All Star Quarterly

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3rd Quarter Review & Preview

Is Another Year-End Rally In Sight?

Overview

There were plenty of reasons for investors to become discouraged during the 3rd quarter, a period of bad news on a number of fronts. Between two destructive hurricanes named **Katrina and Rita**, the steady climb of **oil prices** and continued **interest rate hikes** by the Federal Reserve, the obstacles were obvious. **Nevertheless, markets managed to withstand the challenge**.

The U.S. economy avoided any severe fallout from the successive hurricanes. The jobs picture showed steady improvement even with major layoffs from two airlines that declared bankruptcy, Delta and Northwest. **Corporate earnings also kept pace with only a few exceptions**. While higher energy costs are having an impact, the price spike hasn't overwhelmed the economy to this point.

What is becoming a bigger issue is the risk of higher inflation. Federal Reserve Chairman Alan Greenspan appears determined to continue to raise interest rates in order to stem the threat of inflation, as happened on two occasions in the third quarter. Still, the economy is adjusting nicely to the Fed's policy of monetary tightening.

The markets are watching to see how the nation bounces back from the challenges of the previous quarter. But some **opportunities could arise, including:**

- **The possibility of the economy enjoying a spurt of activity as the Gulf Coast rebuilds from Katrina and Rita.**
- **A rollback in energy prices from the highs reached during the 3rd quarter**.
- **A repeat of last year's strong 4th quarter performance for the stock market**.

Whether those events will occur in 2005 remains to be seen.

Economy

The 3rd Quarter

The U.S. economy faced stiff headwinds in the quarter, due in large part to the effects of Katrina and Rita. Higher interest rates and rising oil prices also had an impact. **But with all of that working against it, the economy appeared to stay on track**. The final report of second quarter **gross domestic product** showed an **annualized growth** rate of **3.3%**, in line with previous quarters.

The economic impact of the **hurricanes** remains a question market. Initial indications are that the **U.S. economy** as a whole was able to **absorb the blow**, although the devastation to the Gulf Coast region is undeniable. **Damage estimates of $150 to $200 billion** will lead to massive federal spending to help rebuild the area. **That combined with the billions spent on the war in Iraq will push the federal deficit near $450 billion this year**.

So far, the nation has managed to attract foreign investors to pay for the government's debt. That's been a key reason why long-term interest rates have remained relatively stable despite a less than hospitable environment, and it also helped the dollar gain 11% in value versus foreign currencies so far in 2005.

The problem of higher **energy costs** worsened in the past quarter. Energy prices have **soared 69%** over the previous year, and **broad commodities** have increased in price by **22%**. Although the **core inflation rate** (excluding food and energy) remains at a **modest 2.0% level**, the **overall Consumer Price Index jumped 3.6%** and seems sure to top the 4% mark before long.

Federal Reserve Chairman Alan Greenspan continues to emphasize the need to fight the inflation threat. In **September, the Fed boosted the fed funds rate to 3.75%, the 11th increase in the past 15 months**. The Fed is clearly doing a balancing act, weighing the risk of higher inflation against the possibility of an economic slowdown. **Consumer spending in August plunged to its lowest level since the 9/11 era four years ago**. Consumer sentiment and spending habits will be a critical factor in determining how well the economy holds up in the coming months.

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Looking Ahead

There seems to be little doubt that the **impact of the hurricane damage** will be noticed in key economic statistics such as **consumer spending**, **employment** and **factory activity**. Still, a number a investment managers anticipate that the **U.S. economy will not be overwhelmed by the bad news**, and there seems little concern that the aftermath of the hurricanes will lead to a recession. It is possible that any bad news stemming from the disaster is already priced into the markets.

American consumers will be acutely aware of energy prices as winter approaches. **Dramatically higher heating costs are expected. This could be a drain on pocketbooks and dampen the Christmas season for consumers, but consumer spending is expected to remain a positive contributor to economic growth**.

Despite the potential hurdles, the economy continues to soldier on. Looking past the near term challenges, **we anticipate expanding corporate profits, modest inflation and a positive jobs environment**. **All that adds up to a sustained expansion for the rest of 2005 and well into 2006**.

U.S. Stock Markets

The 3rd Quarter

It was a solid three months for the stock market as a whole. The broad domestic market (as measured by the **Russell 3000 Index) gained 4.01%** during the period. **Strong corporate profits triggered investor enthusiasm, a factor that is expected to continue in the next three months**.

Value and growth stocks both managed to generate positive returns. While value has been in favor most often in the past few years, **leadership shifted to growth stocks** in the third quarter. The advantage was narrow, with **growth outpacing value by just 0.40%**. **Small-cap stocks** again outpaced **large-cap stocks** (**4.69%** to **3.95%**), but **mid-cap stocks** performed even better, rising **5.92%**.

Not surprisingly, given the trend in oil and natural gas prices, stocks of energy companies led the pack from an industry perspective. **The average natural resource fund was up 22%** for the quarter. **Utility and technology stocks** also performed well (rising 8.3 and 7.8% respectively). **Telecommunications**, **healthcare** and **biotechnology stocks** were close behind. No major industry sector declined, **but weakness was apparent in the financial and real estate sectors due to rising interest rates**.

Looking Ahead

A year ago at this time, the stock market was down for the year and we were anticipating a strong 4th quarter. That turned out to be the case, as all of the market's gains for 2004 came in the final three months. The situation may repeat itself in 2005. **The fourth quarter has historically been strong for stocks. In fact, the market finished higher over the final three months of the year in 13 of the past 15 years**.

Earnings reports are expected to show profit growth of near 18% for the 3rd quarter, up considerably from the 10 to 12% growth rates in the first half of 2005.

Bond Markets

The 3rd Quarter

Bond markets held their own at a time when some anticipated more difficulties. **Returns were relatively flat overall, but the riskier segments proved to be rewarding to fixed income investors**. **Emerging market bonds** advanced **4.1%** while **high yield** bonds were up **3.9%**. Ironically, it was the conservative investors who chose government bond funds who lost ground during the quarter, the worst performance for that segment of the market in more than a year.

The yield curve continued to flatten, a sign of ongoing caution among bond investors, as they weighed both higher interest rates and inflation expectations. Shorter-term rates continued to rise in line with the Fed's interest rate hikes, while yields on the 10-year Treasury note remained stubbornly (and surprisingly) low (4.33% at the end of September).

There is little doubt that continued investment flows from foreign sources are helping to keep demand for government bonds high and interest rates down.

Performance Update

Annualized Returns

Market Index	3rd Qtr	1-Year	2-Year	3-Year
DJ Ind. Average	3.49	7.50	9.21	14.25
S&P 500	3.60	12.27	13.05	16.69
Russell 2000	4.40	16.56	16.99	22.59
S&P Mid-Cap 400	4.88	22.16	19.80	22.09
Russell 3000	**4.01**	**14.57**	**14.39**	**18.11**
MSCI EAFE	9.79	23.62	20.79	20.69
NASDAQ Comp.	4.61	13.44	9.72	22.42
Lehman High-Yield	.93	6.71	9.58	15.99
Lehman Agg. Bond	-.67	2.80	3.24	3.95
Lehman Credit Idx.	-1.00	2.74	3.58	5.83
Lehman Gov. Bond	-.94	2.47	2.49	2.84

One study (by the University of Virginia) suggests that the yield on the 10-year note would be 1.5% higher without the influence of overseas investors. Foreign buyers represent 45% of all government bondholders today, up from 33% just four years ago.

Credit markets continue to be affected by the struggles of several notable corporations, ranging from Delta and Northwest – two airlines that declared bankruptcy – to Ford and GM, both losing market share to automakers in Japan and Korea.

Looking Ahead

The long-running tenure of Alan Greenspan as Federal Reserve Chairman comes to an end in early 2006. He is expected to live up to his reputation as an inflation hawk right to the end of his term, with forecasters anticipating the Fed maintaining its money-tightening strategy.

If the Fed follows through with this approach, government bonds will remain under pressure. In addition, emerging market and high yield bonds are likely to face more challenges in the months ahead. **Bond returns may well depend on the ability to capture yield and maintain solid credit quality in the coming months**.

International Markets

The 3rd Quarter

The best returns in the world of investing during the 3rd quarter could be found in overseas stocks. **The average international stock fund gained 13.4% for the period**. The surge in commodity prices provided a major boost to emerging markets, including Russia and those in Latin America. **Emerging market funds rose 17.1%, led by a whopping 29.4% gain in Latin American stocks**. Foreign **small-cap** stocks advanced **13.5%**. They outpaced **large-cap** stocks that dominate the MSCI EAFE Index, which also gained a more than respectable **10.1%**.

Japan's market has regained some of the luster it held twenty years ago. Institutional investors believe that reforms are finally taking hold in the economy. The Nikkei Index rose to a four-year high during the quarter and the average stock fund in Japan was up 18%. European stocks also performed well, gaining 10% over the three-month period.

A major event in global markets during the quarter was the decision by China to devalue its currency. Rather than pegging the Yuan strictly to the dollar, China will base its value on a basket of foreign currencies, although the dollar remains a prominent player in that calculation.

Looking Ahead

Mutual funds investing in overseas stocks have been on a roll, a situation that could continue in the 4th quarter. While emerging markets such as India and China have offered some of the best growth potential, Japan has captured a lot of attention. Japanese stocks seem to have finally shaken off their long-standing malaise, as much-needed economic reforms appear to be having a positive impact.

European stocks appear to require a more selective approach, but opportunities can still be found. The region as a whole remains mired in a flat growth mode.

Latin American stocks have been red hot, but may cool down in the coming months as political risk becomes more of a factor. Economically speaking, times are good. Much of the region is benefiting from the run up in commodity prices. **But it is election season in a number of countries, including Brazil and Mexico, and that could add to market volatility in the region**.

Summary

As is often the case, the investment environment is not without risks. The cleanup and recovery from Katrina and Rita will require nearly unprecedented effort and investment. Interest rates are likely to rise, as are government deficits. Energy prices have created a strain, and their future direction is not certain. Nevertheless, the U.S. economy has held its ground and most companies remain highly profitable. If recent history is any guide, investors could be in position to take advantage of a strong close to 2005.

BOB'S CORNER

When Wayne Gretzky (one of the greatest hockey players ever) was asked why he was considered the best player in hockey, considering he wasn't the biggest or the fastest or shot the puck harder than the next guy, he responded sincerely, *"I don't go to where the puck is, I go to where the puck is going to be."* At All Star Financial, we live and breathe this philosophy with your portfolios. We are constantly looking forward and anticipating how the current economic cycle will change and, in turn, where we should be with your assets. We did this by going from large-cap growth to large-cap value in early 2000. Also, by over-weighting small caps in late 2002 to take advantage of the first bounce off the bottom. Later, in 2002, we bought high-yield bonds when nobody else wanted them and sold them for a premium 20 months later. We were in Health Care when the market went down, and we anticipated the Biotech bump and the Energy and Commodity bull run before it was fashionable. Where do we want to be 9 to 12 months from now? That question is getting harder to answer, but when the big determinator (oil) gives us our direction, you'll be assured we'll be selling high and buying low, on our way to where the puck is going to be.

How is the Stock Market Affected by Natural Disasters?

The stock market has actually gained ground since the Katrina hurricane disaster in the Gulf Coast. Despite worries over disrupted oil supplies, regional unemployment, and the need for massive disaster relief, the markets appear to have shrugged off the doom and gloom heard on mass media reports. Oil and gas prices have gone up slightly, but not drastically above levels before the storm.

Surprisingly, large-scale hurricane storms have had little long-term impact on the stock market and investors should resist the urge to make any long-term investment changes based on a one time event. In fact, the last three major hurricanes all resulted in market gains in the quarter following their occurrence.

	S&P 500 3-Months Later
Hurricane Andrew (1992)	**+4.18%**
Hurricane Hugo (1989)	**+1.22%**
Hurricane Camille (1969)	**+5.76%**

As the Energy Sector Soars, Caution is in Order

Any investor weighing a move into a “hot” sector or fund-such as energy at the moment-should consider several important points before proceeding:

1. Performance-chasing is usually a no-win game.
   “Unfortunately many investors fall into the behavioral trap of buying what has performed well in the past,” said Joseph Brennan, principal in Vanguard’s Portfolio Review Group. The old adage ‘buy low, sell high’ is easy to say but not easy to execute for most people, “added Brennan.

2. What goes up can –and often does-come down.
   Just because a particular sector or fund did well yesterday doesn’t mean it will do well tomorrow.

3. The energy sector is more volatile than most.
   All economic sectors are subject to volatility but few are as unpredictable as energy.

4. You may be more invested than you think.
   If you own a diversified, broadly based portfolio, it’s quite likely you’re already invested in the energy sector to some degree.

   In the long run, most investment experts agree, you’re better off avoiding a “flavor of the month” and sticking with a balanced diversified portfolio. Don’t be surprised to see us reduce our energy exposure soon!