



Economic and Market Outlook April 2003

Anxiety about the impending and then the actual onset of war in Iraq was by far the dominant factor influencing the U.S. economy and capital markets during the first quarter of 2003. Uncertainty about the implications and outcome of the Iraq conflict caused consumers and businesses to moderate or postpone their spending. Consumer sentiment, retail sales and industrial production all fell during the first three months. In view of the significant success the U.S.-led coalition has enjoyed to date, it appears that the worst-case scenario of a prolonged war will not be realized. One key concern was whether the Iraqi oil fields would be significantly damaged and now that the fields have been secured, the large “war premium” that had been added to oil prices should dissipate. We expect a decline in the price of oil to the mid-\$20 a barrel level, which will act like a tax reduction, thereby reducing a significant expense for businesses and consumers.

While we do not expect the U.S. economy to suddenly take off, we do expect a moderate and sustained acceleration going forward. Consumer and corporate balance sheets, although still leveraged, are in the process of being reliquified. Credit losses could remain a problem for the banking system, but the risk of a major meltdown has diminished. Business inventories are very low and so even a modest improvement in aggregate demand could have a very positive impact on economic activity. The Federal Reserve has made it clear that it is committed to providing an accommodative monetary policy that insures the stability of the U.S. financial system and stimulates economic activity. We remain concerned about the large U.S. trade and current account deficits and expect the dollar to continue weakening versus the euro and the Japanese yen. At this juncture, we believe the risk has shifted from deflation toward modest inflation.

A combination of war fears, a weak economy and cash moving from stocks to bonds caused U.S. Treasury yields to fall to historical lows in the first quarter, which we believe will be their lows for this cycle. Interest rates are expected to move modestly higher, as greater evidence of economic recovery materializes later this year. We expect the earnings of the companies that make up the Standard and Poor’s 500 to grow approximately 10% in 2003. This earnings growth coupled with a 2.5% dividend yield should provide a solid foundation for stocks for the second half of the year.