

## July 2005 Commentary

### Second Quarter 2005 - Market Review

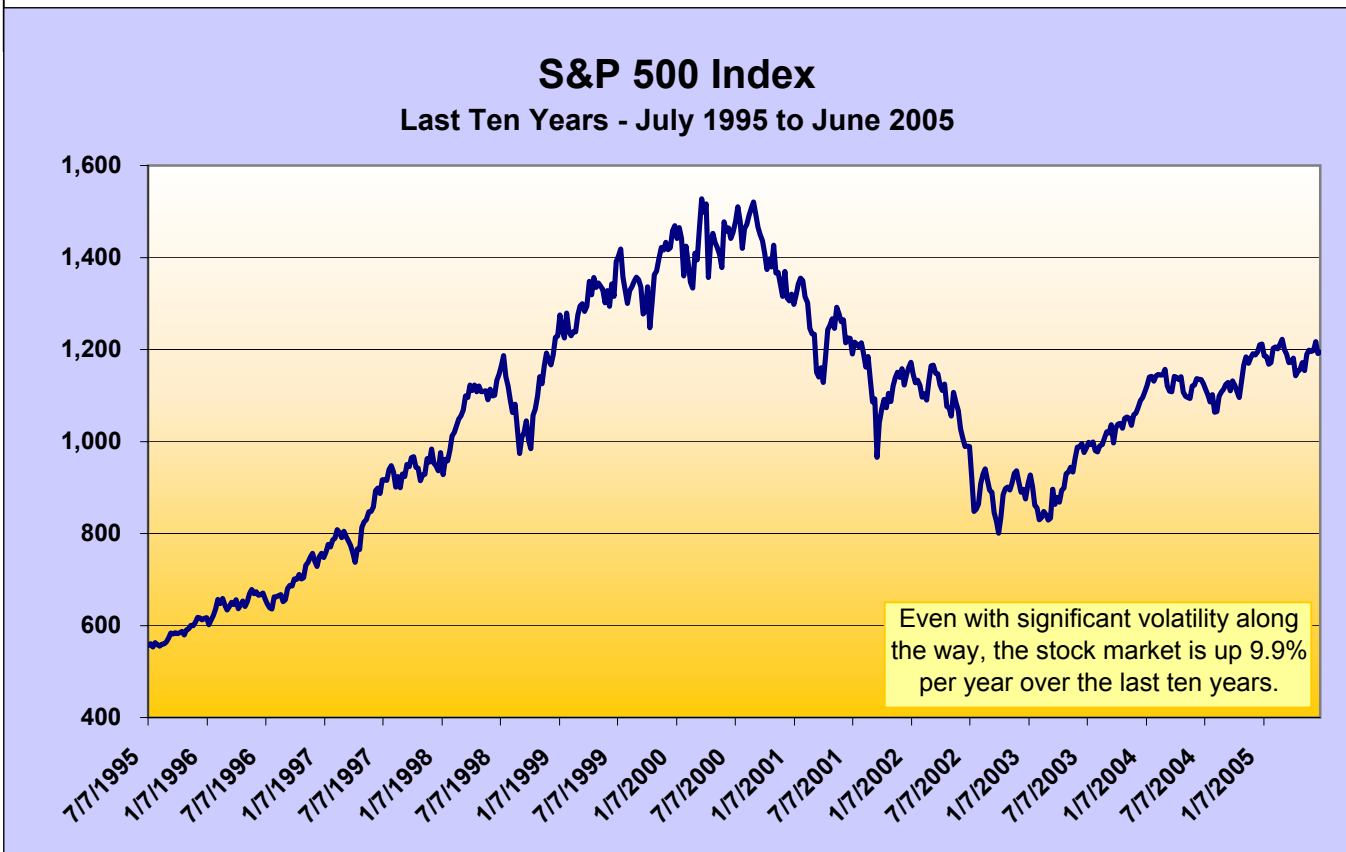
The economy continues to show signs of moderate but healthy growth. While the first quarter was characterized by rising interest rates and gushing oil prices, the second quarter was characterized by falling long-term interest rates and surging REIT (real estate investment trust) prices.

The Federal Reserve continued its interest rate tightening program, ratcheting up short term rates by another 0.50%. After suffering broad losses during the first quarter of 2005, U.S. stocks rebounded the last three months, as widespread fears about inflation eased somewhat. Similar to the first quarter, the Dow Jones Industrial Average ("DJIA") traded within a 600 point range during the second quarter, but briefly tested the lower end of its trading range at the 10,000 level before finishing the quarter at 10,275.

**Large Caps:** The S&P 500 Index gained 1.4% during the second quarter and is up 6.3% over the 12 months ending 6/30/2005. Over longer periods of time, the S&P 500 Index has produced losses of 2.4% per year over the last five years, but has averaged 9.9% per year over the last ten.

**Mid & Small Caps:** Mid-sized company stocks (S&P 400 Index) and Small company stocks (Russell 2000 Index) both rose 4.3% during the quarter. Mid caps have gained 8.5% per year over the last five years and 14.7% per year over the last ten years, while Small caps have posted gains of 5.7% per year over the last five years and 9.9% per year over the last ten years.

"In these matters the only certainty is that nothing is certain." - Pliny the Elder



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**"The minute one utters a certainty, the opposite comes to mind." - May Sarton**

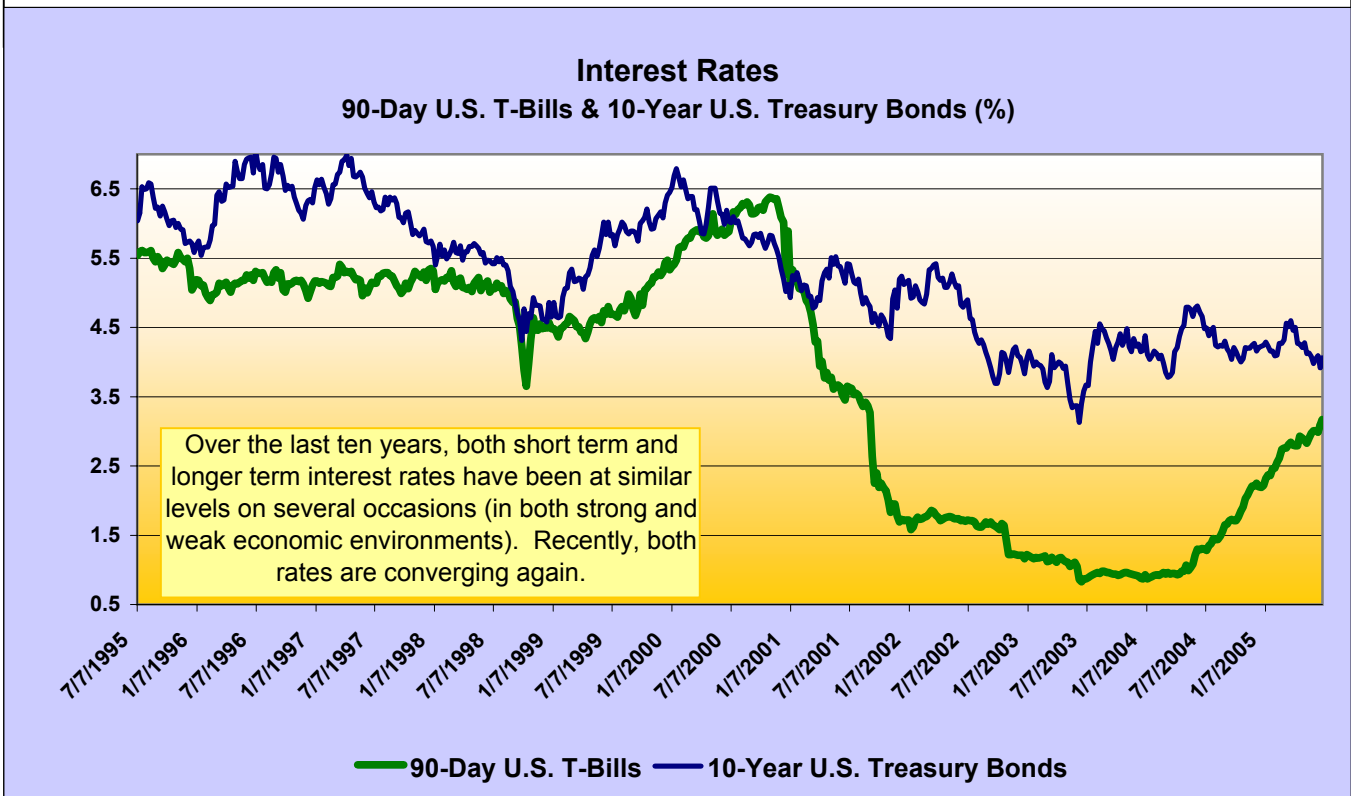
**Real Estate:** It appears that a significant number of Americans now believe that real estate is the best (or even only) long term investment. While Alan Greenspan and many market pundits worry about an overheated real estate market, the prices for REITs and homes just keep going up. Real Estate Investment Trusts (REITs), recovering from a 7.1% decline in the first quarter, rose 14.5% during the second quarter. Over the last five and ten years REITs have produced stellar, and likely unsustainable, annual returns, up 20.5% and 14.9% per year respectively.

**International:** Only one broad area of the financial market fared poorly over the past three months: foreign stocks. The main problem was that the dollar rallied against most foreign currencies causing translation losses. International stocks (MSCI EAFE Index) fell 1.0% in the quarter, led by declines in Portugal (down 9.1%) and Italy (down 4.8%). Norway, Finland and Austria bucked the trend with positive returns during the quarter (up 7.5%, 6.2% and 6.0%, respectively). Looking at the globe as a single market, the MSCI World Index rose 0.4% during the quarter.

**Bonds:** Bonds also enjoyed a surprising rally, thanks to mild inflation news. One spot of weakness was in high yield, as downgrades of General Motors and Ford's debt roiled the market. Government and corporate bonds, as measured by the Lehman Government/Credit Index, rose 3.4% during the quarter. Over the last five years bonds have produced an annual return of 8.0% per year and 6.8% per year over the last ten years. Municipal bonds, as measured by the Lehman 1-10 Year municipal bond index, rose 2.2% in the quarter. In spite of two 0.25% increases in the Federal Funds rate during the quarter, the yield on the 10-year U.S. Treasury bond slid to 4.1% at quarter end (from 4.5% at the beginning of the quarter). Further interest rate increases are still expected in the coming months, but the Federal Reserve is widely expected to be nearing the end of this rate tightening cycle.

**Cash:** Returns on cash continue to be low, but are increasing, as U.S. T-Bills earned 0.7% over the last three months. The chart below compares the 90-day T-Bill yield with the yield on the 10-Year Treasury Bonds over the last ten years. The difference between the two rates is now less than one percentage point, a seemingly narrow spread, but certainly not inconsistent with recent history. Nevertheless, adjusting for inflation, returns on cash have been negative for the last three and a half years.

**Oil:** Crude oil prices fluctuated wildly during the quarter. After falling nearly 20% by mid-May, crude prices rose about 25% to new all-time highs in late June, then settled at about where they began the quarter. The uncertainty associated with oil and other energy products continues to keep economists and investors guessing



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