



Economic and Market Outlook January 2003

Despite a modestly growing economy and the lowest interest rates in forty years, the U.S. stock market produced its third year of negative returns in 2002. We were particularly surprised by how poorly even the traditionally defensive sectors of the market performed, such as energy, healthcare and utilities.

As 2003 begins, investors are confronted with a number of divergent macroeconomic and political issues. The U.S. economy has slowed considerably from its pace in early 2002. Weakening growth, low inflation, Federal Reserve intervention and a reallocation of capital from stocks to bonds have allowed interest rates to fall to their lowest level in 40+ years. Homeowners have taken advantage of the significant reduction in interest rates and the strong rise in real estate prices, to refinance their mortgages and in many cases tap the equity in their homes. While this cash out refinancing activity has provided some borrowers with more capital to spend in the short run, it has also strained their personal balance sheets. Consumer debt has increased to historically high levels and the number of delinquencies has also risen. An increase in unemployment could make it increasingly difficult for borrowers to service their debt obligations in a timely fashion. We do not anticipate a significant further reduction in interest rates and, therefore, believe the refinancing boom has largely run its course. It is clear that consumer spending, which had been the engine of the U.S. economy, has weakened recently as consumers worry about job layoffs and the increased threat of military conflict.

Lower interest rates have not had a salutary effect on corporate spending because profits have been weak. Balance sheets are also leveraged and there is excess capacity in many areas, resulting from the huge capital spending binge of the late 1990's. We do not expect a sustained rise in capital spending until profits and utilization improve meaningfully.

Slowing economic growth has also hurt federal, state and local tax receipts and caused many governments to experience budget deficits, instead of the anticipated surpluses. Further new federal economic programs may have unintended ripple effects. We view reported new tax initiatives with some skepticism, as tinkering with corporate dividend taxation may not provide a sustained equity valuation benefit, and place state and local

governments under pressure to raise taxes, as well as raise interest rates on municipal debt as they attempt to compete for investors' dollars.

The large U.S. trade deficit and suddenly ballooning budget deficit requires the kindness of strangers for funding. Since the U.S. must rely on foreign investment, we believe the dollar may remain under pressure, which could be negative for U.S. stocks and bonds. In addition, on a purchasing power parity basis, the dollar looks overvalued.

We currently believe S&P 500 earnings per share will grow roughly 10% in 2003, after declining 20% in 2001 and possibly eking out a small 5% gain in 2002. However, even our below-consensus forecast could prove to be optimistic, if consumer spending and financial sector earnings are pressured more than we currently expect. Nonetheless, valuations for stocks in general are reasonable for a low interest rate and inflation environment. If earnings can start a sustained recovery with improved quality as well, stocks should, in our view, produce positive returns in 2003. However, given the high level of economic and political uncertainty and the potential risks, we believe the prudent strategy for most of our clients is to err on the side of caution in both asset allocation and stock selection. In addition to our philosophical predisposition towards strong balance sheets, reasonable equity valuations and capable managements (who, of course, candidly and accurately disclose corporate financial circumstances), we continue to emphasize companies that do not require a strong economy to maintain or increase their profits, and will, therefore, provide financial benefit to our clients even in a sluggish economy.