

Lighthouse Beacon

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Lighthouse Investment Commentary

Will 2005 Finally Mark a Return to Normalcy in Markets?

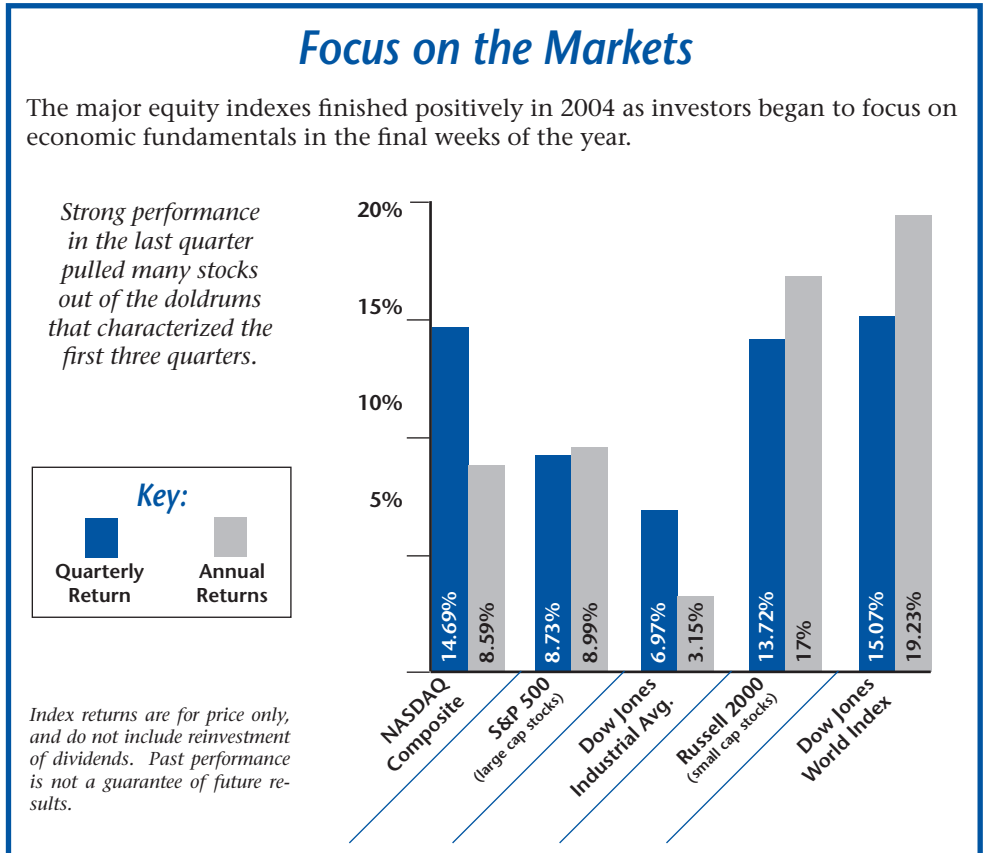
For stock investors, 2004 ended on a high note. In the aftermath of the presidential election and the resulting end to political uncertainty, investors began to focus on the economy as well as on corporate profits. The result was a brisk post-election rally that produced exceptionally strong results for the fourth quarter and decent results for the year, especially for portfolios that included allocations to small- and mid-cap stocks.

Although the past 24 months have not been without their share of volatility, 2004 marked the second consecutive year of healthy returns from equity investments. This should not have been surprising to anyone who has paid close attention to economic fundamentals. After all, we had healthy economic expansion, strong corporate profit growth, and low borrowing rates.

WHAT, THEN, SHOULD WE EXPECT OF 2005?

The economy should continue to expand, and corporate profits should rise, although probably at slower paces than we saw during 2003 and 2004. This should not be an unwelcome development—in fact it may mark the return to normalcy in the economy and in company earnings after a decade of intense volatility. It is feasible to see Gross Domestic Product (GDP) increase by about 3% during 2005 and corporate profits to rise by about 8%. When you consider that we have just gone through six consecutive quarters of double-digit earnings gains, these statistics may not appear eye-popping. However, they could signal a movement to levels consistent with long-term historical averages. And, there is nothing wrong with that.

One of the challenges that investors may face in 2005 will be simply to recognize the situation for what it is—a nor-



mal environment that typically occurs as a second stage of an economic expansion. This more moderate growth traditionally comes after a period of explosive growth that occurs as the economy first emerges from a slump or recession. Yes, corporate profit growth may be decelerating, but earnings still are growing and that should be enough to generate new opportunities. Yes, interest rates may rise a bit, but most likely only to levels that normally would be considered “neutral” to economic growth.

Even the issues that we worry about may become more typical. While turmoil in Iraq and the threat of terrorism may persist, political uncertainty has receded

and oil prices have even started to settle down. Now, we are worrying about issues such as the size of the federal budget deficit, the imbalance in the nation’s current account with other countries, and the value of the dollar. These are traditional economic issues and their re-emergence can be re-assuring. After all, there never has been a perfect environment for investing, and there probably never will be on. We always will have to worry about something!

While warnings about growing deficits and the plunging dollar may dominate some news reports, the situation is hardly dire. In fact, the capital markets

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can understand and absorb the evolving challenges just as they also understand a basic fact of the global economy: the U.S. remains the strongest destination for both trade and investment capital. As long as that fact remains true, foreign investment is not about to disappear, despite some predictions to the contrary.

Some of the most talked-about “issues” in the economic landscape in early 2005 include: The growing federal deficit; the low savings rate of Americans; recent increases in the rate of inflation; the weakening of the U.S. dollar. Let’s take them up, one at a time.

- 1. The rising national debt.** While national debt continues to increase, the dangers from the annual budget deficit of the federal government actually may be easing. As the economy expands and corporate profits improve, federal receipts—predominately taxes—are increasing. Measured against national output, the U.S. budget deficit now is about 3.5%. Compare that to the 6% level we saw in the 1980s. Moreover, President Bush is under great pressure from both political parties to shave the deficit more.
- 2. The low savings rate.** Despite the low level of personal savings, a tremendous amount of cash remains on the economic sidelines as corporations and individuals wait for uncertainty to fade. Both households

and non-financial corporations have record levels of highly liquid assets. That money eventually should be invested, providing further impetus to the economy.

- 3. Rising inflation.** Some increase in inflation is normal in any expanding economy. We have read and heard much about the huge demand in China for oil and other raw materials and the effect of that demand on inflation. However, we sometimes forget that fierce global economic competition is helping to keep prices down. Moreover, the technology revolution continues to improve productivity throughout the world, again keeping a lid on price increases.

- 4. The weakening dollar.** There is no statistical correlation between a weak currency and a bear market for stocks.

So, where do we stand as we enter 2005? The U.S. economy is healthy, corporate profits are rising and are projected to continue to rise, and interest rates are increasing moderately. Meanwhile the quality of corporate balance sheets has improved substantially and stock valuations appear reasonable by historical standards. What may need fixing are not the economic fundamentals, but our expectations.

As investors, we need to adjust our expectations for the stock market to levels consistent with historical averages. An annual capital return of about 8%, for example, would be in line with those averages as well as consistent with an economy that has moved out of its initial fast-growth spurt into a period of more moderate, sustained expansion.

To be successful as investors, we need to look below the surface of the markets. In the first stages of the current economic cycle, the stock market indexes all were lifted higher. Now, we need to focus less on the overall stock market, and more on the market of individual stocks, each with their distinctive opportunities. And, there are many interesting and potentially profitable opportunities.

One final comment: The last time the Boston Red Sox won the World Series, stocks took off in a strong rally! Need we say more?

Lighthouse Spotlight

Dollar's Weakening May Be Self-Correcting

We shouldn't be too concerned about the recent weakness of the U.S. dollar on international currency exchanges. Trying to forecast currency movements is harder than predicting weather along the coast. Changes in currency values have their own cycles, which are almost always self-correcting.

We already have started to see increases in foreign capital investments (and even consumer spending by foreign tourists) in the United States to take advantage of the weak dollar. Such behavior usually results in a natural reversal of trends, which in this case could lead to an eventual strengthening of the dollar.

Until that happens, we can console ourselves with some advantages of the weak dollar. U.S. products and services are more competitive, while foreign goods are less attractive.

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Q: Why isn't the low national personal savings rate a bigger problem?

- A:** You can't just look at the savings rate in isolation. While the savings rate may be low, American consumers have been accumulating considerable wealth, thanks mainly to the value of real estate and of personal investments.

The U.S. consumer is hardly tapped out. In fact, households now hold a record \$4.1 trillion in checking accounts and other cash holdings. While it is very likely that the rate of growth in consumer spending may begin to decelerate a bit, such a leveling off would be consistent with historical patterns during more mature phases of economic expansions.

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