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SUMMARY

- Stocks rally in fourth quarter.
- 2002 marks third consecutive down year in stocks.
- Stocks likely to advance in 2003.
- Cautious and balanced approach in order.

YEAR END 2002 REVIEW AND OUTLOOK FOR 2003

Stocks closed out 2002 on a constructive and hopeful note to end what turned out to be another grim year for the market. A respectable rally from the low in early October trimmed the losses for the full year.

A significant low in October, followed by a sizeable rally, is very much in keeping with the expected seasonal pattern. The October-November low and subsequent rally also was consistent with the four-year presidential election cycle, which anticipates a low in the latter part of the midterm election year followed by a strong rally continuing into the next year and on through the presidential election year.

Curiously, the rally petered out in the first days of December and did not resume in late December as expected. It is likely that mounting concerns over war with Iraq, nuclear proliferation in North Korea, higher oil prices, and a sluggish economy kept investor enthusiasm under wraps.

Looking at the year as a whole, 2002 marked the third down year in a row for the

Year 2002 Stock Market Performance

	Fourth Quarter	Year to date
S & P 500	7.9%	-23.4%
Dow Jones Industrial Average	9.9%	-16.8%
NASDAQ Composite	13.9%	-31.5%
Morgan Stanley EAFE	6.2%	-17.5%

stock market, a sequence that has not occurred since 1939-1941. This string of down years should convince remaining doubters that the market reversal of March 2000 was indeed one of major importance.

In 2002 the U.S. economy returned to growth after a very mild recession. The recovery, led by consumer spending and a strong housing market, has been markedly slower than following previous recessions. Very low interest rates and heavy discounting have played an important part in spurring

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Year End 2002 Review and Outlook for 2003 (continued)

(Continued from page 1)

economic activity. Business spending on capital goods remained stagnant for most of the year, especially in the tech and telecom arena.

The Federal Reserve kept interest rates steady at a very low level throughout most of the year. Then, in November it cut rates a full half point as an insurance measure against potential economic *deflation*. How times have changed! The Fed has been trying to stamp out inflation since the 1970's and now is doing everything within its power to get it going again. A deflationary spiral *a la* Japan of the past decade, though not considered likely by most, has warranted increased attention and concern.

Undoubtedly, 2003 will hold many surprises, but we have some general expectations regarding the economy and the markets. The Fed will keep interest rates low and provide plenty of liquidity until it is certain that the economy is on firmer footing. The economy should continue to grow and capital spending should pick up. Businesses at some point must begin to upgrade and replace plant and equipment as well as resume spending on information technology. Given that consumer spending and housing have held up right along, we can't expect much more there.

Corporate profits should improve along with the economy. However, there is an interesting divergence developing between prices for consumer goods and services versus capital goods, as noted by the technical research department of Salomon Smith Barney. Prices for **industrial commodities** reversed a 27-year up trend six years ago and have been **declining** ever since. On the other hand, the prices for **consumer goods**, including food, energy and gold, have reversed a twenty-year down trend and

are now **headed up**. To some extent, cheap industrial output imported from developing foreign countries such as China and India helps keep a lid on prices for industrial goods in the U.S. Consumer goods and services that are less exposed to foreign competition will likely continue to experience moderate price inflation. Smaller, domestically oriented U.S. companies could very well benefit from this trend.

As always, the outlook for stocks defies accurate prediction. Only once in the past one hundred years, from 1929 to 1932, have stocks experienced four consecutive down years. However, never has the market experienced a mania to the extent of the 1995 to 1999 period, when stocks rose more than 20% a year for five years in a row.

Looking at the positives, stocks are much more reasonably valued now than they were a year ago, or a year before that. Much of the excesses in inflated stock prices, manipulation of corporate earnings, and naked greed has been exposed and rooted out, painfully, over the past three years. Yet, on the traditional basis of how the market values stocks based on corporate earnings, they remain expensive. (Please see the related article on page 3.)

Our most likely scenario for 2003 and the next few years includes the stock market experiencing cyclical rallies and subsequent declines within a trading range, while a repair process takes place in the aftermath of the stock mania of the late '90's. Hopefully, we have seen the worst of the declines. A buy and sell approach will likely be necessary to participate profitably in the market. The days of buy and hold that worked so well from 1982 to 2000 are probably behind us for a while.

Look for dividend paying stocks

to provide better returns than the high fliers. On a long-term basis, the bulk of returns from investing in stocks has come from dividends and their reinvestment. Most importantly, dividends are hard to fake. For the investor who is justifiably skeptical of announced earnings figures, the dividend offers proof positive. Many corporations are reconsidering their dividend payout policies, and good quality companies that have the ability to increase their payouts could be attractive investments.

There are several questions that investors should be asking and that we hope to see answered more clearly in the year ahead. In a low interest rate environment, what investments can investors needing current income use to get higher yields without taking on excessive risk? Can bonds offer an attractive total return considering that prices are already high and yields are so low? Will money flowing into alternative investments such as real estate and gold, as well as into debt reduction, prevent the stock market from recovering?

We know in the long run that the economy will grow, corporate earnings will grow, and stock prices will follow those earnings higher. That has always been so and will continue to be so. However, for the time being, a careful approach emphasizing preservation of capital is in order. When the market shows us it's ready, we're prepared to respond to opportunities. A balanced investment strategy based on total return from interest and dividends as well as capital gains should provide steadier returns in the year ahead.

Best wishes for a happy, healthy and prosperous 2003.

—Whitney Brown

INFLATION...in Stock Prices...and Why We're Cautious

Anyone over 40 remembers the commodity price inflation of the 1970's. An ounce of gold during 1970 traded hands between willing buyers and willing sellers at an average price of \$36. Ten years later during 1980 that same ounce of gold traded at an average of \$612!

Saudi crude oil climbed from \$3 a barrel in September 1973 to as high as \$40 in 1980. And many other raw materials — tin, silver, rubber, cotton, to name a few — rose to very high price levels.

From the early 1980's to the year 2000, common stock prices increased at a well above average rate, due mostly to investors' increasing willingness to value a dollar of corporate earnings at a higher and higher multiple of those earnings... kind of like they did for an ounce of gold in the previous decade.

The most commonly used measure of equity valuation is the Price-to-Earnings Ratio (or P-E Ratio). This ratio defines the relationship between the annual earnings per share (eps) of a stock (or a stock

index) with its price at any given time.

The formula is: $\text{Price} \div \text{eps} = \text{P-E Ratio}$. For example, a \$20 share price \div \$1 of earnings per share = a P-E Ratio of 20. Similarly, another company also having a share price of \$20, but with \$4 per share earnings, has a P-E Ratio of 5 times earnings ($\$20 \div \$4 = 5$).

Naturally, one would prefer to receive \$4 rather than only \$1 of earnings for a \$20 investment (all else being equal), just as one would prefer to buy 1 oz. of gold for \$36 instead of for \$612, or a barrel of crude for \$3 instead of for \$40.

Willingness on the part of buyers to pay higher and higher prices generally reflects optimism that they will be able to sell their purchases at an even higher prices in the future. This optimism commonly is called **speculation**.

Ned Davis Research has put together for us the chart below, which provides some long term perspective. It displays three graphs for S&P 500 Stock Index data from 1936 through 2002: the S&P 500 price index itself,

its P-E Ratio at the various quarters-end; and its quarterly earnings.

Looking first at the Price to Earnings Ratio (middle clip), one observes that since the end of World War II the ratio has moved up and down in long alternating waves of 13 - 20 years.

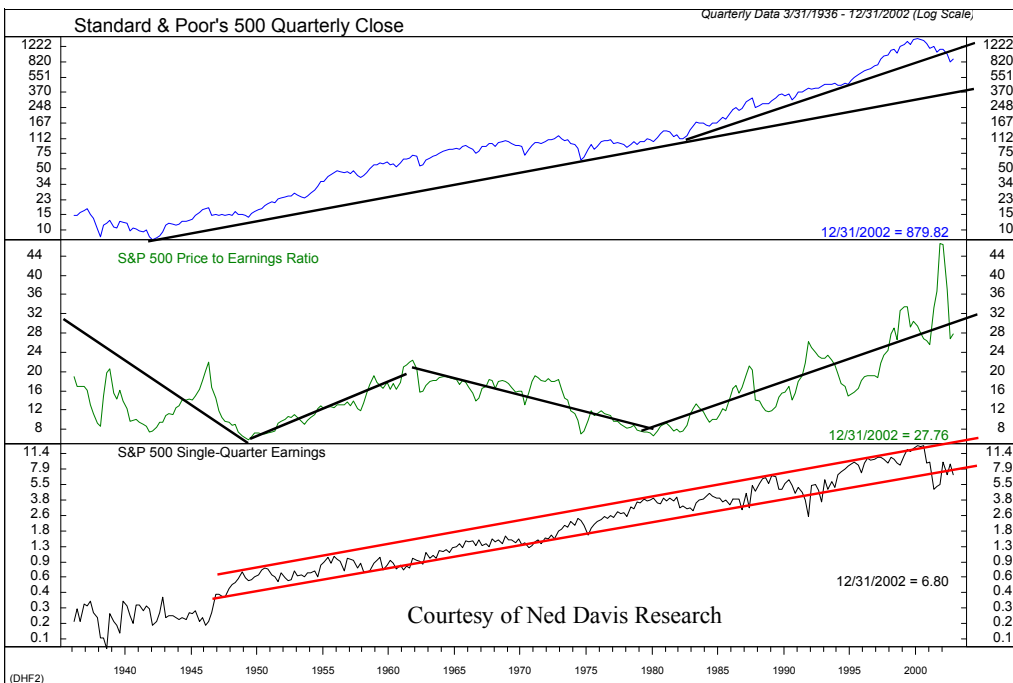
In the most recent wave, beginning in the early 1980's, the ratio rose from about 8 times earnings to over 40 times by the year 2000. **This was stock price inflation, caused by increasing speculation.** Today the P-E Ratio is about 28 times earnings, still above historic secular highs of around 22 times, as indicated on the graph.

The S&P 500 Single-Quarter Earnings clip at the bottom of the graph shows that corporate earnings growth has been surprisingly stable over the past 50 years. It has fluctuated year-by-year; but its fluctuations have been within a relatively narrow band. However, the P-E Ratio middle clip shows that, since 1980, investors have been willing to pay an ever higher price for this same stable earnings growth rate.

Where does this analysis lead us? Certainly, some caution is in order. Since early 2000, investor enthusiasm for stocks has moderated. Earnings growth has slowed (bottom clip), and the S&P 500 has fallen below its eighteen year uptrend line (top clip). Investors are valuing \$1 of S&P 500 earnings at \$28 (middle clip), well below the peak in 2000, but still at a very high level historically.

In the final analysis, corporate earnings and the value that investors place on those earnings will determine the level and direction of stock prices.

—Walter Dixon



INVESTMENT OUTLOOK

GOLD, ANYONE?

Throughout history gold has been an alluring metal, but finding large enough quantities worth mining has been a very rare occurrence. As an investment, gold has a clique of diehard supporters. However, most analysts feel the price of gold is too difficult to predict and probably not worth the trouble. Moreover, it is a “pessimist’s” investment and therefore generally unappealing to most investors, who are by nature optimistic.

There are several ways to invest in gold. Physically taking possession is one method; and coins such as the South African Krugrand, the Mexican 50 Peso, and the Canadian Maple Leaf are popular. More mainstream ways of investing are through gold stocks, mutual funds, and futures contracts.

Major factors that tend to drive up gold prices are fear of war, political instability, and inflation. Conversely, moderation in world tensions and lower inflation tend to cause a decline in prices. When interest rates are high, it can be expensive to carry gold as an investment. Unlike most stocks and bonds,

gold pays no dividend or interest. Its return comes entirely from increase in value. Historically, its price has been quite volatile, but occasionally it has provided an investment hedge during periods of extreme unrest.

Goldbugs believe that paper money is inherently unstable and eventually will be discredited. They believe gold will be the universal exchange medium of choice.

As a long-term investment, gold has significantly under performed common stocks and bonds for the last twenty years. Even so, some investment professionals believe that it should continue to play a small role in well diversified portfolios. However, gold mining stocks tend to produce erratic earnings, thus making traditional analysis particularly difficult.

Since the early 1980’s, the price of gold has been in a long-term bear market. However, it may have formed a substantial base during the past two years; and its prospects for appreciation appear better now than at any time since the ‘70’s. —Watt Dixon

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