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THE RAY REPORT

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Commodities Take Center Stage

It is near the end of April and oil prices have again topped the \$52 per barrel level. In traditionally a slow period for oil, this is disconcerting to the markets.

Oil stocks have gone straight up in the first quarter. Many are up 20% or more in that short period of time. I believe there are at least two contributing reasons for this frenetic move. First, the resiliency in oil prices is beyond most analyst's comprehension. Many believed that oil would be trading in the high \$30's by now and few if any have assumed oil prices higher than the low \$40's when estimating oil stocks' earnings potential for 2005. Clearly, oil companies should earn more than most analysts estimate as a result of current crude oil prices. Second, many money managers including most growth managers traditionally do not invest in commodity based companies and missed the first move in oil stocks that occurred the middle of last year. Determined to not be left out, I believe many growth managers especially large mutual funds are putting lots of money to work in the oil area. As a result of both the buy-side money managers and sell-side analysts having to play catch-up, oil stocks now represent over 8% of the S&P 500, compared to only 6% one year ago.

In the first quarter, the migration to commodity based companies was not limited to oil stocks. Many steel stocks traded near their yearly highs and even the chemical stocks began to climb steadily, despite being hurt by

higher oil prices. The interesting thing about this is the timing of these moves. The Federal Reserve has steadily raised rates and this is likely to continue. Japan and Europe (especially Germany) appear to be slowing. In fact, global growth looks to be decelerating rather than accelerating. Can all of asset inflation be related to China?

Despite China's seemingly insatiable demand for raw materials, I believe there are other economic factors that must be impacting oil and commodity prices. The trade gap and the dollar are clearly factors. While the reasons behind the move in commodity prices are important, the bigger question remains; will the move in the oil and commodity stocks be sustained? The answer lies in how quickly the Federal Reserve is willing to halt the rise in rates, or more recently whether a steepening yield curve may also allow the Fed to raise rates more quickly. In the short run, a change in Fed policy is unlikely, however the gravita-

Market Performance For The March 2005 Quarterly Period

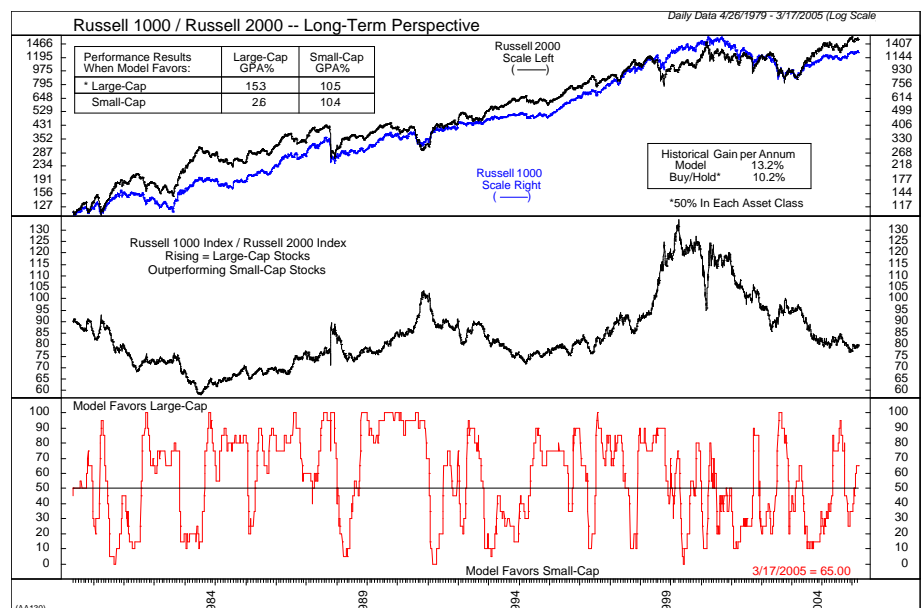
<i>Dow Jones Industrials</i>	-1.59%
<i>Standard & Poor's 500</i>	-2.23%
<i>Russell 1000 Growth</i>	-4.35%

tion to commodity stocks seems to have slowed in the last few weeks. Growth stock investors would prefer technology and financials stocks as market leaders as these groups symbolize a growing rather than slowing economy. However, a change in Fed policy, in either direction, will likely lead to new leadership sometime this year. As to when the market leadership changes, look at commodities for the answer.

Sincerely,

Joseph H. Ray
 President

Are Large Caps Getting Cheap?



Courtesy of: Ned Davis Research, Inc.

A Return to Large Capital Growth

Large cap growth investors have suffered over the last few years. Out of the eight investment categories followed by Callan Associates, large cap growth stocks have finished 7th out of 8 in performance consistently since 2000. Prior to that time, large cap growth companies were the best performing sector each year from 1995 until 1998.

Small cap and Value stocks have outperformed large cap growth as investors have looked at smaller companies which have exhibited faster growth. Value companies, especially small cap value companies have exhibited solid performance as commodity prices have risen steadily the last few years.

As 2005 progresses, large cap growth's prospects should improve as historically, larger companies outperform smaller ones as the economy slows. Additionally, rising interest rates should slow commodity price gains thereby impacting value stocks. Large cap companies could also benefit from the new tax law that allows domestic companies to repatriate cash to the United States at a significantly reduced tax rate. Many companies, mostly large, with overseas operations have returned billions of dollars to the United States. While the funds cannot be used to buy-back stock or pay dividends, they afford these companies tremendous financial flexibility. Increased merger and acquisition activity could also be expected. We

expect some relative improvement in large cap growth names as 2005 unfolds. Yet, the early part of 2005 could remain difficult, however, as the market adjusts to rising interest rates, a problematic dollar and commodity price inflation.

Are High Oil Prices Doing the Fed's Work?

I pull up in my wife, Alyson's, car to the neighborhood Exxon station last week. Her Ford Expedition was almost empty, as usual, I proceeded to fill up this monster with regular unleaded. Some 5 minutes later, I had dropped \$50 for her weekly tank of gas. Americans all over the United States are living this same nightmare. High oil prices affect the economy in a number of ways. Oil prices reduce the amount of disposable income for all of us. They impact shipping costs and travel costs. They impact the car companies who would rather sell you a SUV than a subcompact.

In all these scenarios, high oil prices negatively impact our economy. Ironically, in the last year or so, Alan Greenspan and the Federal Reserve have tried to do very much the same thing through its series of progressive rate increases. While clearly the price inflation that we are seeing in oil and other commodities is undesirable, the slowdown that results from higher oil prices makes it easier for the Federal Reserve to end its rate hikes sooner. It remains our contention that the market will perform better when the

Federal Reserve provides evidence that rate hikes may be coming to an end and in a bizarre way oil may be one component which makes those hikes end sooner rather than later.

A Quick Take on Earnings Reports

IBM set the tone with an awful earnings report. However, given that IBM has become concentrated in middleware and services, two slower growing, less innovative areas of the tech market, its problems may be more company specific than the market suggest.

JP Morgan and BankAmerica registered big quarters and seem to have made reasonable purchases of BankOne and Fleet, respectively. Citigroup had a nice quarter in the financial sector.

Big cap Pharma has done reasonably well given the low expectations with Merck, Wythe and Johnson & Johnson all beating expectations.

EMC gave some credence to the notion that IBM's problems were IBM's with a solid earnings report. Intel, also, was able to raise guidance and even upped its capital spending for the year.

Industrial companies like Honeywell and General Electric are seeing a strong aerospace cycle. General Electric also continues to see growth in may of its new healthcare related initiatives.