

Market Commentary

Renewed Confidence

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In early March who would have thought that in December we would be wrapping up a year of strong economic growth, continued low inflation and interest rates, and one of the strongest performances by the stock market since the heady days of the late 1990's? Yet that's exactly what happened. How and why did this happen and what is the outlook for 2004?

In March when war with Iraq was just on the horizon, consumer and business confidence was languishing, and the economy was seemingly headed for another year of lackluster growth. Then there were two schools of thought about the economy. One argued that the speculative excesses of the late 1990's were still being worked off, that the debt-laden consumer was pretty much tapped out and there remained huge manufacturing over capacity. Adherents of this line of thinking felt that concerns about a possible war in Iraq were an added irritant but not the cause of continued economic malaise. Countering this position were those who believed that once uncertainty about the war in Iraq was resolved, both business and consumers would unleash tremendous pent up demand driving the economy to new growth.

It seems clear that the pessimists were wrong. Whatever one's feelings were about the wisdom of the war, once early major hostilities were concluded the economy did start showing signs of growth. Unquestionably this growth was stimulated by the tax cuts passed in late May. While economists hold differing points of view about the long-term impact of the tax cuts, few would disagree that the effect was, at least in the short term, tremendously stimulative. This was particularly evidenced by more than 8% growth in the third quarter when the cuts first took effect. Combined with continued low interest rates this put money into people's wallets that they clearly spent.

The stock market's strong performance can be attributed to renewed confidence, continued low interest rates which made fixed income investments comparatively unattractive, and the positive impact of cuts in the taxation of dividends and capital gains.

The stock market was reasonably cheap in early March before the 2003 rally started, but it is hard to argue that on an overall basis it is still a bargain. While the

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market rally has been broad based, it has been led once again by the more speculative NASDAQ stocks and many of the strongest stocks in that group are among the weakest financially. There are numerous other signs of speculative excesses creeping back into the market.

While the return of irrational exuberance is something to worry about, the strongest reason for a continuation of the current rally is the “what’s the choice” argument. With money market rates well below 1% and generally fully taxable, dividends and capital gains taxed at 15% (Federal) look pretty attractive. While it is possible to “buy the market” and be subject to the risks of the overall market, that is by no means the only way or the wisest way to invest. This is one of those times when the best approach is to be highly selective where one invests, sticking to the financially strongest companies and those which pay out real money to their shareholders in the form of dividends.

Looking forward into 2004 we think interest rates will remain low for most of the New Year, and the consensus economic forecasts of 3.5% to 4.5% economic growth with low inflation seem reasonable. We don’t expect high double digit returns on stocks in the New Year, but we do think returns commensurate with the historic average of about 10% are not an unreasonable expectation. We believe this is the kind of market environment ideally suited to our value approach.

Best wishes for the New Year.

January, 2004