



THE NAVIGATOR REPORT

SECOND QUARTER 2005

Has The Fat Lady Sung?

The title of the last newsletter was "Is it Over???" Of course that referred to the current bull market and I could not use the same title again. But I am sure you understand the above title from the expression, "It isn't over until the fat lady sings." Well, she has not sung yet, but you might think she has from the action of the stock market so far this year. While the Dow Jones Industrials Average has had two rallies of 500 points or more during this year, the average still stands over 500 points below where it began the year. **The Dow Jones Average has declined by 3.65% while the NASDAQ has declined by 5.12 for the year.** That equates to lots of frustration for most investors. That frustration is aided and abetted by the fact that the Dow Jones Average has been held within a small 4% range for 88% of the time over the past 18 months! So the question of the day is, as always, what is going to happen to the markets during the rest of the year and beyond?

Most investors believe that Corporate Earnings is the engine that drives the stock market higher. Earnings have been extremely good for the past several quarters. They have increased at a double digit pace for the past 12 quarters, a recent record. Yet the market, based on the S&P 500, has only recouped about one half of the losses from

the bear market which ended in October of 2002. According to Bert Dohmen, editor of the *Willington Letter*, "The most important factor in the markets is not earnings or all the financial ratios Wall Street analysts cite on national TV. Everyone knows those

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CCMG in the News

June 21, 2005

CNBC Wake-Up Call Chief Investment Officer, Sean Clark appeared as a live guest to offer his opinion on where the stock market will head this summer. Sean's expects oil prices to remain high and interest rates to increase, making the summer a tough time for stock investors. He recommends that investors select ETFs instead of individual stocks.

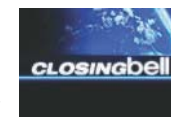


"Those who desire to give up freedom, in order to gain security, will not have, nor do they deserve either one."

Ben Franklin

June 15, 2005

CNBC Closing Bell President Harry Clark, appears as a live guest to discuss Citadel and Merrill Lynch buying a 10 percent stake in the Philadelphia Stock Exchange. Harry gave reasons why each company would want a stake in the exchange.



May 30, 2005



Nightly Business Report Chief Investment Officer Sean Clark, appears in a segment comparing Exchange Traded Funds to Mutual Funds and Index Funds.



May 9, 2005

American Medical News "Personal Finance: Customized Investment Vehicle" Chief Investment Officer



Sean Clark appears in an article discussing the recent popularity of separately managed accounts among physicians.



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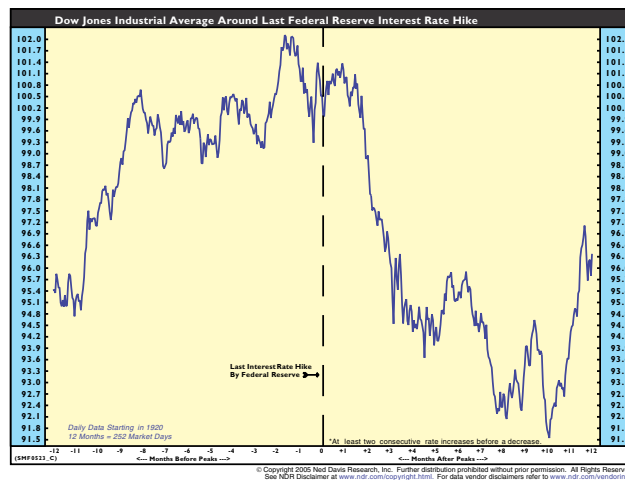
numbers, and what everyone knows is not worth knowing." Economists tell us that all is well with the economy and that earnings are doing just fine. They were saying the same thing in the early months of 1973 just before the devastating Bear Market of 1973-74 began. That bear market saw the Value Line index lose 80% and the S&P 500 lose 48%. In comparison, the bear market of 2000-02 saw the Nasdaq lose 78% and the S&P 500 lose 49%. So, you might ask, "If the economy and earnings don't mean much, what drives the market?" The answer— investor psychology, which determines money flow in and out of the markets. Money flow is what changes supply and demand and that is the only thing that determines market direction. Investor psychology is also what determines individual investment success or failure.

So I suppose the real question is "What events will change investor psychology over the next several months?" **The three items that come to mind immediately are Interest Rates, Oil price, and the Boom (bubble) in the housing market.** While interest rates are still very low by historical standards, the constant increase of 2.25% (from 1% to 3.25%) over the past 18 months is starting to take its' toll. Even though Mr. Greenspan has kept his "measured pace" on rate increases, investors will begin to feel the pinch of higher rates in everything they do. At the same time, we are all feeling the squeeze of higher gasoline and heating oil prices. Albeit the price of crude oil would have to go to about \$90 per barrel to equal an inflation adjusted price of the early 70's. And if the housing bubble gets any further out of hand and bursts, the fallout will affect all or most homeowners. So let's look at each one of these areas!

Interest Rates

The talking heads of Wall Street tell us that the end of the Interest Rate tightening cycle is almost here. They believe that the Federal Reserve will not raise the Federal Funds rate above 3.5% and all will be well. **I wonder how many talking heads, let alone gamblers, would take odds of one in seven in any venture.** Well that is what they are telling us to take when they claim that the Fed will not go too far in this cycle. Over the numerous past years the Fed has raised interest rates three or more times on 14 different occasions. **In 12 of those 14 occasions they went too far and caused a recession.** That means that they were right on only 2 occasions, or 1 in 7 times. And yes, 11 of the 14 times resulted in a bear market. The one glaring exception to the above was in 1994-95 when the market

soared after the last increase. The chart below, from Ned Davis Research, shows market action following the last Interest Rate hike by the Federal Reserve.



Dow Jones Following Last Interest Rate Increase

Another way to look at this is to examine the spread between the Fed Fund Rate and Inflation, as measured by the Consumer Price Index (CPI), as interest rate hikes are ending. **The average spread, at the end of the last six increase cycles, has been 280 basis points. Whereas, the spread today is 105 basis points.** The Fed would have to raise rates another 1.75% to equal the average spread over the years! This will not be the case (I hope) but it does not bode well for the Fed to stop at 3.5% with a 105 point spread. Perhaps 4.25% to 4.5% makes more sense. And we know that investor psychology would not look kindly at that potential in rates. A rate increase to 4.25% would most likely invert the yield curve, (meaning short-term rates above long-term rates) and that would definitely bode ill for the market. In recent testimony before Congress, Mr. Greenspan said, "an inverted yield curve would not have the same negative repercussions as in the past." Is he telling us that he will invert the curve?

The Oil Patch

In the last *Navigator Report* we mentioned that one of the reasons for the rise in oil prices was because the U.S. was filling the Strategic Oil Reserve to capacity. That process should be completed very soon in order to take some pressure from world oil consumption. However another variable has now been added: hurricanes. Currently a major tropical depression is bearing down on the U.S. Gulf Coast, where several hundred oil production platforms are located. There will probably be a short-term spike in crude price as damage is weighed and production is diminished.

But does this matter? Any sudden dislocation in crude oil supply will have a short-term effect on the equity markets. Nevertheless, the real question is **“Can crude oil pricing have a dramatic long-term impact on the security markets?”** Again, history can provide some answers to that question.

In the mid 70’s oil prices increased from **\$3 per barrel to \$12 per barrel**. The bear market of 1973-74 had begun months before oil prices began to escalate, while the bull market that began in October of 1974 totally ignored oil moving to record highs.

Oil prices moved from **\$15 per barrel to over \$39 per barrel** during 1979 and 1980 as the market increased 41%. The bear market of 1981-82 subsequently followed but that was attributed to rapidly rising interest rates that reached 18%. One of the greatest bull markets in history began in 1982 and lasted until March of 2000. During the later stages of the market mania in the late 1990s, **oil prices again doubled**. Drastic increases in interest rates finally killed that bull market and gave us the bear market of 2000-02, whereas oil pricing had little or no effect.

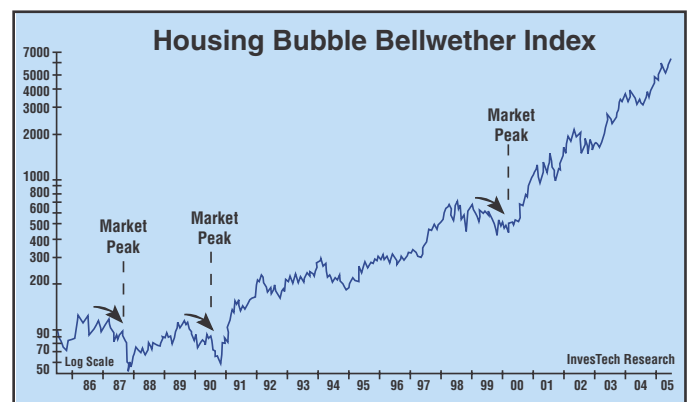
You may have noticed in the above discussion, that while oil prices were rising, the stock market usually also kept rising; but when interest rates rose, market increase ceased.

Conclusion! While oil pricing may have a psychological impact on investors, monetary policy has far more impact on market action than any other factor. Most recently the basic cost of crude oil has almost doubled during the past year while local petroleum prices have increased by about 35%. Thus far the stock market has not been overly concerned with the increase. It is believed that the price of crude oil would have to increase to above \$90 per barrel before any significant economic harm would occur. Psychologically you might be asking, “How likely is that?” You ask that because you, as we all do, cringe every time we fill up at today’s prices, even though it will not change your investment horizon. **According to the Energy Information Administration, crude oil inventories are at a three-year high.** Oil production continues to rise everywhere, and there are still giant untapped oil fields all over the world. Oil demand is softening globally. Overseas, Chinese demand is down more than 50% from last year. China consumes only 6 million barrels per day compared to over 20 million for the U.S. *Most developed countries are trying to prevent recession, since very few economies are booming.* Domestically, leading indicators have declined for

six months in a row, so it appears that our economy will also be slowing. Demand is falling, and, in our opinion, oil prices will also fall. In a recent meeting in London, the Cambridge Energy Institute stated that the world would be awash in oil with 2.5 to 3.0 million barrels a day in overproduction by next year. I can’t wait and I hope it is true!

The Housing Bubble

If anyone doubts that this country is not in the midst of a housing bubble, please look at the following chart from Jim Stack’s InvesTech Research Newsletter.



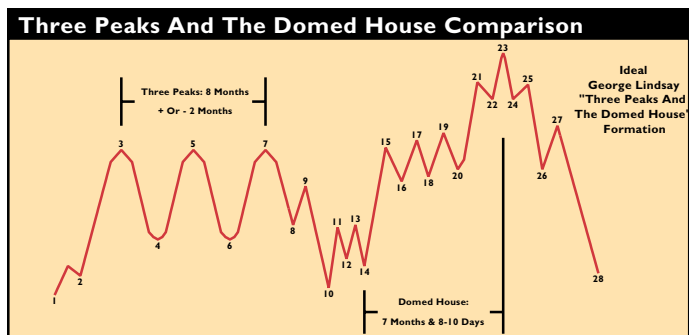
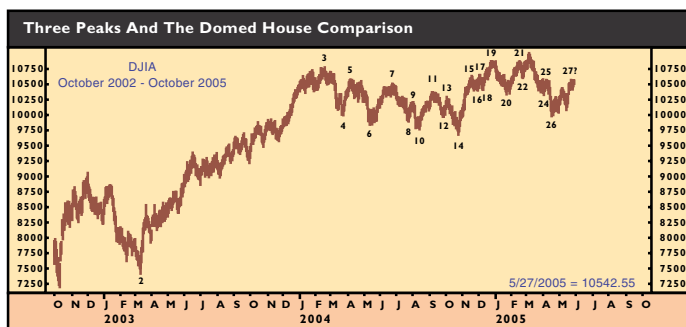
Jim also reports that *The Sacramento Bee Newspaper* (where our comments have appeared in the past) illustrates a UCLA study where they say that the average price for a home in California is now 12 times greater than per capita income. If this is not a bubble, what is? *USA Today* reports that the number of houses for sale, even before they are built has increased by 47%. One writer feels that the Fed might be tempted to raise interest rates .50% in an attempt to cool off the housing bubble and curtail current speculation. Talk about affecting investor psychology!

The Bottom Line

Ned Davis Research reports that at the end of June the Median P/E multiple for the Dow Jones Average was just 6.1% below the extreme optimism level. **The market would have to decline by 28.3% to bring this in line with fair value based on the Median P/E.** Do we expect a decline of that magnitude? Is it possible?

There is a particular chart pattern that some chartists claim every bull market follows from start to finish. The pattern shown below entitled “Three Peaks and the Domed

House" is from a Ned Davis Research Chart (although the Jerry Favors Analysis has done extensive work on this pattern). This pattern was discovered by a famous stock market technician; the late George Lindsey. Some claim that the vast majority of bull markets over the past 150 years have traced out some version of this pattern. This pattern almost always follows a long sideways movement in the Dow. That sideways movement occurred last year from Feb. 19 through Oct. 24. The pattern begins at the prior bear market low. The basic premise is that point 28 will be equal to point 10. The market is between points 24 and 25 currently.



The problem with any chart lies in the interpretation. In the case of the "Three Peaks and the Domed House" chart there are two ways to look at it. If you start the chart from the October 2002 market bottom (which is the proper starting point), it illustrates that the market must decline

to about 7800 to complete the pattern. The time frame for that potential bottom is May or June 2006 from where the next major bull market would begin. In my opinion, this is certainly not a strong possibility. Although, that is about the same decline that Ned Davis mentioned earlier to bring the market to fair value based on the Median Price Earnings ratio. Another interpretation is to use a secondary pattern where point 10 would be the bottom of October 25, 2004. This would give a downside projection of about 9600, which could be a very reasonable target. While it is hard to rely only on specific chart patterns, you have to look at other variables that could influence the outcome. In this case the outcome will be strongly influenced by Federal Reserve Policy as discussed previously.

It is always foolish to make projections because so much can happen to change the outcome very quickly. *If the Fed pulls a hat trick out of the box and stops raising rates now, we could be in for a very nice finish to the year. If they stay the course and raise too far, we could have a very nasty time this Fall.* Since Mr. Greenspan is not going to tell us his intentions, the market will most likely stay on pins and needles. Unless something very positive or very negative happens, the market will probably trade in a neutral range for the remainder of the summer. Ned Davis says that the market will most likely trade between a high of about 20 times earnings and a low of 15.8 times earnings (15.8 is the mean over the last 79 years). Earnings are projected to be about \$65 on the S&P 500. That equates to a high of about 1310 (+8%) to a low of 1030 (-15%).

In any case, we are in the late stages of the bull market that began in October 2002, so caution is the watchword. *I am not trying to be pessimistic, only realistic.* If the markets find new strength and take off to the upside we will participate. If things go south, we will do all in our power to protect capital. The next major bull market in our opinion is anywhere from less than 6 months to a year from beginning but more importantly, it will be essential to protect capital in case this current upswing ends poorly.



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