth of their first child in 1986, and the new family found itself facing another decision. She had a dream job opportunity with the Portland Symphony, but the young family couldn't sustain a com-

muter relationship. Something had to give, and orchestra jobs were scarce in Vermont, so Chris moved to Maine.

In late 1990, his father died quite suddenly, and his family homestead looked likely to be sold. A trust officer with the former First Vermont Bank offered him a job. He had another chance to return to Vermont in his chosen profession and to live in the house where he had grown up. He returned.



Chris, with son William, 1988

Were it not for bank mergers, he might still be with that bank. But the wave of consolidations changed the environment. Our organization rose out of that milieu, and we invited Chris to join us in 2002.

Chris is an estate planner and trust administrator. His duties involve sorting through complex problems, distilling information, and communicating understandable choices. He is a natural for this business. It fits his personality. He likes to help people by making order out of chaos.

One parting comment: Chris is one of several editors of the newsletters. Although he does not have final control, he does have influence. So when you see "archetypal" and "milieu" you know where they came from (and, if we end with a preposition, it just might be an act of rebellion.)