

VTL Associates, LLC

Economic and Capital Market Outlook

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During the previous four years, the Federal Reserve has maintained an extremely accommodative monetary policy. Despite Federal Reserve Chairman Greenspan's temperament toward inflation, Mr. Greenspan became extremely concerned with the U.S. economy's brush with deflation during 2001 and 2002. Consequently, the Federal Reserve now appears to be willing to accept a moderate level of inflation through 2005.

With the U.S. Consumer Price Index ("CPI") currently tracking at an annualized rate of 3.5% and a federal funds rate ("FFR") at 2.25%, the Federal Reserve's easy monetary policy of targeting the FFR below the actual CPI has resulted in a negative FFR for nearly an unprecedented four years. However, virtually every U.S. economic recovery has occurred during this type of Federal Reserve activity.

The following chart compares real GDP, CPI, and Central Bank Rate targets for various industrialized nations.

<u>Country</u>	<u>Year-Over-Year Real GDP</u>	<u>CPI</u>	<u>Central Bank Rate</u>
United States	4.0%	3.5%	2.25%
China	9.1%	2.8%	5.58%
Germany	1.3%	1.8%	2.00%
France	2.0%	2.0%	2.00%
United Kingdom	3.1%	1.5%	4.75%
Italy	1.3%	1.9%	2.00%
Japan	2.6%	0.8%	0.1%

At the start of 2001, the FFR stood at 6.5%. As the economy began slowing, the Federal Reserve responded by reducing the FFR seven times between January, 2001 and the beginning of September, 2001. Although the FFR stood at 3.5% at the beginning of September, 2001, the attacks on September 11th of that year delivered a severe shock to an already slowing economy. Consequently, the Federal Reserve responded by ultimately lowering the FFR to an artificially low level of 1%, where it remained until June, 2004. This created a spread between short-term and long-term rates of approximately 450 basis points, which has had an extremely stimulating effect on the U.S. economy.

Further economic stimulus was provided by Congress and the Bush Administration in the form of classic deficit spending. Aggressive government spending programs were implemented to significantly bolster domestic and military expenditures.

As a result, by 2003, the combined actions of the Federal Reserve, Congress and the Bush Administration resulted in the U.S. economy responding with the highest level of economic performance in over 20 years. Despite very strong GDP growth, unprecedented productivity gains and other factors, inflation remained low, thereby allowing interest rates to reach historically low levels.

However, due primarily to the Federal Reserve's extremely easy monetary policy, the situation is now changing. As the economic recovery continues, the Federal Reserve's approach has shifted toward a gradual increase in the FFR.

The ISM Factory Index is above 58% -- the highest level since 1973. Demand has been reducing inventory as consumer spending reaches levels not witnessed since March, 2000. Steel producers and computer chip manufacturers are hiring employees and opening plants.

Wages, for the first time in several years, are projected to outpace inflation by 0.5% - 1 % in 2005. However, this level of real wage growth has not been perceived as inflationary due to increases in productivity, which has been a major factor in taming inflation. For 2004, productivity increased by 4.5%, which is three times the average productivity rate for the past 22 years according to a Bloomberg News survey. The same survey predicts a 2.0% - 2.5% increase in productivity for 2005. Furthermore, labor costs as a share of corporate income fell to 51% in the third quarter of 2004, down from 55.6% from 3 years ago. This is the lowest level since 1948.

In 1997 and 1998, real wage growth was 2.0% - 2.5% above the inflation rate. Beginning in June, 1999, the Federal Reserve began increasing the FFR, raising the rate from 4.75% to 6.5% by May, 2000. In 1999, mainly due to fears of inflation, the long-term bond market had its worst year in two decades.

The Federal Reserve has begun its gradual approach to raising the FFR back up to at least the pre-emergency easing levels of 3.0%, and is expected to continue to increase rates during 2005. Based upon current economic activity, the U.S. Treasury Bill rate is expected to reach 4.0% and the yield on the 10-year U.S. Treasury Note is expected to climb to 4.75% - 4.90% during 2005.

Unlike the decline in long-term bond prices during 1999, long-term bonds prices have not only remained relatively stable, but have been outperforming bonds with shorter maturities due to minimal fear of inflation in the current economic cycle.

Rising short-term interest rates and relatively stable long-term rates have caused a flattening in the yield curve, reflecting the long-term bond market's confidence in the Federal Reserve's handling of monetary policy and continued productivity gains. Consequently, a flattening yield curve creates more price risk in the short-to-intermediate-term bond portfolios. Although a controlled rise in short-term interest rates will not generally devastate a fixed-income portfolio, it will likely reduce the overall total return of such a portfolio.

In Summary, VTL Associates, LLC believes that the Federal Reserve's current monetary policy of gradual and measured increases in short-term rates will have a neutral impact on the economy. The capital markets have thus far reflected minimal concern regarding inflation. However, in the event employment earnings begin to rise 2.0% to 3.0% above inflation, and productivity gains turn negative, we believe the fixed-income markets will likely sell off aggressively. Therefore, among other economic measures, we will continue to closely monitor both of these economic indicators in the coming months, so that we may continue to provide clients with the professional guidance needed to assist in effectively managing their investment portfolios.