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Political, Economic and Capital Markets Review and Outlook for 2003

Summary

- Bush Administration will likely launch an attack on Iraq in early 2003. Short-term objective of toppling Saddam Hussein will be achieved, but U.S. will get mired in supporting a fragile regime. Global terrorist actions will persist.

- High cost of war in Iraq, other major federal government outlays, and tax cuts will stimulate domestic economy.

- Increasing spending on fixed investment, particularly equipment and software, will offset slowing consumer spending. Overall real GDP will grow 3% in 2003.

- Due to expenses and reduced revenues, however, U.S. Government will incur rapidly increasing deficits. Major deficits will lead to rising inflation.

- Government spending and economic growth will drive equity markets up in 2003. Longer term, rising inflation and ongoing global political contentiousness will undermine real returns on investments.

Political Commentary

In our newsletter of October 3, we noted our belief that global politics will be a major factor in the economic and capital markets outlook – both with regard to international concerns (primarily prospective war in Iraq) and domestic issues (particularly federal government fiscal and monetary policies).

With regard to Iraq, it does not appear that the Bush Administration wants effective arms inspections – rather that they want to depose Saddam Hussein in a swift, decisive military action. Unless there is some substantial covert support for him, we believe the U.S. will be successful in its short-term military goals. We are currently witnessing diplomatic posturing with regard to the weapons inspections. Before long, however, we expect the Administration will launch an attack – perhaps as early as next January or February. We believe spending on such an action could be as high as $200 billion, and that some clandestine spending in preparation for this war is already underway. In our view, this expenditure will result in significant domestic economic stimulus, and the impact of such stimulus will be apparent by mid-2003.

Longer term, the situation in Iraq is less clear. If Saddam Hussein is deposed, major internal Iraqi factionalism and armed conflict will likely come to the surface. Therefore, it appears that a strong interim government will have to be established, and that the U.S. would be a primary support of it – such as that currently in Afghanistan. Exactly how this is carried out (directly by the U.S., or through the United Nations) is uncertain, as well as how long such a regime must be in place, or how other developed countries and political groups will react to this scenario. In the face of these actions, particularly if the U.S. acts unilaterally, we expect global terrorist activities will continue, and perhaps increase.

With regard to domestic fiscal and monetary policies, the federal government has recently moved rapidly from temporary budgetary surplus towards renewed deficits. We expect this trend will continue, and that the deficits will widen.

On the monetary side, for well over a year the Federal Reserve has pursued a dramatic series of interest rate cuts to provide generous liquidity to the system. We believe that this will not necessarily stimulate demand, but that it will lead to inflation. The Bush Administration also has expressed a commitment to using tax incentives to stimulate growth. Various proposals are currently on the table. We think the ultimate impact of these, too, will be inflationary.

With regard to fiscal policy, the Bush Administration has stated its intentions to restrain spending. Nevertheless, we expect federal government expenditures will continue to increase rapidly. In addition to the prospective initial cost of war in Iraq, we see the government voluntarily undertaking other major outlays for "homeland security" and prescription drug benefits. Further, we believe the government will be trapped into other costly expenses – the alternatives being politically unpalatable. Specifically, that the government will be required to provide ongoing support for a fragile interim government in Iraq, and that it will find itself enmeshed in other spending requirements, such as for potential bailouts in connection with Argentina or United Airlines.

In all of this, the initial economic impacts of massive federal government spending and lower taxes will be strong and favorable. Increased military personnel will reduce unemployment. Expenditures on a major military campaign will inject economic stimulus into the system. Lower taxes will boost consumer spending.

What is less apparent, however, is the inflationary impact of this government spending. Unless it results in renewed economic vigor, the outcome will be increased deficits with longer-term inflationary impact. What may initially appear as renewed economic growth in 2003, may subsequently turn out to be ongoing economic sluggishness and escalating inflation.

Economic Review

In our October 3 economic review we noted risk of declining economic activity exists during the second half of 2003. This risk remains but looks less likely than previously noted. Slowing growth in personal consumption and residential investment continues to pose a threat to a strengthening economy in 2003. Increased growth in equipment and software investment and federal government spending should offset this weakness, however, and make a significant contribution to our estimated 3.0% GDP growth in 2003.

Consumption continued to accelerate in Q3, jumping 23% from the preceding quarter accounting for 2.9% of the 4.0% GDP growth (preliminary). This acceleration has probably peaked and slower consumption growth for 2003 is likely to contribute about 1.5% to increased economic activity.

Fixed investment should also contribute to increased economic activity in 2003, though contributions from its underlying components will be mixed:

Fixed investment equipment and software component is estimated to add 1.0% to increased economic activity in 2003. Corporations that have delayed investments will have to upgrade software and replace worn-out equipment to maintain productivity in their organizations.

Fixed investment in non-residential structures will continue to slow, resulting in 0.5% decline in economic activity in 2003. A building boom that began in 1999 is now reaching completion. Uncertain economic conditions will further discourage long-term building commitments next year.

Fixed investment in residential structures will slow, though with interest rates expected to remain low we estimate its impact on the economy will be insignificant.

While we expect inventories will remain lean, some continued rebuilding will contribute 0.5% to increased economic activity in 2003.

Federal spending has recently increased while receipts have dropped causing a return to federal deficits. We expect these trends to continue, resulting in widening deficits. State and local government spending growth will slow as decreasing receipts and requirements for balanced budgets force spending cuts, partially offset by higher local taxes. Overall, we expect government spending to contribute 0.5% to economic growth in 2003.

By combining our estimates for consumption, fixed investment, inventories, and government spending, and assuming net exports of goods and services will make an insignificant contribution to economic activity, we estimate 2003 GDP growth at 3.0%.

In addition to our 2003 GDP estimate, we make the following projections: Unemployment will remain around 5.5%-6.0%; inflation will increase to approximately 3%; short term treasury rates will remain low, around 1.5%, while interest rates on ten-year treasuries will rise to 5%+. We expect this steepening of the yield curve to take place over the course of the year.

Capital Markets Outlook

Given the political and economic scenarios outlined above, the nearer term outlook for the equities markets is favorable. Volatility is a given. In 2003, with some initial resolution to the uncertainties about war in Iraq, as well as other government stimulus, we anticipate the stock markets will perform well. By mid-2003, we expect the S&P 500 index will be around 10% to 15% higher than its current level, rising to around 1000 to 1050, and that it will remain in that general range over the balance of 2003.

In this scenario, strong business enterprises that are not much impacted by inflation or economic weakness are attractive investments. In addition, investment in leveraged companies can be favorable – so long as the underlying businesses are basically sound. REITs may fare reasonably well – so long as they operate in areas (geographically or by property type) that are not overbuilt.

We expect foreign equity markets to tag along after those of the U.S. We think the outlook is also good for developing markets (those markets where there is some stability, such as India, China and Mexico, as well as Russia and Eastern Europe).

In 2003, no doubt the Fed will keep short-term rates low. However in the face of rising longer-term nominal interest rates, bonds – both government and corporate – likely will perform poorly. We expect corporate spreads over treasuries to remain stable, around 1.5%, bringing yields on longer-term corporates up towards 7% by year-end. The exception would be high yield bonds. If one can successfully avoid significant defaults, rising economic activity and inflation will make it easier for companies to fulfill their commitments. A turnaround in that sector would lead to generous returns. Since the markets are likely to move in anticipation of declining default rates, we believe high yield bonds (in well-diversified portfolios) are currently timely.

We prefer productive assets to gold or other commodities. In the face of rising inflation, precious metals may help protect investors, but we believe investments in oil, timber or real estate are preferable.

In 2003, we believe cash will be a poor place to be invested, but initially better than in longer-term bonds. GNMAs should outperform Treasuries. For accounts where they won't create tax problems, TIPS (Treasury Inflation Protected Securities) should fare reasonably well.

This provides our outlook for 2003. Over the longer-term, we believe the most likely economic scenario is modest growth. In 2004, however, we anticipate that global politic tensions and a rancorous domestic presidential election will result in a highly contentious atmosphere, with renewed economic stress and volatile, uncertain investment markets.

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