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SUMMARY

- Stocks rally.
- Cyclical bull market underway.
- Interest rates continue to fall.
- Positive outlook for remainder of 2003.

SECOND QUARTER 2003 REVIEW AND OUTLOOK

by Whitney Brown

Ah, what a relief it is, like an oasis in the desert. The stock market rallied with conviction for three months from mid-March to mid-June. The S&P 500 just delivered its best quarterly return since 1998, rising nearly 15%. Measures of market health such as breadth (number of stocks participating) and volume (number of shares traded) looked better than they have in several years.

Remarkably, bond prices rallied, too, as interest rates took another leg down. At quarter-end we found ourselves in the midst of an orderly pull back in the stock market, as well as a backup in bond yields; but the indications are that the market will resume its rally after this summertime pause.

Though not wanting to seem picky, we can't help but dig a little deeper into the nature of this most welcome rally. Technical analysts of the market, to whom we feel a

Market Measures		2nd Quarter	Year to Date
S & P 500		14.9%	10.8%
Dow Jones Industrial Average		12.4%	7.7%
NASDAQ Composite		21.0%	21.5%
Morgan Stanley EAFE		18.1%	7.7%
Lehman Bros. Intermediate T-Bond Index		1.6%	2.3%
	<u>6/30/03</u>	<u>3/31/03</u>	<u>12/31/02</u>
10 Year Treasury Bond Yield	3.52%	3.80%	3.82%
90 Day Treasury Bill Yield	0.83%	1.09%	1.17%

kindred spirit, would have us believe that we are experiencing a much anticipated bull cycle that could last up to a year or longer. That is good news; but their bad news is that the cycle is occurring within a secular bear market that could last many more years and even take the market below the lows of September 2002.

The robust rally reflected in the market
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Second Quarter 2003 Review and Outlook (continued)

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averages has not been experienced fully by all investors for a couple of reasons. Foremost is that the strongest stocks in the rally have been exactly those which inflicted the most pain over the past three years.

The notorious TNT stocks (tech, internet and telecom) that dominate the NASDAQ have led the way up. Many investors understandably are

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no longer involved with these stocks and have been reluctant to get reacquainted. After rebuilding portfolios of a kinder, gentler nature (more value and defensive issues), many investors have experienced positive returns in the rally, but not on the order of what the market averages would lead them to expect. Also, after three years of decline, the typically risk averse investor probably isn't as heavily invested in stocks as before.

Why is the market rallying? The sluggish state of our economy would not seem to justify the optimism reflected by the market. Our technical analyst friends mentioned above tell us that prices move ahead of the fundamentals; and by the time we know why, the opportunity or threat has passed. What matters most is acting in sync with the market. In the kind of long-term environment we anticipate, most investors will need to change their mindset in order to be successful. Please see the accompanying article

on pages 3-4 for more on coping with a bear market and low interest rates.

Looking ahead to the second half of the year, a number of positives should continue to help investors in the short run. The Bush tax cut reduces rates on dividends and capital gains, making stocks more attractive as investments and as instruments of corporate finance. The tax cut also enables marginally more consumer spending without the need for taking on more consumer debt.

The lowest short-term interest rates since the Eisenhower administration may not spur much additional borrowing. In fact, lower rates hurt savers and those depending on interest income, but they send a loud, clear message that the Fed intends to nip the threat of deflation and get the economy going. Lower rates also make the potential return from stocks relatively more appealing than bonds or cash.

The decline in the dollar, as long as it remains orderly, makes U.S. goods more affordable abroad, which bodes well for our economy. The dollar has declined to a more normal level relative to other currencies, and U.S. dollar denominated investments are still attractive to foreign investors.

However, there are serious issues to confront in the longer term. Our economy is swimming in debt, both consumer and corporate. A lower interest rate makes debt easier to service but doesn't change the fact that debt comes with interest expense. Consumers and corporations can take on only so much leverage before it becomes counterproductive. Also, when

interest rates start going up, so will interest expense.

The Fed, determined to prevent deflation, may be setting the stage for future inflation. The monetary spigot is wide open and will stay that way until the economy shows more definitive signs of sustained growth. Burgeoning federal deficits will be financed by Treasury debt, and other borrowers may find themselves

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having to pay much higher rates of interest in the future.

Finally, stock valuations remain high. While stock prices have rallied strongly, price-to-earnings ratios and other traditional measures of stock value never declined to levels historically associated with significant market lows. New economy and paradigm shifts notwithstanding, the historical record calls for much higher earnings, much lower prices, or both before we can expect another long-term bull run.

All of the short-term positives, long-term negatives and imponderables aside, this past quarter of market rally has provided a much needed respite from three years of decline. The market is running in tune with the established four-year cycle that predicts an up year for stocks in the year prior to a Presidential election. We expect stocks to move higher in the second half after a breather in the third quarter. And, we expect interest rates to remain low.

Finding Investment Returns in Today's Environment

by Walter Dixon

Good investment returns have been hard to come by during the past three years. Capital appreciation in equities has been almost nonexistent. Even after the rally since March, stock prices are back only to where they were in early 1998. Dividend yields have improved a bit, but due mainly to lower stock prices, not to dividend increases.

Interest rates have continued to decline. As bonds bought at higher rates several years ago mature or are called for early redemption, the proceeds must be reinvested in new issues at ever lower rates. And unless interest rates go back up, this problem will only get worse.

Before recapping our outlook for both stocks and bonds, let us put our own limits on two terms we have used, and will be using, in these letters:

Secular – very long term, lasting at least several years and possibly decades

Cyclical – long term, lasting many months, if not several years

We believe that the secular bull market in equities that started in August 1982 came to an end in March 2000. We're now in a cyclical bull market, retracing a portion of the loss since March 2000, that may last 12-24 months. While we do not think there is imminent risk of a major decline in prices, it is possible that the market may not go very much higher than it where it is currently.

The secular bull market for bonds is still intact; i.e., interest rates are still going down. There has been a rise in long term rates in the past several weeks, but the major downtrend continues.

So with stock prices probably in an extended downtrend, interest rates still falling, and yields on money market funds around 1%, how should we invest our money? In the stock market, strategies that worked in a secular bull market likely will be losers in today's environment. We need to make some adjustments.

Common Stock Strategies

1] Lower the equity ratio in a balanced portfolio.

In a secular bull market, such as from 1982-2000, maintaining a high percentage of assets in equities is eminently appropriate. In fact, it usually is the single best investment decision that reasonably and simply can be made.

However, in a secular bear market, holding a high percentage in stocks obviously is hazardous. It is much harder to swim upstream than to float downstream with the current.

2] Take advantage of a range for allocation to equities within a balanced portfolio.

In a secular bull market, a range for equities, say 50-75% of the portfolio, is established, with a target set at 65%. Stocks rise above or decline below the target within the range as the market goes through its cyclical advances and declines; but at least 50%, and usually closer to 65%, is more or less permanently committed to equities.

In a secular bear market a dynamic range of 30-60% without a target percentage may be more appropriate. Secular bear markets have cyclical rallies, significantly strong in extent and long in duration, in which to buy stocks with a shorter holding period than long term. The table below, covering the 20th century, is courtesy of Ned Davis Research.

The seventeen cyclical bull markets

<u>Cyclical Bull Markets</u>	<u>Total # Cases</u>	<u>Extent % Gain</u>	<u>Duration # Days</u>
Median within All Secular Markets	33	66%	573
Median within Secular Bulls	16	77%	870
Median within Secular Bears	17	51%	371

-Courtesy of Ned Davis Research

within the three secular bear markets of the 1900s averaged 51% in extent and over one year in duration. This information is significant; and we should be able to make good use of it.

The idea in mind is to increase the commitment to stocks in the earlier stages of a cyclical advance and to reduce the commitment as the rally runs out of steam. Buy low and sell high, if you will. Being selective about entry prices, setting mental stop loss limits, not letting small losses turn into big ones, and being willing to take gains when they come quickly all require a mindset different from buy-and-hold.

3] Increase dividend income.

In the core equity holdings, that which is not part of the dynamic range described above, a larger proportion of the total return should come from dividend income, since capital gains are less certain. For those issues purchased during the cyclical bull markets as part of the dynamic range, capital appreciation should be the primary objective.

4] Look for special values among regional issues and hybrid securities.

Such issues are often below the radar screen of the giant fund managers and may be underpriced compared to more widely known companies. They may provide opportunities for good income, as well as capital gain, without having to sacrifice financial quality. Regional banks and closed-end funds are some examples of such investments.

Fixed Income Investments

Interest rates are still going down, posing reinvestment

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Finding Investment Returns in Today's Environment (Continued)

(Continued from page 3)

problems for bond holders, in addition to loss of unrealized capital gain when issues are held to maturity. Many investors have bought low quality speculative bonds in an effort to keep yields up, a decision that seems generally inappropriate for most of our clients.

There are several options open to us that offer some relief from low interest rates:

- 1] Sell bonds maturing in 12-18 months, capturing unrealized capital gain, and reinvest in longer maturities (known as "rolling down the yield curve").
- 2] Sacrifice some liquidity for additional yield from good quality issues. These are often found in smaller issues of regional entities and bank certificates of deposit.
- 3] Consider moderate trading in some long maturity bonds for capital appreciation and enhanced income.
- 4] Use other types of income producing securities on a limited basis, such as preferred stocks, closed-end bond

funds, exchange traded partnerships, and other special purpose issues.

Income Tax Issues

Beefing up dividend income calls for close attention to the income tax consequences in most personal portfolios. Federal income tax legislation passed in May reduced the tax rate to 15% on most dividend income (effective January 1) and on capital gains (effective May 6). While these reductions are welcome, the Alternative Minimum Tax continues to make tax planning difficult.

For individuals, the *after-tax* return is their primary consideration. Close coordination with clients and their tax advisors will be important.

Since the year 2000, the investment environment has been very different from the 1980's and 1990's. The stock market has declined significantly, and interest rates have plummeted to levels not seen since 1958. Even so, current conditions are not without precedent. Studying the past, we find guidance for the future; and we welcome the challenge.

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