



# Market Update

Asset Consulting Group, Inc.

www.acgnet.com

Monthly Report

January 2005

## The Economy

Following strong U.S. growth in the fourth quarter, indicators suggest that economic activity remained solid in January, while further signs of potential core inflationary pressures emerged. U.S. real GDP growth slowed to an annualized 3.1% in the fourth quarter from 4.0% in the third quarter on a large jump in the U.S. trade deficit that subtracted 1.7% from overall growth, the deficit's largest drag on GDP growth in more than six years. Final sales to domestic purchasers actually grew a healthy 4.3%, supported by 4.6% growth in consumer spending and a 10.3% jump in business investment. Despite a moderate decline, the Institute for Supply Management's (ISM) manufacturing and service-sector indices, broad indicators of economic activity, remained at levels in January that are historically consistent with 3% to 4% real economic growth. The ISM ser-

vice-sector index fell 4.7 points to 59.2, while the manufacturing index declined 0.9 points to 56.4 (a level above 50 indicates expansion in the sector). Consistent with the decline in the growth rate in the index of leading economic indicators in recent

months, the average ISM index value (manufacturing and service sector) is at an 18-month low of 57.8, suggesting solid, but less robust economic growth. As fully anticipated by economists and the bond market, the Federal Reserve raised the fed funds rate

**“Slower productivity growth at a time of solid domestic demand bodes well for new job creation over the near future, but also suggests potential upward pressures on labor costs.”**

by 0.25% for the sixth straight meeting on February 2, bringing the key interest rate to 2.50%. Supporting the Fed's previously domestic demand bodes well for new job creation over the near future, but also suggests potential upward pressures on labor costs. Unit labor costs, which measure the cost of labor for each “unit” produced, jumped an annualized 2.3% in the fourth quarter, the highest level since mid-2002. Overall, unit labor costs have risen at least 1.6% for three straight quarters for the first time since 1998. While any sustained acceleration in wage pressures would likely unfold over a number of quarters, the Federal Reserve is proactively attempting to head off such a scenario by gradually increasing the fed funds rate to a level materially above the rate of inflation with the goal of stabilizing the current rate of core inflation and prolonging the economic expansion. The futures market currently expects a rise in the fed funds rate to nearly 3.5% by November (see chart). Of particular interest to the Fed is the lack of expansion in the labor force participation rate (the percentage of the population in the labor force). After gradually expanding from 58% in 1954 to more than 67% in 1997, the participation rate has moderated in recent quarters, reaching a 16-year low of 65.8% in January. With the contraction in labor market participation, the past year's moderate job growth has pushed the unemployment rate to just 5.2%, providing fuel to arguments of “old economy” wage-push inflation. Outside of the late 1990's “new economy”, sub-5% unemployment rates have historically coincided with rising levels of core inflation.

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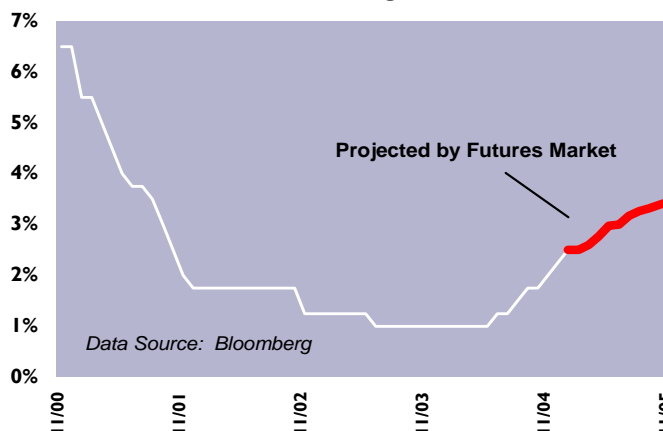
#### Market Commentary

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#### Indices Report

- January 31, 2005

Fed Funds Target Rate



vice-sector index fell 4.7 points to 59.2, while the manufacturing index declined 0.9 points to 56.4 (a level above 50 indicates expansion in the sector). Consistent with the decline in the growth rate in the index of leading economic indicators in recent

stated concerns over weaker productivity growth and higher labor costs, U.S. productivity growth slowed to an annualized 0.8% rate in the fourth quarter, the lowest level since the first quarter of 2001. Slower productivity growth at a time of solid

## Equities

Diverging from relatively positive fourth-quarter earnings reports and delivering its (cont'd on page 2)

## Equities *(cont'd from page 1)*

first negative month since last July, the S&P 500 tumbled 2.44% lower in January, with relatively equal negative return contributions from the index's value and growth component indices. Energy stocks and defensive sectors, such as utilities and consumer staples, produced the

strongest relative total returns. Small-cap stocks lagged behind as the Russell 2000 index declined 4.17%. Fourth-quarter earnings reports have been ahead of expectations, while first-quarter negative earnings pre-announcements have been below historical averages. According to First Call, 65% of the 363 companies in the S&P 500

that have reported fourth-quarter earnings have topped analysts' estimates, ahead of the historical average of 59%. Altogether, operating earnings growth is at 19.8% thus far, running 4.7% above estimates. Excluding the 100% surge in earnings growth in the energy sector, fourth-quarter operating earnings are still up a healthy 13.5% for

the other nine S&P sectors. Thus far, the ratio of negative-to-positive first-quarter earnings pre-announcements is at 1.8, below the long-term average of 2.2. Wall Street analysts currently expect first-quarter earnings growth to slow considerably to a rate of 6.9%, near recent levels of nominal GDP growth.

## Fixed Income

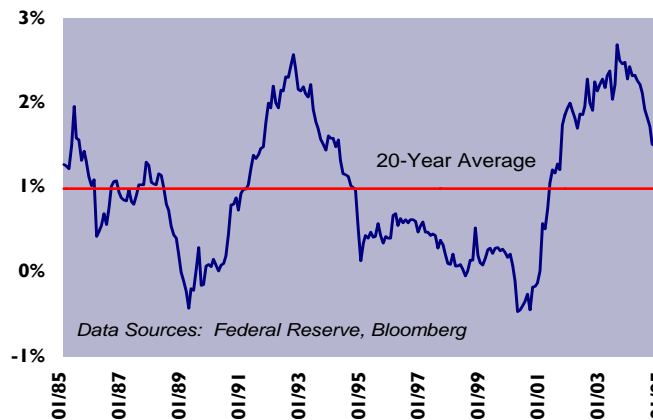
Benefiting from a flatter Treasury yield curve, the Lehman U.S. Aggregate index posted a solid 0.63% gain in January as all spread sectors within the index outperformed duration-matched Treasury securities. The ten-year Treasury yield declined 0.10% to 4.14% in January, while the yield difference between the ten-year and two-year Treasury securities narrowed another 0.31% to just 0.85%, a four-year low. The flatter yield curve contributed 0.20% of the Lehman Aggregate's 0.63% nominal return. At 0.85%, the ten-year-to-two-year yield gap was 0.13% below its 20-year trailing average at the end of January (see chart). During the first week of February, this yield gap has narrowed further to just 0.70%. Excluding periods heading into recessions (1989 and 2000) and periods of financial market distress (1998), the gap has generally remained at levels above 0.40%. Barring any impending recession, the ten-year Treasury yield may

come under increasing upward pressure with even a moderate rise in two-year Treasury yields from current levels. In addition to a flatter yield curve, the Lehman Aggregate also benefited

from outperformance via its spread sectors in January, led by the commercial mortgage-backed security (CMBS) sector's outperformance of 0.32% over duration-matched Treasuries and 0.25% of excess return from the residential mortgage-backed

security (MBS) sector. In step with the weak equity market, the corporate bond sector of the Lehman Aggregate delivered just 0.01% of excess return over U.S. Treasuries. The Lehman High Yield index underperformed duration-matched Treasury securities for the first time since last May with -0.56% of excess return. On a nominal basis, the Lehman High Yield index returned -0.13%. The high-yield index's option-adjusted yield spread over Treasury yields widened 0.28% to 3.06% in January, its highest month-end level in four months. On a related note, Lehman Brothers announced new credit-quality inclusion rules for its indices that would result in the transfer of 56 bonds currently in the high-yield index representing 21 issuers out of the high-yield index and into the Lehman Aggregate index. Beginning in July of 2005, Lehman will incorporate Fitch ratings into its assessment of bond credit quality along with S&P and Moody's ratings. Rather than utilizing the most conservative rating of S&P and Moody's (the current method), the new rules will use a "middle-rating" rule that will determine index eligibility by discarding the highest and lowest rating of the three ratings issued by all three rating agencies. If a bond is only rated by two agencies, then the most conservative rating will be used. No bonds that are currently in the Lehman Aggregate index would be removed from the index under the new rules.

**Treasury Yields: 10-Year Less 2-Year**



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Yield index underperformed duration-matched Treasury securities for the first time since last May with -0.56% of excess return. On a nominal basis, the Lehman High Yield index returned -0.13%. The high-yield index's option-adjusted yield

## International

The MSCI EAFE index posted a -1.83% US-dollar return in January despite a 0.81% local-currency return. The U.S. dollar rallied in January, hurting the US-dollar returns of foreign investments. On a local-currency basis, the euro region returned 1.77% in January, while economic data remained mixed. Retail sales in the euro region fell for the fifth month in six in January,

while unemployment in Germany hit 11.4%, a new seven-year high, despite a reported rise in business confidence. In a move toward structural reform to increase its attractiveness to international investors, France relaxed restrictions on its mandated 35-hour work week and simplified the legal procedures for laying off employees. Japan's equity markets lagged with a -1.38% local-currency return on weak Japanese economic data, including a 1.2% drop in Decem-

ber industrial production and a 2.5% decline in inflation-adjusted December consumer spending. After having previously forecast a modest rise in prices in 2005, the Bank of Japan is now stating that deflation may continue until 2006. The MSCI Emerging Market equity index rose 0.32% in January on a US-dollar basis and 1.07% on a local-currency basis. Emerging market equities received support from multiple credit upgrades from the major rating agencies. S&P upgraded

Russia's credit rating to BBB- from BB+ based on improvements in debt levels and external liquidity. All three major ratings agencies now rate Russia as investment-grade. S&P also raised Mexico's credit rating to BBB- from BBB- citing increased macroeconomic stability. In addition, the following countries all received upgrades from at least one of the major agencies: Ecuador, India, Indonesia, Slovakia, South Africa, Turkey, and the Ukraine.

## Hedge Funds

The size of the hedge fund industry grew to \$972 billion in 2004 and will likely surpass \$1 trillion in 2005. Total hedge fund industry assets grew to more than \$140 billion in 2004, surpassing the previous records of \$60 billion in 2003 and \$31 billion in 2001. Seeking additional diversification, investors poured money into multi-strategy funds in 2004 as the sector posted the largest increase in new assets, with growth of \$22 billion. Equity long-short recorded the second largest asset increase with \$19

billion of new capital. Hedge fund performance was lackluster for most of the year but finished with a strong fourth quarter. Returns for all hedge fund strategies were positive in 2004. Emerging Markets (+18.6%), Distressed Securities (+18.2%), and Event-Driven (+14.2%) were the leading strategies for the second straight year. The HFRI Fund of Funds Composite Index, a broad measure of all hedge fund of funds, was up 6.4% for the year after a strong fourth-quarter return of 4.4%. The HFRI Conservative Fund of Funds Index, a measure of low-volatility hedge fund of funds, was up 5.6% for the year and

3.3% in the 4th quarter. The HFRI Equity Hedge Index, a measure of long-short managers, was up 7.7% for the year and 5.7% in the 4th quarter. Low volatility in the equity markets last year resulted in fewer opportunities and a lower return for long-short strategies. Last year was the first year since 1998 that long-short strategies underperformed the S&P 500. As a result the SEC's decision to require hedge fund managers to become registered investment advisors, industry speculation is rising that hedge funds will take advantage of an SEC exemption available to firms with lock-ups of two or more years. While

the two-year rule was intended as a way to distinguish between hedge funds and private equity funds, the ruling may accelerate the trend of hedge fund managers lengthening their lock-up periods. Reflecting an emerging trend, long-short managers have begun to develop dedicated long-only funds. For the most part, the funds are simply comprised of the long positions from the managers' long short portfolios, minimizing additional work for the investment team. The funds differ from traditional long-only funds as they charge either an incentive fee or a much higher standard fee of 2% or more.

## Indices Report

Periods Ending January 31, 2005

Index Name	Style	Returns							
		Month	Qtr	2 Qtrs	3 Qtrs	1 Year	3 Years	5 Years	10 Years
<b><u>Domestic Equity Indices</u></b>									
S&P 500	Large Cap Core	(2.44)%	4.96%	8.16%	8.08%	6.23%	3.25%	(1.77)%	11.51 %
S&P Equal Weighted	Large Cap Core	(2.98)%	6.44%	11.67%	12.11%	10.78%	9.55%	8.73%	13.57 %
DJIA	Large Cap Core	(2.59)%	5.18%	4.56%	4.20%	2.10%	4.08%	1.12%	12.76 %
Russell 1000	Large Cap Core	(2.52)%	5.33%	8.92%	8.53%	6.57%	3.83%	(1.44)%	11.59 %
Russell 1000 Growth	Large Cap Growth	(3.34)%	3.91%	6.01%	3.15%	0.70%	(0.72)%	(9.04)%	8.99 %
Russell 1000 Value	Large Cap Value	(1.78)%	6.65%	11.67%	13.84%	12.45%	8.20%	5.59%	13.28 %
Russell Mid Cap	Mid Cap Core	(2.48)%	7.87%	14.94%	15.76%	13.93%	11.46 %	7.78%	13.98 %
S&P Mid Cap 400	Mid Cap Core	(2.55)%	7.57%	12.24%	11.71%	11.10%	9.78 %	9.60%	15.68 %
Russell 2000	Small Cap Core	(4.17)%	7.22%	13.88%	12.44%	8.67%	10.29%	6.05 %	11.20 %
Russell 2000 Growth	Small Cap Growth	(4.51)%	7.29%	13.48%	8.85%	3.71%	5.44%	(4.28)%	6.84 %
Russell 2000 Value	Small Cap Value	(3.87)%	7.16%	14.24%	15.91%	13.59%	14.48 %	16.93 %	14.77 %
NASDAQ Composite	Broad Equities	(5.20)%	4.43%	9.28%	7.41%	(0.18)%	2.17%	(12.15)%	10.57 %
Wilshire 5000	Broad Equities	(2.63)%	5.59%	9.41%	9.06%	7.14%	4.94%	(1.13)%	11.37 %
<b><u>International Equity Indices</u></b>									
MSCI World	Broad Global	(2.23)%	6.91%	12.20%	11.93%	10.88%	7.75%	(1.37)%	8.42%
MSCI World Ex US	Broad International	(1.97)%	8.96%	16.65%	16.24%	16.38%	13.55%	0.26%	6.40%
EAFE	Developed Markets Intl	(1.83)%	9.51%	16.77%	16.02%	16.83%	13.67%	0.13%	6.15%
EAFE Growth	Developed Markets Intl Growth	(2.30)%	8.89%	15.47%	12.10%	11.61%	10.31%	(5.11)%	3.57%
EAFE Value	Developed Markets Intl Value	(1.37)%	10.12%	18.02%	19.88%	22.08%	16.99%	5.36%	8.64%
MSCI Emerging Markets Free	Emerging Market	0.32%	14.88%	29.64%	25.41%	22.02%	19.55%	3.52%	N/A
IFCI Composite	Emerging Market	0.24%	14.53%	30.22%	25.80%	24.14%	23.20%	6.02%	5.56%
<b><u>Domestic Fixed Income Indices</u></b>									
Treasury Bills	Cash	0.17%	0.52%	0.91%	1.18%	1.42%	1.43%	2.90%	4.10%
Lehman Intermediate G/C	Intermediate Govt/Credit Bonds	0.19%	(0.05)%	2.48%	3.18%	2.56%	5.56%	7.33%	6.99%
Lehman Intermediate Aggregate	Int. Core Bonds	0.34%	0.39%	2.95%	4.03%	3.43%	5.53%	7.43%	7.17%
Lehman Aggregate	Core Bonds	0.63%	0.74%	3.81%	5.01%	4.16%	6.14%	7.92%	7.58%
Citi Broad Investment Grade	Core Bonds	0.64%	0.75%	3.92%	5.12%	4.28%	6.17%	7.94%	7.59%
Lehman Govt/Credit	Govt/Credit Bonds	0.69%	0.63%	4.02%	5.01%	3.98%	6.57%	8.16%	7.67%
Lehman Long Govt/Credit	Long Govt/Credit Bonds	2.56%	3.16%	9.82%	11.95%	9.44%	10.13%	10.84%	9.72%
Lehman Government	Government Bonds	0.63%	0.32%	3.30%	4.30%	3.27%	5.69%	7.58%	7.32%
Lehman Mtg Backed Securities	Mortgage Bonds	0.53%	0.98%	3.52%	5.14%	4.59%	5.34%	7.44%	7.39%
Lehman Muni 3 Yr	3 Yr Municipal Bonds	(0.13)%	(0.22)%	1.22%	1.74%	1.30%	3.23%	4.71%	4.88%
Lehman Muni 10 Yr	10 Yr Municipal Bonds	0.85%	0.89%	4.47%	6.32%	4.60%	6.28%	7.31%	6.90%
Lehman U.S. Credit Index	Corporate Bonds	0.79%	1.09%	5.06%	6.06%	5.02%	7.78%	8.88%	8.27%
Merrill Lynch High Yield	High Yield Bonds	(0.08)%	2.43%	7.74%	9.04%	8.98%	11.45%	7.41%	8.27%
Merrill Lynch Conv US	Convertible Bonds	(2.28)%	3.23%	5.53%	4.07%	3.26%	8.29%	2.27%	N/A

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