



Economic & Market Commentary

October 2003

After struggling the last few years, U.S. economic activity accelerated in the third quarter, with Gross Domestic Product (GDP) forecasted to have grown at a significantly above-average rate of 5% or more. Despite the negative headlines regarding jobs, the economic rebound continues to be driven by strong consumer spending, which was bolstered by the recent tax cuts and the benefits of the huge mortgage-refinancing wave. However, we believe the stimulus from these factors will dissipate shortly and, as a result, 2004 U.S. economic growth will moderate to around its long-run average of 3%. We do not expect a big near-term cyclical rebound in capital spending, because of the excess global capacity in many industries, high current levels of productivity and tight operating budgets.

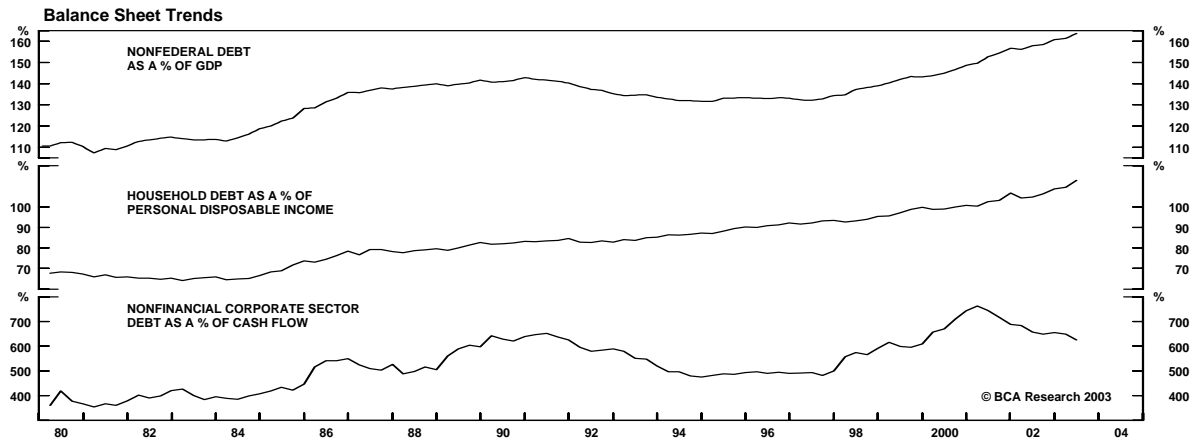
As investors gained greater confidence in the pace and sustainability of the economic recovery, they have shifted assets from relatively low yielding fixed income assets into the U.S. stock market. The Standard & Poor's 500 index produced a total return of 2.7% during the third quarter and 14.7% year-to-date.

The positive corporate operating leverage from an improving economy and the sharp cost cutting that has been implemented over the last few years is having a salutary effect on earnings. Indeed, we have raised 2003 and 2004 earnings estimates for the majority of our companies. Clearly some of the earnings improvement has already been discounted by this year's stock market advance. Given the market's current valuation (19 times estimated 2004 S&P 500 EPS of \$57) and our expectation of rising U.S. interest rates, we do not expect the stock market's price/earnings ratio to rise appreciably. However, we do believe equity prices could rise in line with their earnings growth rate, which should be strong the next few years. Equities should, in our opinion, produce better returns than cash, money market and fixed income securities.

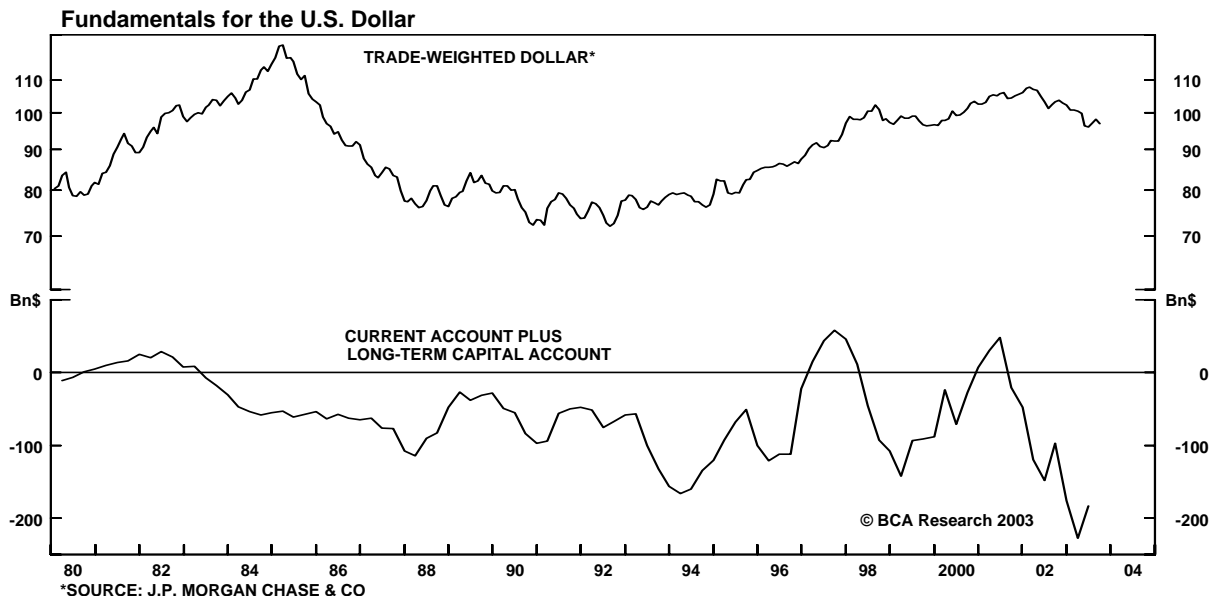
It is not unusual for lower quality stocks to outperform higher quality stocks in the early stages of a market recovery and the last twelve months has been no exception. Nevertheless, the better financial characteristics and cheaper valuations of the higher quality stocks should permit them to reassert their market leadership role.

We continue to have several long-standing economic concerns. First, is the significant increase in business, consumer and governmental debt over the last twenty years, as

shown in the “Balance Sheet Trends” exhibit below. Clearly, higher debt levels raise the risk that borrowers may not be able to adequately service their obligations. Capital that must be used for debt service cannot be used for consumption or savings. We believe high debt levels will act as a governor, limiting the potential growth of the economy.



We believe the dollar is overvalued given the large current account deficit as shown below. While the Bush administration (as with most administrations) is publicly committed to a strong dollar policy (to reassure foreign investors that their investments in U.S. securities, particularly Treasuries, will not be devalued), it appears they would not mind seeing the dollar continue its decline in order to improve the competitive position of U.S. companies. However, since the U.S. savings rate is so low, we must rely on foreign investors to finance our, once again, rapidly growing budget deficit. At some point, foreign investors could decide that there are risks to their dollar-denominated assets or there are more attractive opportunities outside the U.S. securities markets. If foreign investors decide to reduce their dollar exposure, the U.S. bond and equity markets and the dollar would all probably decline. We are monitoring this risk closely and have mitigated this risk by owning positions in the stocks of gold, international and multinational companies and by maintaining relatively short duration fixed income portfolios.



*SOURCE: J.P. MORGAN CHASE & CO