

## Greenspan's "Conundrum" Solved

Despite oil's recent surge to \$60, the June PPI and CPI remained contained. The likelihood that China will soon return to its historical status as a chief exporter of steel has caused an astounding 30-40% retreat in most American steel stocks over the last month or so. Traditionally, the Federal Reserve primary objective in setting the federal funds rate was to encourage price stability, or more simply, to target inflation. Yet, despite the difficulty in oil and an increasing government deficit, long-term bond holders remain unafraid.

Despite the Federal Reserve using 9 rate hikes to take the federal funds rate from 1% to 3.25%, long-term interest rates remain low. Following the May 18th release of the CPI, which showed 0.0% increase in core inflation, the ten-year bond was at a 2005 low yield of 4.05%. Currently, the 10 year rests at 4.18%. Not so coincidentally, mortgage rates have fallen. Last June, 30 year fixed rate mortgages averaged 6.29%. Today, Bankrate.com advertised a 30 year fixed at 5.27%. The fall in long-term rates despite the Fed's insistence on raising short-term rates was described by Alan Greenspan as a "conundrum." Yet, is the bond market reaction really that hard to understand? Long bond rates are affected by inflation expectations, deficits and such other factors that may affect demand for money over the longer term. However, despite Greenspan's rate increases and high prices for certain materials like oil, labor, the most important component in most goods and services, remains cheap. The migra-

tion of jobs overseas to countries like India and China is disinflationary. The increased use of migrant workers in the United States also is disinflationary. It can even be argued that the troubles of General Motors and Ford, as a result of spiraling healthcare and pension costs for its union members will soon be disinflationary as these companies and their unions will be forced to face reality and work hard to reduce their costs. The recent debt downgrades of both automakers reinforced the urgency of the situation.

Bond bears point to the record deficit as another reason why long-term rates must rise. While deficits have to be funded by the government, it is clear that the government's demand is not squeezing out corporate demand. In fact, corporate debt was up only 3% last year despite a reasonably strong economy. Companies have not used the strong economy to lever up and buy businesses. Instead, companies have used their stronger cash flow to

### Market Performance For The June 2005 Quarterly Period

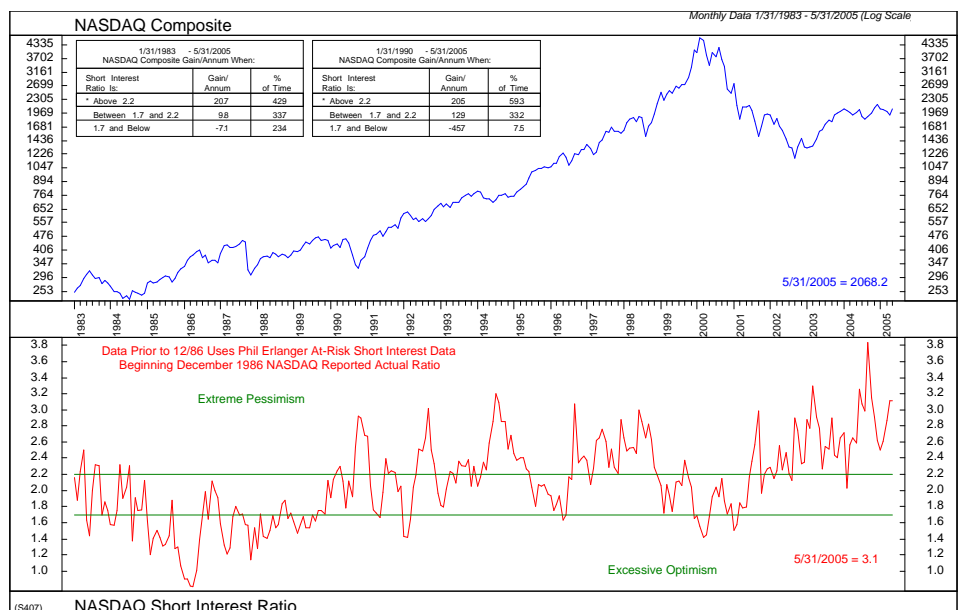
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|----------------------------------|----------------|
| <i>Dow Jones Industrials</i>     | <b>- 1.85%</b> |
| <i>Standard &amp; Poor's 500</i> | <b>1.37%</b>   |
| <i>Russell 1000 Growth</i>       | <b>2.19%</b>   |

reduce their debt levels.

It is clear that the issue that is most worrisome to many economists is the enormous demand in housing and significant price appreciation for homes over the last couple of years, especially on both coasts and in the south. This "housing bubble", which has seen prices escalate 30% in a year in such markets as Silicon Valley and Sarasota Florida may be Greenspan's greatest fear, especially given his failure to adequately respond to the dot.com bubble of 1999 through his failure to raise margin requirements. Some observers suggest that Mr.

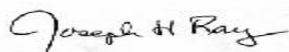
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## NASDAQ Pessimism Could Lead To Rally



Greenspan will continue to raise rates until we see a slowdown in housing. The problem with this rationale is that long-term rates drive housing as does unemployment. Both barometers are low and healthy. The rise in short-term rates has reduced the role of gimmicky adjustable rate mortgages in many areas of the country and that is good. With the 10 year Treasury a little over 4%, housing remains affordable and a good investment. Greenspan will be watching closely. If commodity prices continue to moderate, I would hope that favorable housing conditions would not override what the bond market is telling us. Long-term expectations are that inflation remains contained and it should be possible to stop raising rates soon. If Greenspan listens to the market, the music for stocks could be sweet.

Sincerely,



Joseph H. Ray,  
President

### Biotech Bargain?

The combination of Genetech's product driven rise and Pfizer's cash acquisition of Vicuron, a biotech specializing in anti-fungal drugs, has led to a lot of interest in biotechnology stocks. As more and more biotech companies have products that have received, or are nearing FDA approval, the interest in biotech companies among large pharmaceutical firms in need of bolstering their pipelines should remain high. Many large companies provide marketing services to smaller companies. They sell the drug and often pay a 25-50% royalty to the developer of the drug. In some cases because of perceived or actual questions concerning the strength of

the smaller companies pipeline, these smaller biotechnology or specialty pharmaceutical companies can trade at very low price to sales or price to earnings ratios. Companies like Forest Labs or Biovail trade at forward multiples of 15x and 9 x earnings, respectively. On a price to sales basis they trade at 4x and 3x sales. Pharmion trades at 2.5x sales. These low valuations make acquisitions attractive despite relatively poor pipelines. Traditionally, biotech and specialty pharma could trade at 5-10x sales. Another factor that should benefit small and mid cap healthcare stocks is the enormous amounts of cash repatriated to the United States from overseas. Both Bristol Myers and Pfizer have brought over billions which need to be put to work. I expect numerous other deals in the specialty pharma and biotech area as the year progresses.

### An Early Look At Earnings

The re-modeling of GE under Jeff Immelt continues to be successful. Immelt has moved GE into higher margined businesses and has shed certain lower marginal ones. 2Q earnings were up an astounding 24% with all 11 business units showing gains. While Jack Welch was much higher profile, Immelt continues to show himself a worthy successor.

Citigroup struggled in the second quarter with a flat yield curve and higher bankruptcies. BankAmerica benefited from its more retail focus and the hot housing market but both stocks remain stuck at 11x earnings. Expect the situation to remain until the Fed signals it is done raising rates.

While Southwest Airlines has struggled through a tough environment for airlines, new CEO Gary Kelley has

shown himself to be a tough negotiator and solid CEO. He has stepped up his attacks on the Wright Amendment and the expensive Seattle Airport. He seems to have rekindled some of Southwest's spirit that was dampened under Jim Parker's checkered tenure.

### Signs That the Oil Thing Is Overdone

1. Goldman Sachs discusses the possibility of \$105 within a year. Unocal sells itself to Chevron the same day. I guess Unocal did not believe the hype.
  2. Nippon Energy's purchase of Devon Energy's domestic reserves. Are foreign buyers ever right?
  3. Oil inventories are up about 9% year over year. I thought there was a shortage.
  4. Car companies need something to replace the SUV in popularity. Could it be the hybrid? If hybrid's popularity takes off, what then?
  5. Since last September, weekly crude oil inventories have risen at an above average rate in all but 9 weeks.
- That said, the oil stocks look okay given \$60 oil, strong cash flow and reasonable private market value relative to share price.

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