



Market Update

Asset Consulting Group, Inc.

www.acgnet.com

Monthly Report

July 2004

The Economy

A sudden spate of weaker-than-expected economic data in July renewed debate about the ongoing vigor of the current economic expansion, causing some economists to lower their estimates for economic growth in the second half of the year. While broad-based measures such as the Institute for Supply Management's manufacturing and service sector indices suggest that overall economic activity remained solid in June and July, a number of specific indicators, particularly relating to the consumer sector, weakened suddenly in recent weeks as the June swoon in energy prices proved short-lived and oil surged to a new all-time high. After jumping more than 1% in May, U.S. personal spending tumbled 0.7% in June, as higher energy prices cut into consumer expenditures more than economists had expected. Second-quarter U.S. real GDP growth slowed to an annualized pace of 3.0% from 4.5% in the first quarter as con-

sumer spending grew by just 1.0%, down from 4.1% in the first quarter and the weakest pace in three years. Compounding worries over consumer spending, U.S. non-farm payroll growth slowed to a crawl in July as the economy added just 32,000 new jobs, disappointing economists for the second straight month. Other consumer-related indicators, including auto sales, retail sales, and housing starts, also missed economists' estimates. According to the U.S. Department of Energy, the average retail price of U.S. regular gasoline jumped to \$1.92 in the second quarter of this year from \$1.66 in the first quarter and \$1.52 in the fourth quarter of 2003, cutting into consumers' excess discretionary income (see chart). Speaking before the Senate Committee on Banking, Housing, and Urban Affairs on July 20, Federal Reserve Chairman Alan Greenspan acknowledged the "observed softness in consumer

spending of late" as a result of "the surge in energy prices," while stating that the softness in spending "should prove short-lived." While the Fed expects consumer spending to bounce back, some economists have begun to scale back their near-term economic growth expectations.

"...there is less debate that the economy appears to be slowing to a more sustainable level of GDP growth..."

According to the latest Bloomberg survey of economists, the economy is expected to grow an annualized 3.9% in the second half of the year, down from an estimate of 4.2% in early July. At his July 20th testimony before the Senate, Alan Greenspan conveyed the Fed's latest forecast of economic growth for all of 2004 of 4.0% to 4.75%, down from February's estimate of as high as 5%. While economists will continue to debate whether recent data represent a short-term, energy-price fueled hiccup in economic activity or a broader fundamental weakening, there is less debate that the economy appears to be slowing to a more sustainable level of GDP growth from the fastest recorded 12-month pace of growth in the last 20 years.

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Inside this issue:

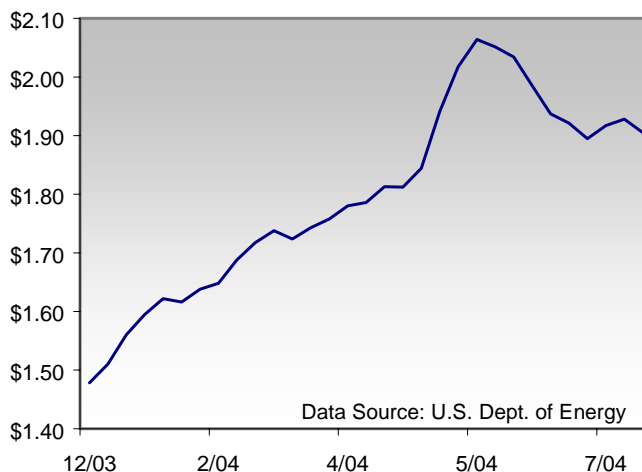
Market Commentary

- The Economy
- Equities
- Fixed Income
- International
- Hedge Funds

Indices Report

- July 31, 2004

Retail Price of Regular Gasoline, All Formulations



You may request email delivery by contacting Aleta at abohlmann@acgnet.com.

Information contained in this report is based on reliable sources. We cannot guarantee its accuracy.

Equities

In the face of a sharp increase in energy prices, weaker-than-expected economic data, and a probable peak in earnings growth rates, the S&P 500 tumbled 3.31% in July, erasing the index's year-to-date returns. The price of oil on the New York Mercantile Exchange jumped more than 18% to finish the month at \$43.80 per barrel, a new all-time high, renewing fears that higher energy prices will hurt corporate earnings growth. Based on a regression analysis, 57% of the daily variation in the price of the S&P 500 over the last three months can be explained by daily changes in

oil prices. Second-quarter earnings growth has been strong and ahead of analysts' estimates, but has failed to spark a continuation of last year's equity rally. According to First Call, with more than 450 of the companies in the S&P 500 having reported, the index's second-quarter operating earnings-per-share grew 25.3% versus the same quarter last year, rising more than 20% for the fourth consecutive quarter. On average, companies are beating earnings estimates by 4.3%, above the historical average of 3%. With the first and second quarters expected to have produced the peak growth rates in

the current earnings cycle (25% to 26%), the second quarter's stellar earnings growth has failed to drive stock prices higher. Analysts expect earnings growth to slow to 15% in the second half of the year and to 10% in 2005, levels above historical averages but only half of recent earnings growth. With earnings growth rates peaking and equity valuations still above historical averages, investors have been reluctant to drive valuations higher. The equity market's pause, combined with the surge in earnings growth, has led to a significant improvement in equity valuations. The S&P 500's 12-

month trailing price-to-earnings ratio over reported earnings has fallen to 19.7 from 22.8 at the beginning of the year, but is still above its historical average of 15.8. Value stocks continued to outperform their growth counterparts in July as the S&P 500 Barra Value index lost just 1.90%, outperforming the growth index by 2.83%. For the year, the value index is ahead of the growth index by 4.33%. The Russell 2000 index of small-cap stocks plummeted 6.73% in July and now trails the S&P 500 by 0.45% on a year-to-date basis.

Fixed Income

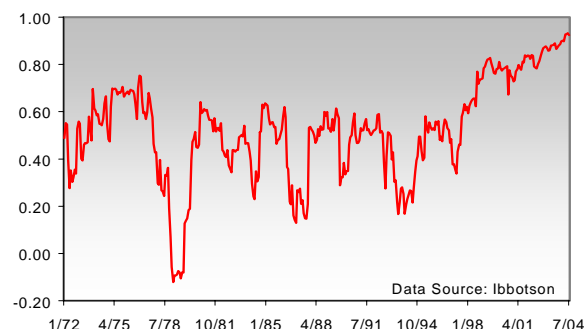
The ten-year Treasury yield finished July at 4.49%, down 0.13% for the month, after a sharp decline following the release of the weaker-than-expected June jobs report on July 2. The decline in rates drove the Lehman Aggregate to a monthly return of 0.99%, bringing its year-to-date return to 1.14%. All non-Treasury sectors of the index outperformed similar-duration U.S. Treasury securities, lead by 0.21% of outperformance from the Lehman Credit index. Lower credit-quality bonds performed best, despite the sell-off in the stock market. The Lehman U.S. High Yield index rose 1.36%, bringing its 2004 return to 2.74%, ahead of both investment-grade bonds and the stock market. The Lehman I-10 Year Blend Municipal index, similar in duration to the Lehman Aggregate, returned 1.01% in July, outperforming the taxable Aggregate index.

economic data, international equities fell in step with U.S. stocks in July as the MSCI EAFE index tumbled 3.23%, moving in the same direction as the S&P 500 for the 20th time in the last 24 months. A stronger U.S. dollar subtracted 0.93% from the index's monthly return after a late-month rally in the currency following Alan Greenspan's statement before the U.S. Senate on July 20 that the recent lull in economic activity should prove "short-lived," maintaining prospects for higher short-term interest rates in the U.S. over the near-term. With the Bank of Japan still fighting outright deflation and the European Central Bank on hold due to weak eco-

nomical growth, U.S. short-term rates are expected to rise relative to those in Japan and Europe. Diverging from the rest of Europe, the Bank of England is expected to raise its benchmark rate in August for the fifth time since November following second-quarter economic growth of 3.7%, the fastest pace in nearly four years. German Chancellor Gerhard Schroeder's council of economic advisors increased its estimate for the German economy's growth this year to 1.8% from 1.6%, citing weak consumer spending but stronger-than-expected export growth in another sign of the increase in economic globalization in recent years. With both U.S. and inter-

national corporations increasingly affected by the same global macro-economic factors, such as rising energy prices, developed international equities have provided lower diversification benefits within domestic equity portfolios in recent years. The two-year rolling monthly total return correlation between the S&P 500 and the MSCI EAFE index is now at 0.92, near an all-time high (see chart). While a portion of the jump in correlations since 1999 is due to generally weak equity returns, as correlations between asset classes tend to rise in down markets, global economies and financial markets have also become more integrated in recent years as trade barriers have fallen, financial markets have become more flexible and intertwined, and central banks have increasingly coordinated monetary policy. The reduction in diversification benefits in recent years has placed an increased emphasis on active management within international equity portfolios, as well as the increased diversification and potential return enhancement provided by emerging market equities.

Two-Year Rolling Correlation, S&P 500 & MSCI EAFE



International

Amid surging oil prices and weaker-than-expected U.S. eco-

Hedge Funds

Inflows to hedge funds declined in the second quarter to \$7.5 billion after having record flows for each of the four previous quarters. New asset growth had averaged over \$20 billion per quarter from IQ 2003 to IQ 2004, according to Hedge Fund Research (HFR). Because of the volatility in traditional markets during the past few years, institutional investors have sought out absolute return strategies that provide a better risk-adjusted return. As a result, total assets invested in hedge funds has grown to an estimated

\$830 billion. Hedge fund performance in the second quarter was generally flat to negative across all strategies. The HFRI Fund of Funds Composite Index, a broad measure of all hedge fund of funds regardless of strategy, was down 1.5%. The HFRI Equity Hedge Index, a measure of long/short managers, was down 1.2%. The HFRI Conservative Fund of Funds Index, a measure of low volatility hedge fund of funds, was down 0.6%, the first negative quarter since 3Q 2002. One of the few strategies with a positive quarter

was distressed debt, with the HFRI Distressed Securities Index up 3.1%. Early in the quarter when China announced they would attempt to slow their economic growth, many managers took their bets off the table. Hedge fund managers suffered from low levels of trading, little corporate activity and asset classes moving in the same direction. Because of the decrease in activity, managers had difficulty finding opportunities in the second quarter. In other Hedge Fund news, on July 14, the Securities and Exchange Commission,

by a 3-to-2 vote, proposed a rule that would require hedge funds to register as investment advisors. In making his case for the proposal, Chairman William Donaldson cited the rapid growth of the industry, hedge fund involvement in the recent mutual fund market timing scandal and an increase of pension fund investments in hedge funds. Another vote to make the proposal final will occur in September. Currently about 48% of hedge funds are registered investment advisors.

Indices Report

Periods Ending July 31, 2004

Index Name	Style	Returns							
		Month	Qtr	2 Qtrs	YTD	1 Year	3 Years	5 Years	10 Years
<u>Domestic Equity Indices</u>									
S&P 500	Large Cap Core	(3.31)%	(0.08)%	(1.78)%	0.02%	13.17%	(1.47)%	(2.24)%	11.09%
S&P Equal Weighted	Large Cap Core	(4.40)%	0.40%	(0.80)%	1.61%	19.99%	4.66%	5.29%	12.65%
DJIA	Large Cap Core	(2.69)%	(0.34)%	(2.35)%	(1.91)%	12.16%	0.86%	0.91%	12.65%
Russell 1000	Large Cap Core	(3.51)%	(0.36)%	(2.15)%	(0.29)%	13.03%	(1.05)%	(1.74)%	11.08%
Russell 1000 Growth	Large Cap Growth	(5.65)%	(2.69)%	(5.01)%	(3.07)%	8.51%	(4.79)%	(6.96)%	9.11%
Russell 1000 Value	Large Cap Value	(1.41)%	1.95%	0.70%	2.47%	17.68%	2.55%	2.19%	12.13%
Russell Mid Cap	Mid Cap Core	(4.37)%	0.71%	(0.88)%	2.00%	19.78%	5.87%	6.15%	12.60%
S&P Mid Cap 400	Mid Cap Core	(4.67)%	(0.47)%	(1.01)%	1.14%	17.83%	5.43%	8.48%	14.54%
Russell 2000	Small Cap Core	(6.73)%	(1.26)%	(4.57)%	(0.43)%	17.06%	5.74%	5.74%	9.98%
Russell 2000 Growth	Small Cap Growth	(8.98)%	(4.08)%	(8.61)%	(3.81)%	11.32%	(0.39)%	(1.70)%	6.00%
Russell 2000 Value	Small Cap Value	(4.60)%	1.46%	(0.57)%	2.87%	22.83%	11.25%	12.30%	13.17%
NASDAQ Composite	Broad Equities	(7.83)%	(1.71)%	(8.65)%	(5.79)%	8.78%	(2.35)%	(6.49)%	10.08%
Wilshire 5000	Broad Equities	(3.73)%	(0.31)%	(2.07)%	0.11%	13.98%	0.08%	(1.13)%	10.79%
<u>International Equity Indices</u>									
MSCI World	Broad Global	(3.24)%	(0.24)%	(1.17)%	0.43%	18.12%	0.67%	(1.93)%	6.99%
MSCI World Ex US	Broad International	(3.05)%	(0.35)%	(0.23)%	1.16%	25.06%	3.78%	(0.57)%	4.19%
EAFE	Developed Markets Intl	(3.23)%	(0.65)%	0.05%	1.47%	25.50%	3.75%	(0.85)%	3.93%
EAFE Growth	Developed Markets Intl Growth	(4.05)%	(2.92)%	(3.34)%	(1.45)%	20.06%	1.49%	(4.18)%	1.53%
EAFE Value	Developed Markets Intl Value	(2.45)%	1.58%	3.43%	4.36%	30.98%	5.94%	2.32%	6.23%
MSCI Emerging Markets Free	Emerging Market	(1.83)%	(3.38)%	(6.06)%	(2.78)%	23.06%	14.69%	3.35%	0.36%
IFCI Composite	Emerging Market	(2.06)%	(3.39)%	(4.67)%	(1.41)%	25.55%	16.78%	4.91%	0.95%
MSCI Japan	Japanese	(5.93)%	(4.34)%	2.32%	4.17%	32.19%	1.89%	(4.68)%	(3.55)%
<u>Domestic Fixed Income Indices</u>									
Treasury Bills	Cash	0.11%	0.27%	0.51%	0.59%	1.03%	1.64%	3.24%	4.26%
Lehman Intermediate G/C	Intermediate Govt/Credit Bonds	0.84%	0.69%	0.08%	0.74%	3.59%	5.78%	6.95%	6.83%
Lehman Intermediate Aggregate	Int. Core Bonds	0.87%	1.05%	0.47%	1.12%	4.24%	5.63%	7.00%	6.98%
Lehman Aggregate	Core Bonds	0.99%	1.16%	0.34%	1.14%	4.84%	5.93%	7.25%	7.28%
Citi Broad Investment Grade	Core Bonds	0.99%	1.15%	0.34%	1.17%	4.91%	5.92%	7.25%	7.29%
Lehman Govt/Credit	Govt/Credit Bonds	1.06%	0.96%	(0.04)%	0.87%	4.73%	6.23%	7.39%	7.33%
Lehman Long Govt/Credit	Long Govt/Credit Bonds	1.85%	1.95%	(0.34)%	1.39%	8.59%	7.73%	8.72%	8.75%
Lehman Government	Government Bonds	0.93%	0.97%	(0.02)%	0.81%	3.86%	5.61%	6.95%	7.06%
Lehman Mtg Backed Securities	Mortgage Bonds	0.90%	1.56%	1.04%	1.67%	5.11%	5.30%	6.94%	7.17%
Lehman Muni 3 Yr	3 Yr Municipal Bonds	0.73%	0.52%	0.08%	0.43%	2.28%	3.86%	4.66%	4.85%
Lehman Muni 10 Yr	10 Yr Municipal Bonds	1.37%	1.77%	0.12%	0.54%	6.25%	5.53%	6.25%	6.43%
Lehman U.S. Credit Index	Corporate Bonds	1.23%	0.94%	(0.04)%	0.97%	5.83%	7.05%	7.93%	7.82%
Merrill Lynch High Yield	High Yield Bonds	1.37%	1.20%	1.14%	2.72%	13.08%	8.81%	5.65%	7.74%
Merrill Lynch Conv US	Convertible Bonds	(2.94)%	(1.38)%	(2.16)%	0.29%	9.85%	6.45%	6.43%	N/A

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