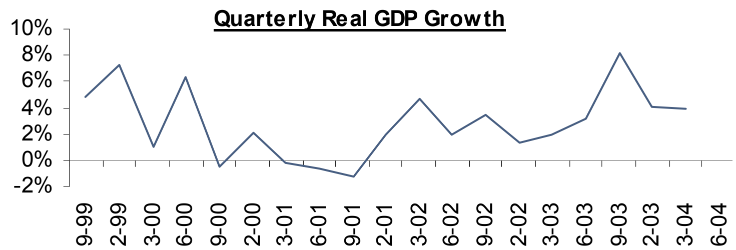
Your Quarterly Update on the Financial Markets
June 30, 2004

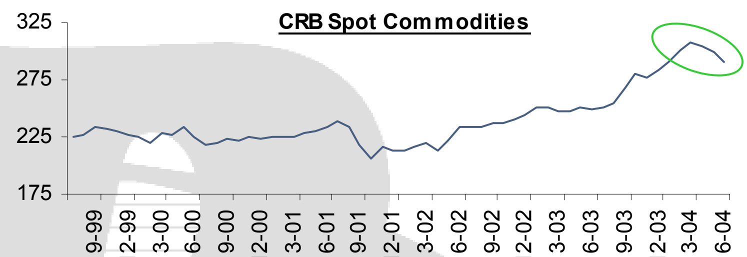
2nd Quarter

MARKET Recap

The Economy: *"Not So Fast!"*

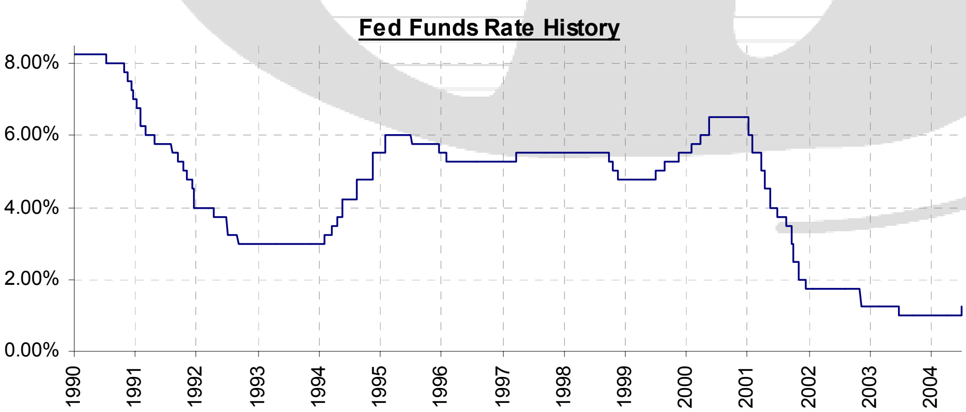


The U.S. economic recovery showed early signs of slowing in the second quarter, even as the Federal Reserve began its long-awaited program of monetary tightening. GDP growth for the first quarter was announced at 4.4%, and then subsequently revised downward to 3.9% on better data. Renewed strength in the dollar mid-quarter curtailed growth in exports, which was only partially offset by slower growth in imports.



Several data points in the second quarter seem to confirm the notion of slowing growth. Orders for durable goods fell in April and May, surprising economists and suggesting that corporate spending may remain tight despite continued very strong profits. Unemployment remained steady through May at 5.6%, but first-time jobless claims rose unexpectedly to 349,000 for the week ending June 18, and 351,000 for the final week of the quarter. The economy continued to create new jobs for the 10th consecutive month, but at a somewhat surprisingly slower pace – 112,000 new jobs in June compared to 235,000 in May, according to Labor Department statistics. Note that these data are by no means recessionary, and there was corresponding good news as well. The dollar resumed its pattern of depreciation in the second half of the quarter, which should help labor-intensive manufacturing and other export industries.

Importantly, consumer price inflation remained modest and fuel prices eased. Brent crude reached a high of $39.22 per barrel on May 24th then fell steadily, ending the quarter around $33.25. Crude oil stocks on-hand exceeded 300 billion barrels (excluding the strategic petroleum reserve) for the first time since 2002. However, excess production capacity is now at a historical low, leaving little buffer for potential political disruptions in volatile South American, African, or Middle Eastern production zones.



We remain concerned about raw material prices, but last quarter's respite and the absence of other dramatic inflationary signals helped support a more modest course of action by the Federal Open Market Committee. Their June 30 statement said as much: "Although incoming inflation data are somewhat elevated, a portion of the increase in recent months appears to have been due to transitory factors."

As expected, the FOMC increased the fed funds rate by 0.25% on June 30, a move so widely anticipated that the bond market barely budged. The only question going into the meeting day was whether the Fed would adopt a gradual pattern of tightening or choose a quicker course. There really was little chance of the latter. Under Greenspan's tenure "gradualism" has been the rule, particularly in the early stages of tightening phases which tend to last a year or more; since 1990, 34 of the Fed's 52 rate changes have been quarter-point moves. Barring the very real chance of an election-year shock event, we expect continued gradual tightening through 2004 and into 2005.

The U.S. Stock Market

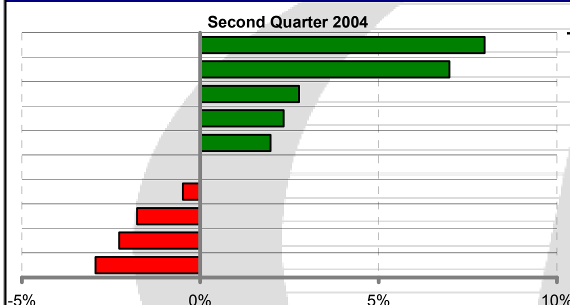
The equity markets took a breather during the second quarter. The volatility so prevalent in previous quarters slackened as continued economic improvement proved to have a calming effect. Evidence of sustained economic recovery prompted the Fed's first rate increase in 4 years. As the quarter closed the market responded as it did for most of the quarter by remaining flat. The S&P ended up 1.30% for the quarter. The tech bellwether NASDAQ was up 2.70% for the quarter as technology issues rebounded from their first quarter slippage. Large cap issues outpaced their small cap counterparts for the first time in five quarters.

Stock Indices - Total Return

Largecap Stocks		**Midcap Stocks**	
S&P 500	1.30%	S&P Midcap 400	0.68%
Russell 1000	1.40%	Russell Midcap	1.45%
Growth	1.94%	Growth	1.05%
Value	0.88%	Value	1.73%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	2.70%	S&P Smallcap 600	3.38%
Wilshire 5000	1.29%	Russell 2000	0.47%
		Growth	0.09%
		Value	0.85%

The S&P 500 continued its streak of consecutive quarterly gains. Sector performance for the quarter was mixed as half of the industry sectors in the S&P 500 were in the black. Industrials led all sector performance as the strengthening economy translated into strong performance for companies like Boeing and Goodyear. Financials lagged all sectors as investors moved to cut their positions in advance of the Federal Reserve's anticipated rate increase.

S&P 500 Economic Group Components - Total Return



Sector	2Q04
Industrial	7.97%
Energy	6.98%
Information Tech	2.77%
Healthcare	2.34%
Materials	1.97%
Consumer Staples	-0.01%
Consumer Discretionary	-0.49%
Telecom Services	-1.77%
Utilities	-2.27%
Financial	-2.94%

Source: Standard & Poor's

Consumer confidence climbed again as the quarter closed, but there was little correlation between the level of confidence and consumers reaching into their wallets as evidenced by disappointing sales for the largest retailers such as WalMart and Target – with both projecting lower than expected second quarter sales. Continued positive consumer sentiment combined with positive business sentiment has helped sustain the markets. However, given the Fed's move, growth is now expected to tail off towards the end of the year. According to First Call earnings growth forecasts for the S&P for the second quarter were revised to 20.5%. But future growth rates are expected to fall to 13.5% for the third quarter and 15.3% for the fourth quarter.

If the second quarter earnings estimate holds it would be the fourth straight quarter with earnings growth greater than 20%. According to Thompson Financial, growth streaks of this magnitude have occurred only four times in the last 50 years. Three of the four times these streaks have occurred the S&P fell or had much lower gains in the subsequent 12 months. With the specter of inflation on the horizon and the markets already beginning to price in a slowdown in earnings growth there is some fear among investors that there will be no fundamental forces to continue to drive market growth and the days of 20% growth may be coming to an end.

As we reported in our last issue, with the increases in reported earnings, the price-to-earnings ratio of the S&P 500 continues to fall - the P/E ratio currently stands at a still high 21.9 times trailing earnings. We expect at least one more interest rate move by the Fed prior to the November election which may erode additional earnings growth momentum by further increasing the cost of capital.

The U.S. Bond Market

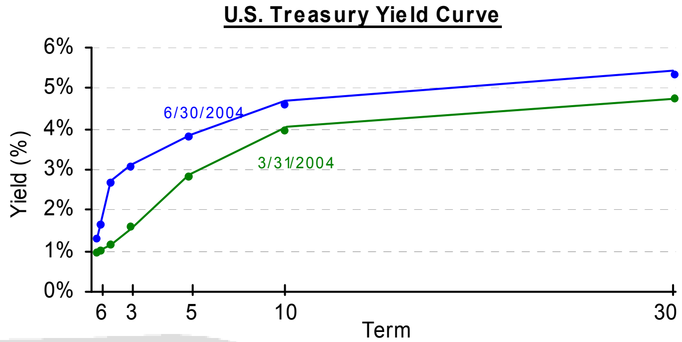
Sustained growth of the economy during the second quarter ended all speculation of whether the Federal Reserve would raise the Federal Funds Rate or leave it unchanged. On the last day of the quarter the Fed raised the short-term borrowing rate by 0.25% (25 basis points) to 1.25%.

Bond Indices - Total Return

Lehman Aggregate	-2.44%
Lehman Interm. Gov't	-2.30%
Lehman Long Gov't	-5.28%
Lehman Interm. Credit	-2.82%
Lehman Long Credit	-5.37%
Lehman High Yield	-0.96%

As consumer confidence continues to remain robust and business confidence and spending picks up we have seen price inflation creep into various sectors of the market. The Fed's move was consistent with their long-term view of inflation – that it is not a serious issue and will be dealt with in "measured" steps. At the same time, the Fed has said it stands ready to take whatever steps necessary to combat inflation. Reaction to the move in both the fixed-income and equity markets was quite tame however, given the Fed's telegraphing of its punch.

Upward movement in rates hurt bond performance for the quarter as most sectors experienced negative returns. Long Credits slightly outpaced losses in the Long Government sector by virtue of a small flight to quality. Yields on the short end of the curve backed up, with the 2- and 3- year yields widening out over 1.50% during the quarter. The 10-year treasury yield ended the quarter at 4.58% after peaking at around 4.75% earlier in the quarter. Consensus estimates put the 10-year yield over 5% at the end of 2004. The result of the current rate movement has been a general flattening of the yield-curve between 2- and 10-years, while the long end of the curve steepened slightly, having already priced in the effect of future interest rate moves. We expect a continued difficult environment for bonds in the near-term, as our economic outlook calls for inflationary pressure and rising rates.



Source: Bloomberg LP

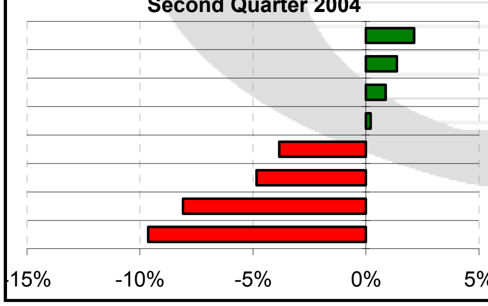
Overseas Markets

Global markets hit the brakes in the second quarter as geopolitical issues and fear of an economic bubble in China cooled off performance. Nowhere has the impact been felt more than in the Asian markets as the Japanese and other Pacific and emerging markets tumbled.

Performance in Europe strengthened slightly as the MSCI Europe market outperformed North America. Early in the quarter the ECB left interest rates unchanged even in the face of pressure from EU constituents. The bank can do little to help with the structural problems driving performance – low consumer spending due to unemployment fears, weak growth in incomes and anxiety over the lack of reforms in Europe's pension and health care systems. In Germany, slackening domestic consumption was to blame for a fall in the business confidence sentiment from 96 in May to 94.6 in June. Unemployment in the region also rose slightly during the quarter but job vacancies did not decline. This was seen as a positive for the country. The MSCI Germany Index was up 3.75% for the quarter. Although France also continues to struggle with high unemployment and low consumer confidence the MSCI France Index managed to post a 3.5% gain. The ECB has held rates steady at 2%, however there is fear that high oil prices, inflated commodities prices and the rate increase in the U.S. may force the ECB's hand and stall any chance of growth in the region.

Gross Total Return of Selected MSCI Regional Indices

Second Quarter 2004



Region	2Q04
Europe	2.13%
North America	1.37%
World Index	0.87%
EAFE	0.22%
Japan	-3.83%
Pacific ex Japan	-4.84%
Latin America	-8.09%
Emerging Markets Free	-9.64%

Japan had a minor setback this quarter but all signs are positive. The Tankan Index which measures large manufacturers' sentiment was 22, beating the consensus forecast of 17. This is the strongest reading since 1991, and increased from 12 in the prior year's survey. The index measures the number of companies reporting favorable business conditions minus those reporting unfavorable conditions with a positive reading meaning that optimists outnumber pessimists. Survey results show large companies planning to increase capital expenditures through March 2005, revising these plans upward from a projected cut of 0.6% in the last survey. The sentiment reading for non-manufacturers also rose to 9 from 5 in the previous survey demonstrating a broadening of the export-driven recovery in the sector. The MSCI Japan Index was down 3.8% for the quarter, but is still up nearly 11% for the year.

China remains the dominant story in Asia and the world. Industrial production continues to thrive in the country along with a coincidental growth in the money supply. Growth in China continues to be robust and has led to the government initiating steps to cool the economy down. During the second quarter both price controls in provinces where costs were rising rapidly and higher banking reserve requirements were instituted in an effort to slow growth. While these steps were successful in slightly cutting the growth rate, the central bank has drawn the line at another interest rate increase. The MSCI China Index was down 7.6% for the quarter.

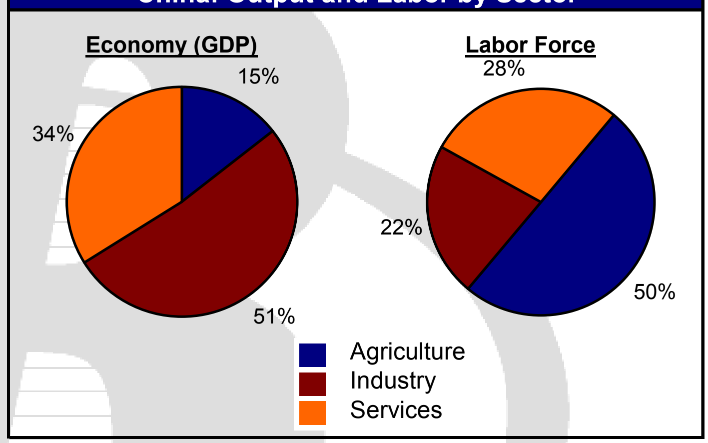
Latin American markets slipped sharply this quarter. In Brazil, inflation climbed to a three month high with consumer prices rising 0.51% in May alone. The increases were attributed to a spike in food and pharmaceutical prices. Even though Brazil was able to post a budget surplus for the quarter, the MSCI Brazil Index was down nearly 12%. Argentina continues to suffer as past-due interest holders of nearly $100 billion in debt have launched lawsuits against the country. The government's proposal for swapping new bonds for old would leave investors with significant losses and the proposal was rejected by two leading creditor groups. The MSCI Argentina Index was down 17.3% for the quarter.

Focus On: *The Rise of China.*

During a recent meeting, one of our clients asked a prospective investment manager "So, do you think China is over-hyped or under-hyped?" It's a particularly insightful question, because China poses a number of profound contradictions to investors. Until recently, institutional investors could study the Dragon with detached interest, as allocations to "emerging markets" tended to be small and skewed toward the hot capitalist economies of the Pacific Rim. Not so today; liberalization effected through constitutional changes in 1982 has unleashed a surge of economic growth truly unparalleled under a socialist system, sparing the people of China many of the economic hardships experienced in the former Soviet Union. That growth has supported a level of political and social stability that, while not without flaws, makes China look downright esteemed compared to other developing regions such as Latin America and Africa.

In 20 years China has grown from economic obscurity to the second-largest national economy in the world. On that basis alone, one cannot simply treat China as just another developing economy. The world's mature economies, including our own, are now tied to China's fortunes. In the long run we view that fact very positively, as it is unsustainable that so much of the planet's population can lag so far behind modern standards of living and comfort.

China: Output and Labor by Sector



2003 est. Source: World Factbook, U.S. CIA

Astounding Economic Growth

It comes as no surprise that China is the world's most populous country. However, it is only recently that the output of this vast nation has begun to reflect its size and resources. Growth in real GDP averaged 9.9% from 1986-95, and 8.2% in the largely recessionary years that followed. This is an astounding rate of growth, more than double the sustainable growth rate generally accepted for developing nations – and 3-4 times the sustainable growth rate for mature economies. That said, China is truly still an emerging economy; with a population topping 1.2 billion, each person contributes only $5,000 per year to real GDP, about 1/8th the efficiency of the United States and 2/3^{rds} that of the world in aggregate.

Economic activity is highly focused in relatively small regions around the industrial centers of Beijing and Shanghai, while the vast population is spread over a region just slightly smaller than the United States (including Alaska). The industrialized regions are enjoying a surge in wealth and consumerism, but the standard of living in rural areas remains austere. Unemployment hovers at about 10%, fairly nominal by world standards, but underemployment is significantly higher.

Shifting from an agrarian to an industrial economy is a high priority for the government, which must deliver higher living standards to maintain stability. Employing the classical socialist approach, massive state-owned enterprises focus their activities on increased employment with, at best, muted responsiveness to supply and demand forces. Consequently, output is concentrated in labor-intensive manufacturing sectors such as textiles and apparel, toys, consumer electronics, and automobiles – along with intermediate sectors such as cement and steel necessary to support booming industrial con-

Selected Statistics on National Size, Production, and Wealth

Country	Population	% of World
1 China	1,298,847,624	20%
2 India	1,065,070,607	17%
3 United States	293,027,571	5%
4 Indonesia	238,452,952	4%
5 Brazil	184,101,109	3%
World	6,379,157,361	

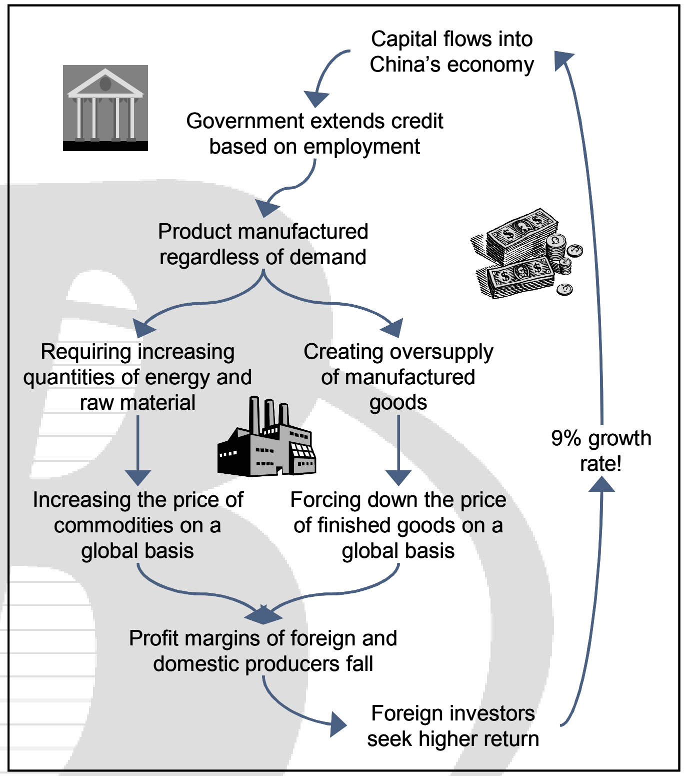
Country	GDP ($bil)	% of World
1 United States	$ 10,980	21%
2 China	6,449	13%
3 Japan	3,567	7%
4 India	3,022	6%
5 Germany	2,271	4%
World	$ 51,410	

Country	GDP/Capita
1 Luxembourg	$ 55,100
2 United States	37,800
3 Norway	37,700
4 Bermuda	36,000
5 Cayman Islands	35,000
120 China	5,000
World	$ 8,200

Source: World Factbook, U.S.Central Intellegence Agency struction. Since the early 80's China has adopted a degree of capitalist reform, allowing privately-owned enterprises to exist and compete; however, their activities are controlled through several mechanisms, including a state-controlled banking system which allocates capital according to national goals.

China's Capital Problems

Space does not permit even a cursory examination of the economic and social issues faced by China: the need for reforms and improvements in currency valuation, banking, legal infrastructure, pensions, human rights and diplomacy. Rather we focus on capital allocation, as it is perhaps the greatest and least widely understood issue, and one which is fundamental to their economic system. Foreign capital pours into China at an ever-increasing pace, to be allocated not according to market forces, but through a weak banking system to companies with the right combination of political pull and compatible social objectives. The result is inefficient and redundant production capacity in labor-intensive industries, placing downward pressure on prices locally and globally. Oversupply leads to low return on capital, which would drive plant closures and downsizing in a capitalist economy; in China it leads to the extension of more credit, and ultimately the development of more redundant productive capacity.



Simultaneously the growth of China's manufacturing sector has stressed domestic supplies of raw materials, causing pressure on commodity prices world-wide. Basic infrastructure is strained as well, with electric production capacity far below that needed to meet demand. There has been much debate in the U.S. of late as to whether China was causing inflationary or deflationary pressure in our economy – the answer is both, simultaneously, because of inefficient capital allocation. Over time the system will become less and less efficient, with more incremental capital required to generate a diminishing amount of real growth. The American high-tech bubble dramatically illustrates the dangers of over-capitalization. To thrive in the long run, China's economy must slow down.

Chinese officials are aware of the problem, although it remains to be seen whether or not they appreciate the scale. In April the People's Bank raised the required reserves to 7.5%, the third capital-constraining increase in the last year. Inter-bank lending rates are also on the rise, and the central government has at least made overtures toward gradual policy change. But China is addicted to growth; market-based capital allocation comes with a heavy political price.

Is China Over-Hyped or Under-Hyped?

With all the drama in the Middle East, it is easy to downplay the importance of the Sino-American and Sino-European economic relationships; it's also a significant mistake. China needs us as a cooperative trading partner, and we need to fully engage them to manage the inevitable effects on our economies and societies. After decades of cold war, it is not in the nature of either side to develop trust, acknowledge each other's successes, or learn from each other's mistakes. In that respect, China is under-hyped. Every business should plan carefully for China's continued emergence.

However, one thing they don't need is more capital, at least not right now. Investors looking to satisfy unrealistic expectations for returns are risking much by becoming capital "pushers" to an economy that desperately needs to learn how to wisely manage the abundance of capital already on hand. So to the investor, we say proceed with caution – China is over-hyped. Another contradiction in a very complex relationship, but cash is not a substitute for time and free trade.