



Seven Reasons the Market will Go Up

1. Small business income is continuing to grow and at a faster rate. Small business is the growth engine for the economy through job creation. This is also a good sign for capital spending.
2. Strong productivity gains and rising GDP growth are fueling gains in corporate profits. According to Bear Stearns, economic profits as a share of GDP reached record levels in the last quarter of 2004. This combination should continue to drive profits higher.
3. Capital Goods shipments have increased for four consecutive quarters. This is good for manufacturing jobs.
4. Jobless claims have hit a 3 year low in the last two weeks, and the economy created over 500,000 jobs in the first quarter.
5. Bond yields have declined recently, fueling yet another round of mortgage refinancing.
6. The Federal Reserve is again increasing the money supply.
7. Oil prices will be lower in the coming months.

**UNDERVALUED
SECTORS
(CONSIDER!)**
• **LARGE CAP VALUE**
• **CONSUMER DEFENSIVE**
• **MINING**
• **TRANSPORTATION**

**OVERVALUED SECTORS
(AVOID!)**
• **HOME BUILDERS**
• **CALIFORNIA
MUNICIPAL BONDS**
• **CHINA**
• **ENERGY PRODUCERS**

How to Play the Coming Drop in Oil Prices.

OPEC just announced a production cut, gasoline prices are at record highs and John Kerry came to San Diego to say he was shocked at the high prices. Storage levels of petroleum products are near record lows; Asia is growing rapidly and requires more oil every day. So why do we think oil prices will decline?

Simple! Buy on rumor, sell on news. The production cut by OPEC was anticipated several months in advance. This had the effect of driving up prices in advance of the cut as supplies built up inventory. We believe that in the next 30 days, this will show up in the April and May inventory figures. In addition, the price of oil tends to peak during the greatest rate of growth in the economy. The economy grew at a record rate in the second half of 2003, because of the tax cuts and other economic stimuli put in place. We have no doubt that the economy will continue to grow the remainder of this year but at a slower pace.

The higher energy prices in the first quarter of this year caused a drag not only on consumer spending but on corporate earnings. If the price of oil were to drop 10%, we believe it will have a positive effect on the earnings of many companies. Overall, the earnings of the S&P 500 should increase about 2% for every 10% drop in price. In addition, energy prices typically increase the most at the beginning of a recovery. This has certainly been true this time as the economy is growing at its best levels in almost 40 years. The price of oil goes up in anticipation of this growth only to level off or even drop as the economy grows but at a slower pace. Using our rule of thumb above, if oil dropped to the \$30 a barrel range S&P 500 earnings would increase almost \$2.00.

The consumer is the obvious winner with lower energy prices resulting from lower heating, utility and gasoline prices putting more dollars in their pocket. This money is often spent which is obviously a good thing for the economy. Past history has shown that consumer defensive and telecommunications are the sectors that perform best in a period of declining oil prices. Transportation companies such as airlines, trucking and rails also benefit from the decreased cost of fuel. In contrast, companies in the energy sectors will under-perform in a falling price environment.

Who let the Dogs out?

Just when the punters thought that they had it all figured out, the Dow Jones Industrial Average is throwing them a curve. On April 8th, the average removes Eastman Kodak (EK), AT&T (T), and International Paper (IP), to make room for American International Group (AIG), Pfizer (PFE), and Verizon Communications (VZ). These changes affect the Dogs of the Dow Index (MUT) making observers of the strategy reshuffle their portfolios.

The Dogs of the Dow strategy involves buying the stocks with the highest dividend yields from the thirty companies included within the Dow Jones Industrial Average. Michael O'Higgins outlined this investment strategy in the 1991 book *Beating the Dow*. The theory underlying this approach is that the "dogs," or those stocks with the lowest stock prices and highest yields, will eventually recover and offer superior returns. Every twelve months, the Dogs of the Dow portfolio is rebalanced to include the ten highest yielding Dow stocks.

Two of the current 10 puppies, Eastman Kodak and AT & T, will be removed from the industrial average and therefore from the Dogs of the Dow Index. They will be replaced by Verizon and Citigroup (C). Centurion Counsel, on behalf of its clients, has positions in VZ, EK, T, AIG and PFE.

Does renewed job growth mean an increase in interest rates?

In recent speeches, Governors of the Federal Reserve have made it clear that two factors are responsible for the Fed maintaining an accommodative monetary policy. They are core inflation being held under control and sluggish job creation. The economy created over 500,000 jobs in the first quarter and inflation is running at double the pace of a year ago, although a still low 2.2%.

We feel that the jobs reports for the months of April and May will hold the key. If these two reports show continued strong job growth we believe that the odds favor a small increase in the short term rates. It is important to note that after the last jobs report the yield on the 10 year Treasury Notes rose from 3.91% to 4.24% two days later.

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We do not believe that the rate on the 10 year will increase too much beyond 4.5% this year even with strong job growth. This of course assumes that the Fed will increase short term rates a $\frac{1}{4}$ to $\frac{1}{2}$ % to show that it is ahead of the inflation cycle.

What we fear the most is the Fed doing nothing this year. If they sit on their hands in the face of strong job growth, the 10 year rate might increase to 5%, as the market takes matters into its own hands.

More workers doesn't necessarily mean more work

Barney Frank, a Democrat member of the House from Massachusetts, has called for the Government to once again become the 'employer of last resort.' He and Senator Kennedy have called for massive job creation by the Federal Government to result in "full employment." They claim that the private sector is not creating enough new jobs and Mr. Frank stated "the situation cries out for government job creation". Normally we ignore the financial thoughts of Mr.'s Frank and Kennedy but this being an election year and their statements recently aired in the Sunday New York Times, we feel that a comment is in order.

First of all, the current rate of unemployment is lower than the average of the past 30 years and is, in fact, lower than when President Clinton sought re-election so we disagree that the job market is in such dire straits. Meanwhile, as Mr. Frank's is undoubtedly aware, it is increasing hiring in the private sector that will provide the biggest boost to the economy. The private sector creates jobs primarily based on improvements in productivity. As productivity increases, more people are hired and productivity increases further and the cycle continues. The last recession caused an excessive overhang of capacity, which is just now being worked off, but if last months job's report is any indication, we are near the beginning of the job growth cycle.

One could argue endlessly in an election year about the merits of President Bush's economic policy. What we are confident of, however, is that government employment does little or nothing to improve productivity. If you doubt this, go stand in line at any Department of Motor Vehicles. The very nature of government full employment means little or no productivity growth and the supposed panacea of "full employment" sought by Mr. Frank's just means we'll have more people adding less to the economy.

**We at Centurion Counsel Wish You
Continued Success in 2004!**