



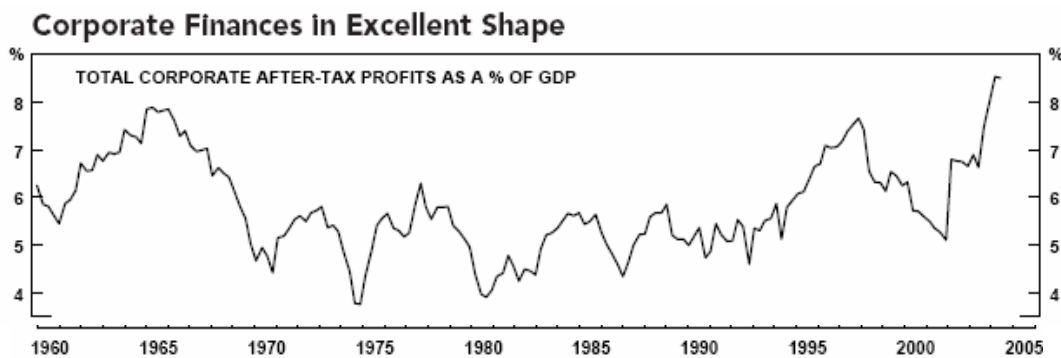
## Economic & Market Commentary October 2004

The main thesis of our July 2004 Economic & Market Commentary was that a host of economic and political factors were going to cause a sustained, and possibly volatile, rise in energy prices. At the time, crude oil was selling for approximately \$37 a barrel, whereas it is \$54 a barrel today. While we expected upward pressure on energy prices, the suddenness of the recent increase has taken investors by surprise. In addition to the economic and political factors we described, weather has turned out to be the wild card. The four hurricanes have negatively impacted not only the production of energy in the Gulf of Mexico, but perhaps more importantly the delivery and refining of energy products. As the chart below illustrates, commercial crude oil inventories are at the low end of their recent range, but accelerated demand from the Strategic Petroleum Reserve has increased stored reserves.



We believe refinery capacity utilization will return to normal fairly soon and, barring a prolonged supply disruption, the price of energy and refined products will begin to adjust lower. Additionally, most of the world's major economies (with the exception of China, India and the United States) are generating modest growth and the current high cost of energy is clearly going to have a dampening effect on economic activity. We have already seen a weakening in U.S. consumer confidence and retail sales. While the increase in energy prices has been positive for energy companies' expected earnings, a number of non-energy companies have been unable to pass the increases along to their customers, negatively impacting their own profits. We believe energy company stocks are modestly undervalued, based on what we believe the companies will earn over the next few years. We would consider increasing the energy commitment in our clients' portfolios, if the valuations of the stocks improved either as a result of a pullback in the price of the shares or an increase in their longer-term earnings power.

With regard to capital expenditures, spending on Information Technology (IT) grew at a significantly above-average rate during the late 1990's, in response to the emergence of the Internet, replacement of older systems in advance of Y2K, telecom services deregulation and the widespread adoption of wireless phones. The IT spending binge set the stage for a significant contraction in 2001 and 2002, causing technology companies' revenues (and profitability) to fall significantly short of the very high expectations that had developed and led to a huge downward revaluation in technology company shares. Fortunately, the aggressively pro-cyclical monetary and fiscal policy that was implemented during this timeframe prevented the U.S. economy from slowing even further. However, the stimulus from lower interest rates and tax cuts has largely run its course and, at this stage of the business cycle, we need businesses to increase their hiring and increase capital spending. We believe we are at the early stages of a recovery in IT capital spending. U.S. corporations are in the strongest financial position they have been in decades. There is approximately \$1.2 trillion in cash currently on nonfinancial U.S. corporate balance sheets, which represents 140% of capital expenditures. Additionally, total corporate after-tax profits as a percentage of Gross Domestic Product (GDP) are at a 50-year high as illustrated below.



Clearly U.S. companies have the financial wherewithal to selectively increase capital spending. More importantly, U.S. companies need to continue investing to improve their productivity and competitive position. A couple of examples follow.

With the Federal Communication Commission's (FCC) ruling that the Regional Bell Operating Companies (RBOCs) would not be forced to lease out their networks to competitors, the RBOCs have announced significant spending initiatives over the next few years to upgrade their legacy copper networks for fiber to the premises (FTTP). These expenditures are an effort to fend off competition from cable and other service providers. By installing fiber to their customers' homes, the telephone companies can offer local and long distance telephone service over the Internet, high speed Internet access, as well as video services. In another example, WCDMA (Wideband CDMA is a wireless technology) upgrades will start in earnest by 2005 on a global basis, providing another uptick for Information Technology (IT) spending.

While we are not suggesting a return of the 1990s for IT, we do believe the bust is over. We continue to view the IT business as a cyclical growth industry, with some of the participants able to build profitable, growing businesses that warrant inclusion in our clients' portfolios.