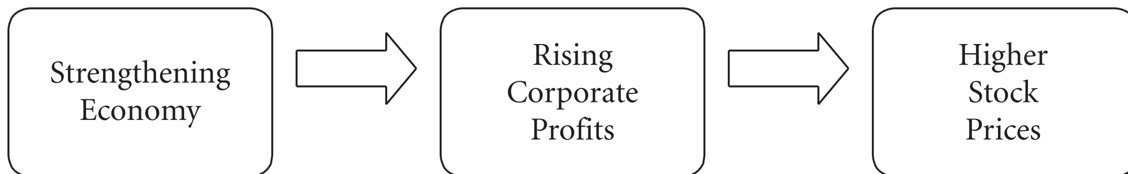
Saybrook Capital
Investment Review

June 30, 2004

After a steady second quarter, July incurred signs of economic weakness that have been reflected in the equity markets. Although we may be experiencing a modest deceleration in business activity, an analysis of the causes and effects of this slowdown leads us to believe that the strong fundamentals supporting our three-part paradigm are still in place: self-sustaining economic growth, record corporate profits, and a rising equity market.



While the stock market has remained in a remarkably narrow range through the first half of 2004, the issues weighing on investors have partially shifted from geo-politics, to a 'jobless recovery', high oil prices, and a fear of accelerating inflation. All the while, continued broad increases in corporate profits have acted to offset these downward pressures. Earlier the investment consensus called for a surging global economy with the risk of demand-driven inflation. Timely data now points to evidence of economic deceleration, manifested in areas as diverse as commodities, shipping, employment, auto and consumer sales, advertising, and technology. This evidence begs three questions pertaining to our above model.

I. What is the cause and extent of the slowdown?

The often-cited reason for the current soft spot in the economy is the fading of the economic and fiscal stimuli of 2003 and early 2004: mortgage re-financings, tax cuts and credits, and record low interest rates. Although the declining influence of these factors certainly make for difficult comparisons during the second half of this year, a greater impact on economic activity stems from radically higher commodity prices, especially oil and gas. In last quarter's 'Outlook' we highlighted energy prices as a potential economic restraint, and this argument is now supported by economic weaknesses concentrated in automobile sales and discount chains (high gasoline prices act as a regressive tax, disproportionately impacting lower income consumers). Commodity/energy price stresses have frequently led to Fed tightenings and recessions, so we are closely following events that impact these markets. Despite these clear concerns, our thesis remains that economic damage will be more limited than during the energy shocks of the 1970's. We do expect oil and gas prices to remain above historic levels, but inflation-adjusted energy prices are far below the peaks of thirty years ago and the US economy is less resource dependent.

Another reason for this deceleration is that recent rates of economic growth (the last four quarters have seen the fastest GDP growth since the early-1980s) are simply unsustainable. The above-average growth (culminating at +8% in the U.S. for the third quarter of 2003) here and abroad creates dangerous levels of demand on goods and services, leading to inflation. A "soft-landing" or moderation of growth, as experienced in 1995, is the ideal path at this juncture. Moderate self-corrections are the normal self-sustaining nature of our economy. If history is a guide, the economic cycle is in the second or third inning, as the previous strength of the consumer translates into cash for companies, which is then invested into inventory restocking, capital equipment, and job creation. These expenditures pass through to other businesses and consumers, and the expansion cycle continues. Fortunately, inflation can be self-correcting, as evidence shows that the recent soft-spot here and abroad releases some of the pressure on prices.

II. How will this slow-down impact earnings?
As long as the economic deceleration remains benign, corporations should continue to post impressive profits. In the past year-and-a-half businesses have been able to increase earnings at an even higher level than revenue growth due to their sustained operating leverage. Just like the economy as a whole, we believe the rate of profit growth will eventually slow from its lofty levels, but the upward direction will be maintained. Wall Street's new-found conservatism has led to wide-spread profit underestimations five quarters in a row. As forecasts gradually rise and our forward 12-month moving target of corporate earnings advances with time, the expected earnings level for the market as a whole should continue to climb steadily. In fact, the Standard & Poor's estimate of earnings for the next 12 months has risen nearly 5% in the last three months.

III. Is a further market correction justified?
The third part to our paradigm is positive equity returns generated by growth in the economy and earnings. In our last 'Outlook' we described a scenario with gains generated by solid profit growth and increasing dividends, with market multiples remaining in a range of 15.5 to 19 times forward EPS. In the three months since then stock prices have moderated slightly, as profits have continued to expand, leading us to the lowest market valuations since 1996. It is difficult to make the argument that equities are still over-valued, especially with inflation and interest rates on a clearer path than thought this spring. Even precluding the possibility of multiple expansion, continued record earnings and dividend growth should provide respectable equity returns. As mentioned in our last report, the true risk to the stock market and our model comes from the unexpected events, policies, changes, and rates of changes that could cause valuations to deviate from this range – either above or below.

As always, prudent stock selection is imperative to achieve long-term equity out-performance. Our "undervalued growth" strategy has two equal components. The first requires investing in companies with prospects for superior future earnings growth. The second ensures that we only buy those stocks when they are undervalued. These strict disciplines enable us to own superior growth companies, which is particularly pertinent in a period that may not enjoy multiple expansion. Despite a slowdown in the overall economy, our portfolios have benefited from holdings in energy and defense, as well as long-term investments in the industrial and business services segments of the economy.

We are excited to announce that Saybrook Capital now has an address on the internet. Investors can now go to our website to find a summary of our goals and strategies, an archive of our quarterly 'Outlook' reports, biographies of our investment professionals, and updated composite performance. We look forward to further customizing this site to provide dynamic access for current and prospective clients. Please visit us at: ***www.saybrookcapitol.com***