October 15, 2003

THE ECONOMIC OUTLOOK – JOB GROWTH BEGINS

A combination of federal tax cuts and rebates, a very accommodative monetary policy and an unprecedented volume of mortgage refinancings have provided the stimulus for the sharp acceleration in the business recovery we have experienced since the conclusion of hostilities in Iraq last April. Estimates of real GDP growth for the second half of this year, which as recently as late spring had centered around 3 1/2%, have steadily risen to where the consensus, with which we agree, now expects growth to have reached 5%+ in the quarter just ended (more than three times the 1.4% rate of growth in the first quarter) and 4.5% for the current quarter. This underappreciated stealth expansion will, in our opinion, continue into 2004 despite the views of many whose optimism has understandably been tempered by an unprecedented succession of adverse developments since mid-2000.

Numerous pieces of evidence detailing improving conditions in the *business* sector have come to light since our August client letter.

- The Institute of Supply Management (ISM) index of manufacturing activity has shown expansion for the third consecutive month through September. This strength has been confirmed by government reports showing both rising industrial production and factory orders.

- The service sector of the economy continued to advance for the sixth consecutive month in September with the ISM non-manufacturing index rising to 63.3, the second highest reading since this survey was first conducted in 1997.

- Durable good orders for technology products have shown a rising sequential trend growing 1.1% in May and 7.2% in June, followed by 10.1% in July and 12.1% in August.
- Anecdotal evidence of improving business conditions continues to accumulate. For example, American Airlines has begun to recall

furloughed flight attendants as new flights are added. Federal Express has noted growth in US air shipments for the first time in two years. And, railcar loadings of bulk chemicals have shown above-trend increases since mid-summer.

Job Growth and Consumer Spending

The long-missing factor many believe is needed to sustain this advance into 2004 and beyond - - job growth - - was notably absent until last month. On October 3rd, the Labor Department reported that payrolls rose a surprising 57,000 in September, according to a poll of non-farm employers, halting a seven month stretch of job losses totaling 551,000. Employment has fallen because companies have been able to expand with less labor, either by outsourcing a portion of their operations, having their remaining employees work harder, hiring temporary help, and/or applying new technology to improve efficiency. (Recently, productivity has grown at an astonishing 6.8% annual rate, more than double the estimates of what the economy can achieve over the long term). While the September employment gains were only slight, there were other encouraging signs in the Labor Department's report including the smallest drop in manufacturing employment in over a year, the second consecutive monthly expansion in the factory work week, and the fifth straight monthly increase in the hiring of temporary employees. Another positive sign of improvement in the job market has been the recent decline in weekly initial jobless claims which are now at an eight month low when averaged over the past four weeks.

While the Department of Labor survey of business *establishments*, referred to above, shows significant job *losses* over the past year, a separate survey of *households* by the same agency actually shows job *growth* during the same period as laid off employees of major corporations have either found work with smaller firms not included in the *establishments* survey or as entrepreneurs in their own businesses. The continued high level of consumer outlays, in the face of repeated warnings that spending is about to "fall off a cliff", supports our view that the labor markets have probably been stronger than portrayed by the *establishments* survey and that the jobs recovery is already under way. Consider the following:

- auto sales over the past six months have been above the levels reached during the heady days of 1999;

- housing starts and permits for new residential construction remain near record levels, and;

- retail spending at chain stores for September grew at its most rapid pace in 18 months. While September sales for all categories of retail have not been fully reported, overall consumer spending through August was on track to have experienced the strongest quarterly growth since 1985.

In summary, consumers continue to spend and, now, businesses have now begun to add to their payrolls and make investments in capital equipment. While the recovery in the labor markets may not be evident in every future report, we believe employment trends will strengthen and support a protracted expansion. Indeed, our Economic Model (a copy of which is attached as Exhibit I) which meandered from the spring of 2002 through this spring - - a period of sub par growth - - is pointing toward stronger business conditions ahead.

Weaker Dollar

In late September, major G-7 nations announced a significant change in foreign exchange policy. While not explicitly stated, the intent of this shift toward "flexibility" was to gradually weaken the US dollar to address perceived global trade imbalances. Since then, most economic forecasts, including our own, have incorporated projections for a decline in the dollar which has now fallen 8% vs. the yen and 5% vs. the euro since the change in policy was signaled by US Treasury Secretary Snow. So long as the dollar decline is orderly and restrained, it is likely to favor Americans who own domestic stocks with substantial foreign operations. A weaker dollar makes our exports more competitive abroad, strengthening sales and increasing the value of corporate profits when they are repatriated. A weaker dollar also makes imports less competitive against businesses here at home, stimulating sales and corporate profits. Interestingly, for bonds, a dollar decline will make it harder to attract the foreign investment we need to cover the country's $500 billion current account deficit. All other things being equal, interest rates are likely to move higher to attract foreign capital, putting pressure on bond prices.

Corporate Profits

The willingness of businesses to begin making capital investments and add to payrolls is directly traceable to sharply improved corporate profits - - a trend we expect to continue well into next year. The attached Exhibit II shows that while expectations for corporate profits have been improving since the end of the 2001 recession, only recently has there been an acceleration in profit projections as analysts have ratcheted up their economic growth forecasts and incorporated the well above-trend productivity increases we have been experiencing. For the quarter just ended, Wall Street analysts project S&P 500 operating profits grew 14%, a figure we believe is a tad too conservative. Profit growth is likely to be strongest in financial, consumer discretionary, technology and basic materials companies - -all economically sensitive businesses.

Investment Strategy

Given our positive view regarding the outlook for the economy and corporate profits, we remain fully invested in equities, with portfolios now tilted 65% toward *growth* shares and 35% in *value* holdings. We continue to emphasize economically sensitive stocks, even among the *value* issues. Specifically, we have significant weightings in financial, consumer discretionary, technology and industrial capital goods companies totaling about two thirds of clients' equity portfolios. In fact, in the past three months, as we have gained greater confidence in the durability of this expansion, we further added to holdings whose earnings are likely to expand in the more robust economy we foresee. Multinational companies, whose earnings should be positively impacted by the weaker dollar, remain core holdings. This mix of equities continues to perform well relative to our benchmark, the S&P 500 Stock Index. Through October 13th, equity portfolios have advanced about 25.0% (after fees) versus 20.5% for the benchmark this year.

Our fixed income strategy remains cautious with interest rates, in our judgment, still too low to adequately compensate investors for the long-term inflation risks we see. Stronger economic growth, a weaker dollar, rising commodity prices and the substantial but declining deficits we forecast for the next two to three years will, in our judgment, eventually place upward pressure on interest rates. In fact, we now expect the Federal Reserve to begin to tighten monetary policy by the middle of next year since the current 1% federal funds rate is inconsistent with the above-trend economic activity now unfolding. We, therefore, continue to maintain substantial reserves for the purchase of bonds as rates move higher.

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Economic Model

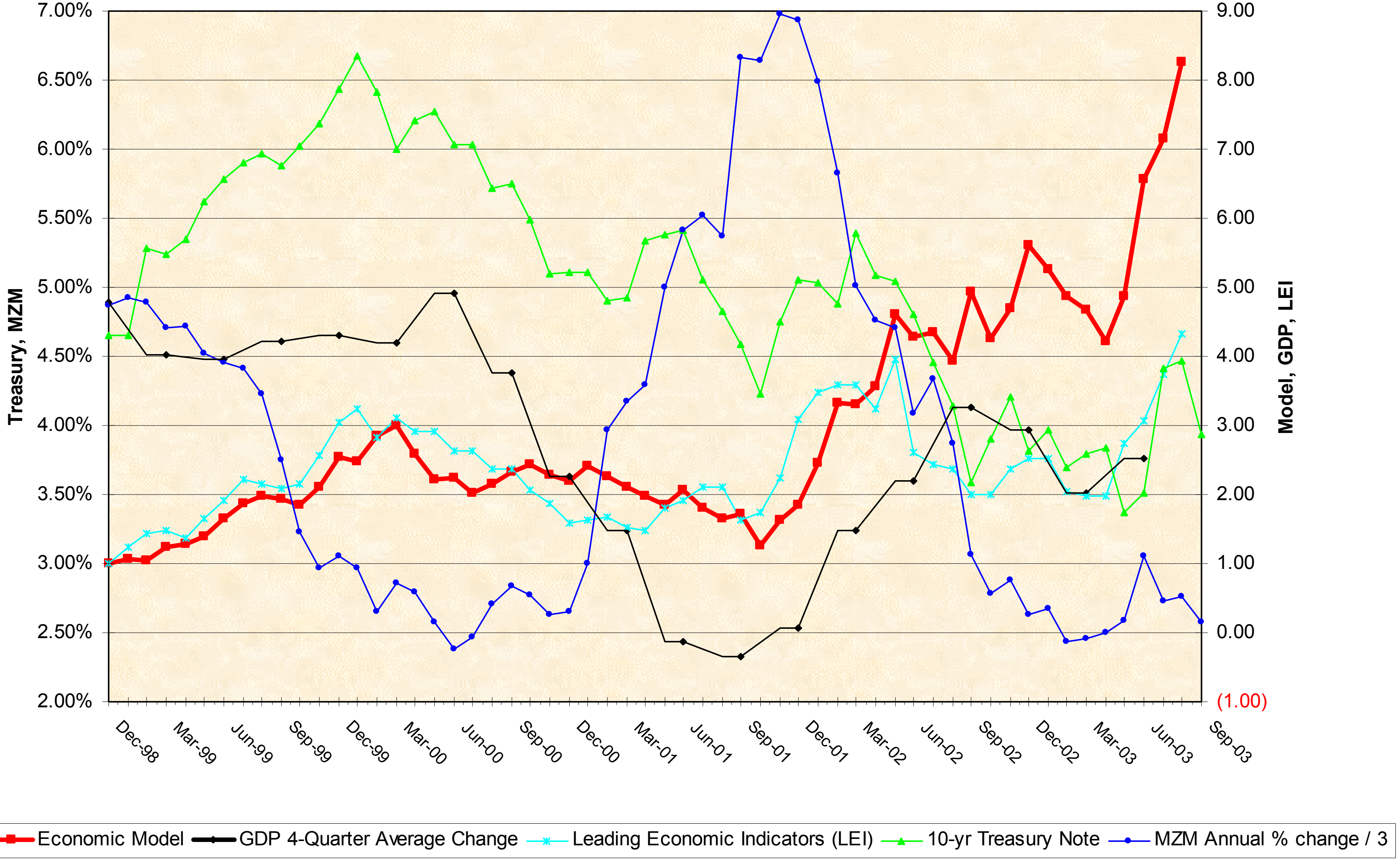
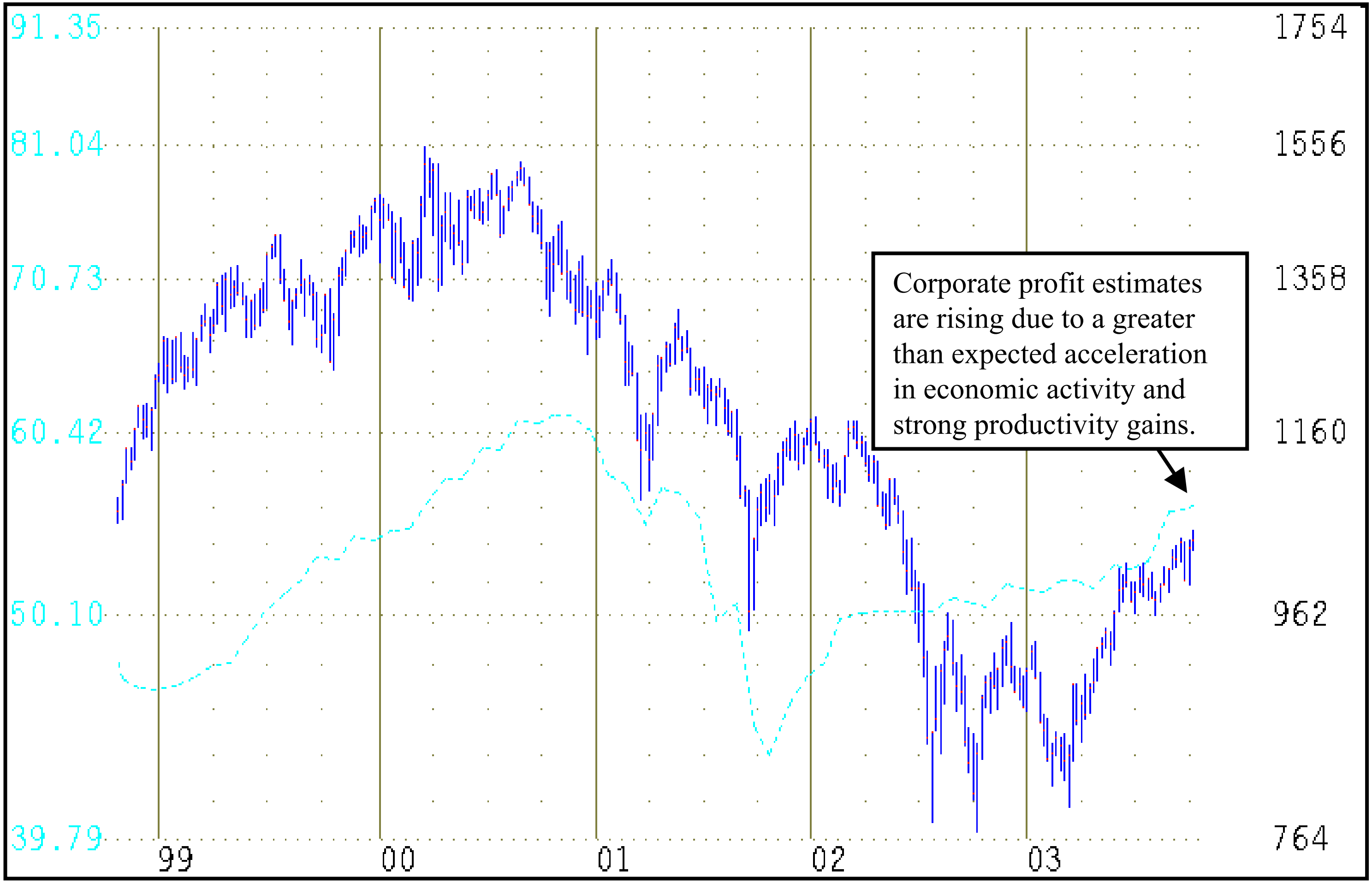


Exhibit II

S&P 500 vs. Consensus Earnings Estimate for the S&P 500



Source: Baseline Financial Services