



ECONOMIC OVERVIEW

HEADLINES DURING THE THIRD QUARTER OF 2004 WERE PRIMARILY DOMINATED BY THE PRESIDENTIAL ELECTION AND THE ONGOING CONFLICT IN IRAQ, CONSPIRING TO CREATE UNCERTAINTY FOR INVESTORS.

Secondarily, extreme weather along the eastern seaboard and southern part of the US has wreaked havoc for citizens in those areas affected. The uncertainty created by these events, coupled with higher energy prices has the stock and bond markets entrenched in a trading range, despite what appears to be a healthy economy and rising corporate profits. While there was a dip in economic activity in July, it was short lived, as GDP is expected to complete the year at a 4.2% annual increase, which is 1.2% above the long term trend line.

Bonds have been this year's winner despite the Federal Reserve pushing short-term interest rates up to 1.75% from 1.00%. We continue to believe that the long bull market in bonds which started in 1981 (with a 30-year bond at approximately 15%) has come to an end as interest rates begin to move upward. This trend has clearly started during the third quarter. The 10-year Treasury yield rose from 3.1% in June of 2003 to a peak of 4.9% before settling in at 4.2% at the close of September 2004. Interest rate forecasts call for the 10-year bond to be yielding over 5% by this time next year.

The stock market, as measured by the S&P 500, was down 1.9% for the third quarter. For the year, the index is up 1.5% and continues to trade within a fairly narrow range. The Dow Jones Industrial Average trailed the S&P 500, returning -3.4% in the quarter.

Following the consolidation of the markets over the past three quarters, we would expect the market's performance to resume a more positive trend moving into 2005. Unlike the initial period of rebound last year, however, the incremental appreciation of the market will be more selective and tied directly to specific companies and their ability to record continued solid fundamental growth as general economic growth trends moderate. Within this type of environment, sound fundamental analysis and a focus on individual security valuation levels remain an important component in providing attractive relative investment returns.

INTEREST RATES AND INFLATION

A benign inflation outlook continues despite the increases in home and energy prices. In the last year, housing prices in the Philadelphia area were up 19%. Since 12/31/03, oil is up over 50%. With all of this, the Consumer Price Index is boasting a mere 2.7% increase year-over-year; producer prices are up only 3.4%. Removing the effects of food and energy (two very volatile sectors) the increases are 1.7% and 1.5%, respectively.

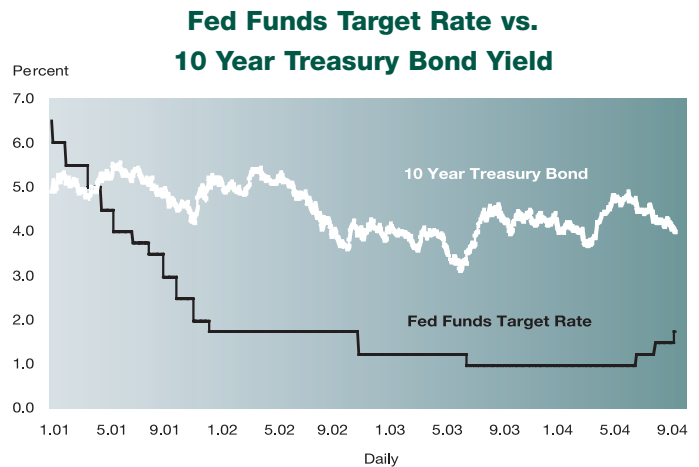
The dollar has found a stable footing and gold prices have stabilized (one of the first signs of the market buying into pending inflation). Technology based productivity gains have helped to keep inflation manageable and deliver more goods to the global marketplace by increasing production while reducing costs. Furthermore, domestic inflation has exported itself overseas where Asian countries provide cheaper labor and costs of goods sold. These factors combined with China's economic expansion, continue to provide incentive for Americans to increase debt and consumption.

Wall Street continues to look to the Fed for any indication of their long term plans. The Federal Reserve needs to find a platform to defend the economy from future potential economic catastrophes by bringing rates back to an historical "norm". The FOMC lowered rates from 3.5% to 3.0% on 9/17/01, down to a low of 1.0% by June of 2003. All of this was in an effort to support liquidity for the financial community; in turn, consumers and businesses felt the advantage as well. The Fed is now trying to recapture their financial tools to be prepared for the future.

The 10-year Treasury hit a recent high of 4.9% with a very steep yield curve, temporarily slowing the economy this summer. The fundamentals and long term trends show the economy still has some steam. Today's current yield has come back to 4.2% and the yield curve has flattened significantly, with the long end falling on technical issues such as large short positions in the 10-year Treasury.

Historically, oil prices and interest rates move in the same general direction. With oil prices rising substantially and long Treasury yields pushing lower on technical issues, there is a divergence in this trend; oil up, Treasury yields down. Our outlook is for rates to normalize in the near term by rising on the long end of the curve, resulting in a more even shift upward of the entire yield curve. The Fed should finish this year with an overnight rate around 2.0% and the 10-year area of the curve settling in around 4.5%-4.7% in the next few months.

From an investment perspective, we look for durations to be slightly shorter than performance indices, providing flexibility to reinvest at higher interest rates and protect portfolio market value. Adding callable bonds to portfolios results in spreads on those bonds to tighten as rates rise, in essence a natural hedge against loss of market value. Municipal weekly floaters have performed very well, currently yielding 1.60% vs. municipal money market accounts at 1.20%. The bottom line, shortening durations, investing cash on sell offs, adding callable bond structures, and laddering portfolios should make for a winning strategy in total return accounts.



Source: Federal Reserve Board; Clarion Inv. Research, Inc.

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EQUITIES

Corporate earnings growth remains strong, with year-over-year percentage gains in the high-teens, despite formidable comparisons to the earnings recovery of last year. Over the last several quarters, there has been a marked increase in capital spending, particularly as it relates to information technology and productivity enhancements. In addition to spending on technology, the corporate sector has become more acquisitive. Corporations view the current landscape as an opportunity to add business segments at attractive market valuations.

Despite the improvement in both earnings and financial strength, the equity markets have been buffeted by a number of other events and factors. In addition to the sea change with respect to monetary policy, energy prices have been a major stumbling block to any sustained advance in equity prices. Specifically, the price of crude oil rose from the low \$30 per barrel level to almost \$50 at the time of this writing. We have taken the view that there is a secular case to be made for higher energy prices based on the growing demand from China and other emerging countries. However, the current level of pricing is being artificially

"Keep away from people who try to belittle your ambitions. Small people always do that, but the really great make you feel that you, too, can become great." Mark Twain

elevated by geopolitical concerns, recent hurricane activity in the Gulf of Mexico and inclement weather in other oil-producing areas.

Looking ahead, we anticipate that the gradual approach to Fed tightening and the eventual moderation in oil prices to more sustainable levels will reduce the level of uncertainty with respect to consumer and capital spending plans. We believe that revenues and earnings will continue to rise at a steady pace which should provide the base for a more gradual and sustainable advance in equity prices.

We maintain that security selection will remain the key to achieving above-average equity returns in the absence of any significant expansion in the valuation multiple of equities. Further, we believe that the market will gradually reward the stocks of higher quality companies with successful business models and a proven track record.

OUR PERSPECTIVE

This October marks the third anniversary of the start of the current economic recovery. While investors continue to operate with a healthy degree of near-term skepticism, the overall economy has shown impressive resilience over the past three years. The recovery was initially carried almost exclusively by consumer spending with aid provided by increased governmental spending and fiscal stimulus. While the year-over-year trends in consumer spending have softened over the past two quarters, this trend has been a function of the temporary rapid rise in energy prices coupled with the artificially stimulated spending levels experienced during the summer of 2003 base period resulting from the tax reductions and tax refund checks that were sent out in August of last year. While the consumer spending trends have softened, business investment spending has been strengthening as a result of solid corporate profit growth, increasing capacity utilization and modest inventory levels.

During the past three years, while the economy has shown steady improvement, inflation has remained well under control with the Consumer Price Index up only 2.7% over the past twelve months in spite of the recent surge in energy prices. Within this environment, the Federal Reserve has had the flexibility to begin to gradually move the Federal Funds rate back up to more normal levels. The funds rate has been artificially depressed since the fourth quarter of 2001 due to the Fed's aggressive moves to add liquidity to the system following the terrorist attacks of September 11, 2001.

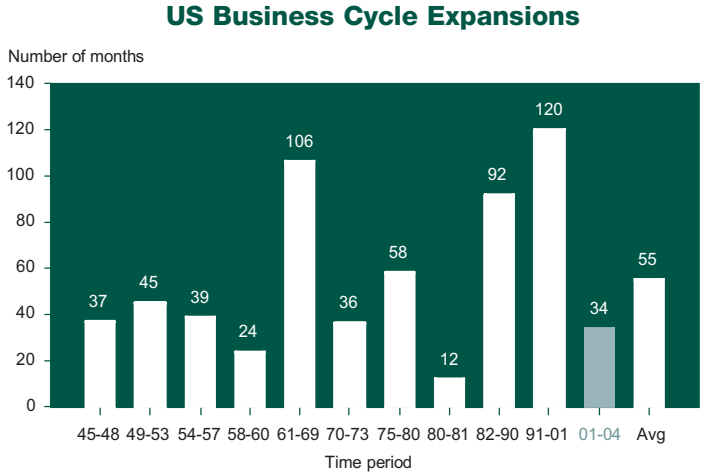
During the fourth quarter, economic momentum should continue to remain positive, as both consumer and business spending trends will contribute to ongoing gains. For the full year, GDP growth is expected to be in the area of 4.2%. Corporate profits, as measured by the S&P 500, are expected to increase close to 20% to the area of \$67.00 per share.

The year 2004 has been one of investment market consolidation with moderating economic growth. The continued gradual improvement experienced by the economy has been in direct contrast to the investor uncertainty created by the continuing conflict in Iraq and the high level of political rhetoric during the final days of the Presidential campaign.

The economic expansion is currently showing the breadth and underlying strength that should result in a sustainability of the recovery over the next twelve to eighteen months. Continuing job growth, increasing capacity utilization, healthy corporate balance sheets, relatively modest inflationary increases and improving pricing flexibility should all contribute to continuing productivity gains and corporate profit increases. Current projections for 2005 call for GDP growth in the area of 3.5% with S&P 500 earnings expected to post an additional 11% gain to \$74.00 as the expansion continues.



Our positive investment outlook of two years ago was based on the premise that the economy had indeed turned around following the recession of 2001 and was capable of a significant cyclical recovery that would drive both earnings and market valuation levels. With the economy now celebrating the third anniversary of the economic recovery and valuation levels much improved, the foundation for a continued positive investment posture must be based on the continued sustainability of the recovery. The accompanying chart shows the sustainability of past post World War II economic expansions in relation to the recovery that we have seen to date. As can be seen from the chart, this recovery is still twenty months less than the average recovery for the period. Based on the balanced support of consumer, government, and corporate spending growth that is currently funding the recovery, in conjunction with growing corporate profits, relatively low capacity utilization rates, and multinational economic recovery trends, it is our view that the current period of economic expansion is capable of sustaining itself over the next twelve to eighteen months. This sustainability of growth, coupled with continued investor skepticism, continues to create the potential for significant investment appreciation.



Source: National Bureau of Economic Research; Clarion Inv. Research, Inc.

AT THE FIRM

We are pleased to announce that on September 27, 2004, Mary Powers joined our firm as a Trust Administrator. Mary has over twenty years of experience in the trust area. Prior to joining DCM, she spent the last five years as a Fiduciary Account Officer specializing in fiduciary account administration with JP Morgan Private Bank/Chase Manhattan Bank. Mary’s previous experience includes twelve years with First Union National Bank (now Wachovia) holding various trust positions. Mary completed the Central Atlantic School of Trust at Bucknell University and is currently pursuing her legal studies at St. Joseph’s University.

Robert Lodge | *Managing Director* | Davidson Quarterly Review is a publication of Davidson Capital Management.