



Market Update

Asset Consulting Group, Inc.

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Monthly Report

August 2004

The Economy

Economic activity appeared to pick up and energy prices fell from all-time highs in August, easing concerns that growth was stalling and suggesting that the economy is on a solid, but more modest, growth track. Supporting the Federal Reserve's view that the late second-quarter economic slowdown was a temporary "soft patch" induced by higher energy prices, incoming economic data broadly improved in August across most sectors of the economy. Retail sales, personal spending, housing starts, industrial production, and construction spending all posted solid gains in July after declining or stagnating in June. Importantly, the economy added 144,000 non-farm payroll jobs in August, while payroll growth for June and July was revised modestly higher, suggesting that the negative effect of the energy price spike on hiring may prove transitory. With consumer debt near record levels and short-term interest rates

rising, continued job growth is required to sustain a solid pace of consumer spending. Holding to its theory that the recent economic slowdown would prove short-lived, the Federal Reserve raised the fed funds rate by 0.25% to 1.50% on August 10, increasing its benchmark rate for the second straight meeting. With any lingering fears over possible deflation generally dispelled by the jump in inflation earlier this year, the Federal Reserve is now gradually shifting the fed funds rate toward a more neutral position that is consistent with the current level of inflation and economic growth. Relative to the last 12 months' CPI growth, the inflation-adjusted fed funds rate, known as the "real" fed funds rate, is still negative (see chart), meaning that short-term borrowers are actually being paid to borrow money on a post-inflation basis. The real fed funds rate has been negative for 23 straight months, the longest period of

time since January of 1978. Given the still highly accommodative position of the fed funds rate, a continued gradual rise in the rate is unlikely to derail the economy from its current growth track. Given congressional testimony by Federal Reserve Chairman Alan Greenspan in early September that the "most recent data" suggest that "the expansion has regained some traction," fed funds futures prices suggest that investors expect another 0.25% rate increase from the Fed at its September 21 meeting. Following a calming of geopolitical supply concerns relat-

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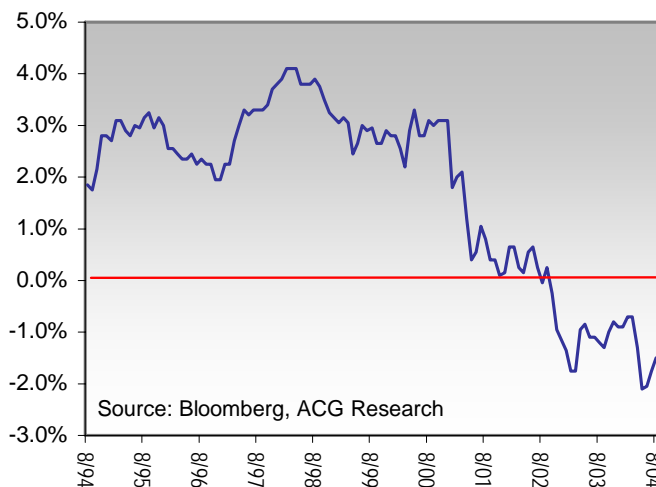
Indices Report

- August 31, 2004

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“The real fed funds rate has been negative for 23 straight months, the longest period of time since January of 1978.”

Fed Funds Rate Less Year-Over-Year CPI Growth



ing to Venezuela, Russia, and Iraq, and comments from both OPEC and the International Energy Agency suggesting that prices do not reflect current supply and demand, oil prices retreated from all-time highs in August. After reaching a closing high of \$48.70 per barrel on August 20, oil prices plummeted 13.5% to \$42.12 by the end of the month. While acknowledging the recent decline in energy prices during recent Congressional testimony, Alan Greenspan noted that the risk of another rise in oil prices is still present, particularly given robust demand from China and India.

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Equities

After falling more than 3% during the first two weeks of August following a weaker-than-expected July jobs report, the S&P 500 surged nearly 4% in the second half of the month as oil prices fell and incoming economic data improved, finishing the month up 0.41% and bringing its year-to-date return to 0.42%.

Value stocks continued to outpace growth stocks as the S&P 500 Barra Value index rose 1.08%, more than 1.36% ahead of the S&P Barra Growth index. For the year, the value index has now outperformed its growth counterpart by more than 5.7%, reflecting the low-return environment for equities in 2004.

Historically, value stocks have tended to perform better during periods of below-average returns for equities. In ten of the last 25 years, the S&P 500 returned less than 10% per year. Over these ten years, the S&P Barra Value index outperformed the S&P Barra Growth index by an average of 5.87% per year. In

the fifteen years in which the S&P 500 returned more than 10% per year, value stocks trailed growth stocks by an average of 3.63% per year. The Russell 2000 index of small-cap stocks fell 0.51% in August, trailing the S&P 500 for the second straight month.

Fixed Income

Despite another increase in short-term interest rates, the Lehman Aggregate jumped 1.91% in August as the ten-year Treasury yield declined 0.37% to 4.13% as inflation expectations continued to stabilize. Both the consumer price index and the producer price index rose less than expected in July as the year-over-year growth rate in each index continued to level off after an increase earlier in the year. The level of expected inflation over the next ten years implied by the yields of the ten-year Treasury and the ten-year inflation-protected Treasury fell to 2.39% in August from 2.48% in July, and is now 0.30% below its May level. Declining inflation expectations and the steepness of the yield curve have allowed

longer-term interest rates to remain relatively unchanged on the year, despite higher short-term interest rates. Since 1980, the average difference between the ten-year Treasury yield and the fed funds rate has been 1.18%, significantly less than the current difference of 2.63%. This yield curve spread has narrowed, or flattened, by 1.03% over the last three months as the Federal Reserve has increased the fed funds rate by 0.50% (see chart). This flattening of the yield curve has allowed longer-term interest rates to remain level as short-term rates have risen. If the yield-gap between the ten-year Treasury and the fed funds rate continues to flatten toward longer-term averages, long-term interest rates

could remain within their recent ranges until the fed funds rate rises another 1.25% to 1.50%. If the Fed increases the fed funds rate beyond this range, the yield spread between the two rates would have to fall below historical averages for the ten-year Treasury to remain near its recent levels. At the current year-over year rate of inflation, the fed funds rate would have to exceed 3% for the real, inflation-adjusted, fed funds rate to turn positive. Thus, while the bond market appears to have priced a number of future short-term rate increases into current Treasury yields, a shift in the fed funds rate to a more neutral level may still place upward pressure on interest rates. All spread sectors within the Leh-

man Aggregate outperformed similar-duration Treasuries in August, led by 0.49% of excess return from the CMBS index. Investment-grade corporate bonds delivered 0.19% of excess return, ahead of high yield credits, which outperformed Treasuries by 0.01%.



Ten-Year Treasury Yield Less Fed Funds Rate



International

A moderately weaker U.S. dollar added 0.57% to the return of the MSCI EAFE in August, lifting its total U.S.-dollar return to 0.46%. On a year-to-date basis, the EAFE index is up 1.95%, despite a 2.35% drag from a stronger U.S. dollar. The European Central Bank once again decided to maintain its short-term benchmark rate at 2%, while raising its euro zone GDP forecast for this year to a range of 1.6% to 2.2%, up from a range of 1.4% to 2.0%. In its annual review of Japan, the International Monetary Fund was generally optimistic about the Japanese economy, noting that "there are clear indications that

Japan's longstanding economic problems have eased." The IMF predicted that deflation within the country may end by late 2005. The MSCI Emerging Markets index rebounded sharply in August from recent losses, rising 4.19% and bringing its year-to-date return to 1.54%. Emerging market equities benefited from generally positive economic news from within individual markets, as well as lower U.S. interest rates. The Lehman Global Treasury Ex-U.S. index jumped 2.4% in August as a weaker U.S. dollar added 0.86% to the index's return.

Real Estate

Demand for commercial real estate assets is strengthening. The downward trend (since 2001) in cap rates and IRRs appears to be stabilizing with the expectation of rising interest rates. Vacancy levels are generally stable in all of the major property types. With the continuing economic expansion, the South and West are showing the best near-term strength. The strongest metropolitan markets are in the Southwest, with Las Vegas and Phoenix leading the way. Markets with exposure to concentrations in defense, electronics and health services are

benefiting, while weakness is predominantly coming from the heavily industrialized areas in the Northeast and Midwest. Over the last three years, vacancy rates for **apartments** have doubled to a first-quarter 2004 high of about 7%. Over this time there has been a steady increase in supply leading to lower rents. Projects under development may continue to increase vacancy rates in selected metro areas later this year. Continued employment growth should increase demand for apartments, and rising interest rates should help improve

apartment affordability relative to home ownership. Within this same time span, vacancies for **industrial** properties have risen from 7% to a first-quarter 2004 high of almost 12%. Demand for industrials has shown sustainable improvement during the second quarter of 2004 with new supply holding steady. Further growth in capital spending, production, and inventories should support lower vacancy levels. **Office** vacancies have risen from about 9.5% to a mid-year 2003 high of 17% since 2001. Office rents declined for the 13th straight quarter in the second quarter

2004. A recently moderate increase in demand appears to be accelerating and may continue as office-using jobs increase. Also, over the last three years **retail** vacancies have held steady between 6% and 7%. Retail has been the strongest of the four property types and continues to outperform in occupancy, effecting rent growth and appreciation. However, the impact of superstore concepts from value retailers such as Wal-Mart and Target in the grocery-anchored subtype is a cause for concern. Overall, rents should increase at a modest pace.

Indices Report

Periods Ending August 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	0.41%	(1.03)%	(2.74)%	0.42%	11.46%	0.81%	(2.06)%	10.69 %
S&P Equal Weighted	Large Cap Core	(0.21)%	(1.65)%	(2.96)%	1.40%	14.66%	6.10%	5.71%	12.05 %
DJIA	Large Cap Core	0.58%	0.38%	(2.90)%	(1.34)%	10.37%	2.91%	0.68%	12.26 %
Russell 1000	Large Cap Core	0.49%	(1.29)%	(3.02)%	0.20%	11.33%	1.22%	(1.46)%	10.67 %
Russell 1000 Growth	Large Cap Growth	(0.49)%	(4.95)%	(6.08)%	(3.55)%	5.36%	(2.20)%	(7.36)%	8.46 %
Russell 1000 Value	Large Cap Value	1.42%	2.36%	(0.01)%	3.93%	17.52%	4.45%	3.25%	11.98 %
Russell Mid Cap	Mid Cap Core	0.43%	(1.30)%	(2.55)%	2.44%	15.29%	7.42 %	6.80%	12.13 %
S&P Mid Cap 400	Mid Cap Core	(0.26)%	(2.75)%	(3.58)%	0.87%	12.42%	6.51 %	9.18%	13.93 %
Russell 2000	Small Cap Core	(0.51)%	(3.31)%	(5.91)%	(0.94)%	11.35%	6.72%	6.43 %	9.33 %
Russell 2000 Growth	Small Cap Growth	(2.15)%	(7.97)%	(10.44)%	(5.88)%	3.37%	1.04%	(1.37)%	5.02 %
Russell 2000 Value	Small Cap Value	0.98%	1.23%	(1.50)%	3.88%	19.49%	11.74 %	13.36 %	12.84 %
NASDAQ Composite	Broad Equities	(2.61)%	(7.48)%	(9.45)%	(8.25)%	1.52%	0.60%	(7.68)%	9.15 %
Wilshire 5000	Broad Equities	0.34%	(1.34)%	(3.15)%	0.45%	11.68%	2.30%	(0.88)%	10.35 %
<u>International Equity Indices</u>									
MSCI World	Broad Global	0.48%	(0.73)%	(2.37)%	0.91%	16.15%	2.50%	(1.81)%	6.72%
MSCI World Ex US	Broad International	0.42%	(0.40)%	(2.06)%	1.58%	22.43%	4.86%	(0.55)%	3.97%
EAFE	Developed Markets Intl	0.46%	(0.61)%	(1.77)%	1.94%	23.09%	4.79%	(0.83)%	3.73%
EAFE Growth	Developed Markets Intl Growth	0.12%	(2.69)%	(5.04)%	(1.33)%	18.04%	3.12%	(4.27)%	1.32%
EAFE Value	Developed Markets Intl Value	0.78%	1.39%	1.47%	5.18%	28.15%	6.45%	2.44%	6.06%
MSCI Emerging Markets Free	Emerging Market	4.19%	2.81%	(6.26)%	1.54%	14.72%	14.96%	3.10%	N/A
IFCI Composite	Emerging Market	4.47%	2.32%	(4.98)%	3.00%	22.34%	19.04%	5.60%	0.17%
MSCI Japan	Japanese	0.72%	(0.14)%	3.37%	4.93%	20.45%	2.97%	(4.41)%	(3.55)%
<u>Domestic Fixed Income Indices</u>									
Treasury Bills	Cash	0.12%	0.31%	0.56%	0.72%	1.08%	1.57%	3.18%	4.24%
Lehman Intermediate G/C	Intermediate Govt/Credit Bonds	1.67%	2.83%	0.72%	2.42%	5.08%	6.01%	7.29%	6.97%
Lehman Intermediate Aggregate	Int. Core Bonds	1.64%	3.07%	1.15%	2.78%	5.49%	5.87%	7.34%	7.12%
Lehman Aggregate	Core Bonds	1.91%	3.51%	1.16%	3.07%	6.14%	6.19%	7.67%	7.47%
Citi Broad Investment Grade	Core Bonds	1.98%	3.60%	1.24%	3.17%	6.26%	6.22%	7.69%	7.49%
Lehman Govt/Credit	Govt/Credit Bonds	2.12%	3.63%	0.85%	3.01%	6.25%	6.53%	7.86%	7.55%
Lehman Long Govt/Credit	Long Govt/Credit Bonds	3.78%	6.56%	1.51%	5.22%	10.44%	8.34%	9.62%	9.23%
Lehman Government	Government Bonds	1.95%	3.32%	0.72%	2.77%	5.30%	5.86%	7.36%	7.26%
Lehman Mtg Backed Securities	Mortgage Bonds	1.54%	3.36%	1.74%	3.24%	5.98%	5.53%	7.27%	7.30%
Lehman Muni 3 Yr	3 Yr Municipal Bonds	1.05%	1.97%	0.28%	1.48%	2.83%	3.86%	4.86%	4.92%
Lehman Muni 10 Yr	10 Yr Municipal Bonds	2.19%	3.93%	0.55%	2.75%	7.65%	5.70%	6.79%	6.62%
Lehman U.S. Credit Index	Corporate Bonds	2.36%	4.05%	1.04%	3.35%	7.49%	7.41%	8.48%	8.06%
Merrill Lynch High Yield	High Yield Bonds	1.81%	4.71%	3.01%	4.58%	13.64%	9.11%	6.24%	7.86%
Merrill Lynch Conv US	Convertible Bonds	(0.00)%	(1.76)%	(2.92)%	0.29%	8.59%	6.98%	6.36%	N/A

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