



Economic & Market Outlook July 2003

The U.S. stock market continued its recovery from the lows reached in mid-March, with the Standard and Poor's 500 index producing a total return of 15.8% during the second quarter. The primary stock market drivers were: the success in Iraq, historically low interest rates, and an improvement in consumer confidence and investor psychology.

We continue to believe that the U.S. economy is undergoing a slow, but somewhat erratic recovery. While the recent evidence has been decidedly mixed, we expect signs of a recovery will become more apparent as the year progresses. However, investors who expect a strong cyclical upturn may be disappointed. Consumer spending has been relatively strong during the last few years, bolstered by low interest rates that allowed homeowners to refinance their mortgages, and by large sales incentives offered by automobile manufacturers and retailers. In fact, housing and auto sales have already been running at record levels, although a slowing of sales activity appears to be now occurring. Consumers' balance sheets remain highly leveraged, which should limit their ability to spend above their income growth.

On a secular basis, we are concerned that a structural change in U.S. employment is under way. Job creation is being dampened by several forces: automation of the factory and office, shifting of both manufacturing and white collar jobs to lower cost localities, and a tax and benefits system that encourages companies to export jobs overseas. The strong U.S. productivity growth is great for wealth creation, but slows job growth over the short term. U.S. domiciled engineers, software developers, customer service operators and even lawyers are being replaced by skilled low cost employees on the other side of the world, who often cost a fraction of their U.S. peers. Further exacerbating the problem is a tax system that requires employers to pay a tax (6.2% Social Security tax) on U.S. employees. In addition, the well-intentioned corporate pension and healthcare benefit programs for retirees are under-funded or unfunded, which increases current cash expenditures for retired employees who can no longer contribute to a company's profitability. These under-funded and unfunded costs will remain a drag on employment growth for numerous mature industries like automobile manufacturing, defense, steel, mining and transportation. While the recent unemployment increases are cyclical in nature, the secular forces will prevent, in our opinion, strong job growth even after the economic recovery is on solid ground.

On the capital spending side, low capacity utilization rates and depressed corporate profits are likely to restrain business investment until demand shows steady improvement.

We believe intermediate-to-long-term interest rates reached a cyclical low in June, exacerbated by the Federal Reserve's recent deflation commentary. While there is no question that pricing power is limited because of excess capacity in most segments of the global economy, the risk of deflation in the U.S. remains low in our opinion, given the Federal Reserve's stated intention to reflate through any means necessary. Prices in many areas of the services sector continue to rise steadily, most notably healthcare. Since the lows, the yield on five year U.S. Treasury Notes have already risen by one percentage point. During May and June, we reduced the duration of our clients' fixed income portfolios, where client objectives warranted, by selling long-term bonds and buying higher coupon, callable securities with shorter effective durations. Moreover, depending on client circumstances, we purposefully increased money market holdings instead of exposing client capital to the risks that we see in the long end of the bond market. While the sell off in bonds has thus far been fast and brutal, we expect further upward pressure on rates and corresponding downward pressure on prices and have positioned our clients' portfolios for this scenario. Please call us if you would like a further explanation of your portfolio positioning with regards to bonds and money market instruments.

Despite the weak economic recovery, we expect corporate earnings to grow over the next few quarters, as a result of the significant cost cutting and productivity gains that have been achieved. However, the strong stock market advance has clearly anticipated some of this potential improvement and investor sentiment has become decidedly bullish. The overall equity market is fairly valued, in our opinion, given the earnings recovery underway and our expectations of higher interest rates; hence, we expect five year returns for the S&P 500 to be close to normalized levels of 6-10%.

We expect energy prices (particularly natural gas) to remain stubbornly high because of strong seasonal demand, low inventories and constrained supplies. We think most investors have underestimated the positive impact high commodity prices will have on energy company profits. As a result, we have maintained our investments in exploration and production companies whose earnings and cash flows are leveraged to these higher prices.

In summary, the economic recovery, while subdued, is underway and will drive earnings higher in the second half of 2003 and into 2004. The "spent up" demand in the consumer area and in capital expenditures will cause the recovery to be well below post World War II trends. While parts of the market are grossly overvalued after the most recent run up in stock prices, many other areas are reasonably priced. We continue to find and own superb companies selling at reasonable prices. As always, please call if you would like to discuss our outlook and how it affects you. Questions, comments and your opinions are always welcome.