

DIXON, HUBARD & FEINOUR, INC.

INVESTMENT COUNSEL

601 S. Jefferson Street, Suite 410
 Post Office Box 2768
 Roanoke, Virginia 24001-2768
 Telephone (540) 343-9903
 Fax (540) 343-7684
 www.dhfinc.com

SUMMARY

- Stocks gain for the quarter.
- Bond yields bounce.
- Economy improves.
- Bullish cycle for stocks to continue.

THIRD QUARTER 2003 REVIEW AND OUTLOOK

by Whitney Brown

In the third quarter stocks extended their gains from the previous quarter but at a more leisurely pace. The S&P 500 and the Dow Industrials tacked on a relatively modest 2.2% and 3.2%, respectively. The more speculative NASDAQ added a robust 10%. International stocks pulled ahead of the U.S. for the year to date.

Gains, whether modest or robust, are a welcome change of pace from losses which are what most investors had become accustomed to during the prior three years of bear market misery. The quarter was marked more by what did not happen than what did. Although there was a mild pullback, stocks did not undergo a major sell off. Previous rally attempts since the March 2000 peak had met that fate. Investors now appear to be more willing to hold their positions. This implies an expectation of higher prices.

The real excitement during the quarter came when bond yields spiked sharply from extremely low levels reached in June. The back up in yields was triggered when bonds sold off after a smaller

than expected rate cut from the Federal Reserve. Investors saw the market prices of their bond holdings plunge, and some analysts were announcing the end of the twenty-plus year bull market for bonds. By the end of the quarter, yields had settled back down but not all the way to the summer lows. The long-term downtrend in interest rates, as indicated by bond yields, remains

(Continued on page 2)

Market Measures	3rd Quarter	Year to Date	
S & P 500	2.2%	13.2%	
Dow Jones Industrial Average	3.2%	11.2%	
NASDAQ Composite	10.1%	33.8%	
Morgan Stanley EAFE	7.6%	15.8%	
Lehman Bros. Intermediate T-Bond Index	0.1%	2.5%	
	<u>9/30/03</u>	<u>6/30/03</u>	<u>12/31/02</u>
10 Year Treasury Bond Yield	3.94%	3.53%	3.82%
90 Day Treasury Bill Yield	0.92%	0.83%	1.17%

Third Quarter 2003 Review and Outlook (continued)

(Continued from page 1)

intact, but the magnitude of the back up was significant enough to raise the question of whether or not we are beginning the transition from a very long period of declining rates to one of rising rates. Please see the related article on the next page.

Some Wall Street pundits have voiced concerns over a resurgence of excessive speculation as evident in the 34% year-to-date gain in the NASDAQ. They fear an “echo” of the bubble of 2000. However, there are reasons for the investor optimism expressed by the last two quarters of broad market gains. Foremost is the very accommodative stance of the Federal Reserve. An old Wall Street adage is “don’t fight the Fed,” and Job One at the Fed now is to prevent a deflationary recession by keeping short-term interest rates very low and pumping up the money supply. The Fed will keep monetary policy very easy until the economy is well back on an expansion track. The results should be a growing economy, improving corporate profits, and inflation. Those conditions are good for stocks but probably not for bond prices, especially if interest rates start to rise in earnest.

Additional cause for investor optimism lies in the revival of spending. Corporations have started to increase spending on capital goods, and consumer spending has held up all along. The weakness in the labor markets has been disappointing but is expected to improve as other economic indicators continue to show expansion. Furthermore, the decline in the dollar relative to other currencies has caused some short-term concerns but ultimately will cause U.S. goods to be more competitive globally. Small cap stocks usually benefit more from a declining dollar than large caps.

There are other factors at work that tend to favor small caps over large caps at this time. Small caps usually perform

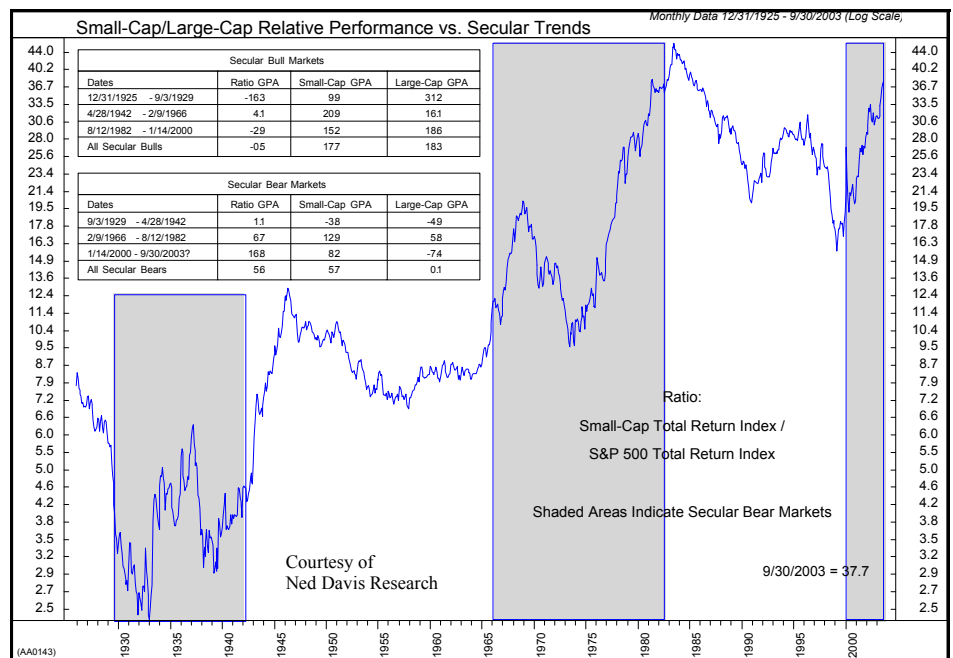
better as the economy comes out of recession. The current recovery has been no exception. From a longer perspective, small caps tend to outperform large caps in secular bear markets. The chart below illustrates the relative performance of small cap versus large cap stocks since 1925. A rising line indicates that small cap stocks were providing better returns than large caps, and a falling line indicates the reverse, large caps outdoing the small. The shaded areas represent three secular bear markets, the two of the twentieth century and the current, unfinished one. In all three the total return on small cap stocks bested the large caps.

It is not reasonable to expect that all the ill effects of the spectacular boom and crash that capped off the great bull market of 1929 to 2000 could be remedied in three short years, or that the market would be ready to start another 18-year bull run. Stocks remain richly valued by many measures, including P/E ratios. Indicators of investor sentiment, currently very optimistic, never reached the extreme levels of pessimism associated with long-term market

bottoms. Debt levels among corporations and consumers remain alarmingly high. But, analysis of historical market patterns does show that we can expect significant bull cycles within a long-term, or secular, bear market. Analysis further shows that a typical bull cycle in a secular bear market can last 12 months and generate gains of 50% from trough to peak.

Looking ahead, we can expect stocks to finish the year at higher levels, though a stiff correction along the way is a distinct possibility. We’ve escaped the usually poor third quarter in good shape, but October has been known to deliver some very nasty surprises. The market action so far this year continues to track the four-year stock market cycle based on the Presidential election year, explained in the April [Investment Outlook](#). Interest rates may spike higher again, but a sustained upward trend in rates will probably not begin until the latter half of next year.

These are interesting times, and, as always, we remain flexible and alert to both risks and opportunities.



GOING WITH THE FLOW...but which way are we flowing?

by Walter Dixon

It's easier to swim *with* the current of a river than *against* it. A rising tide lifts all boats. Go *with* the flow.

Investment Rule No. 1: Invest *with* the long-term price trends of the securities markets, not *against* them.

Most of our clients—at least those who regularly read our newsletters—know that we try to invest in sync with the long-term price trends (to us, anything longer than fifteen years is “long-term.”). With hindsight, these extended cycles are easily discernible, as the graphs in the April '03 [Investment Outlook](#) showed. (They are reproduced on this page for those who missed them.)

The 1979-82 period was a time of major transition in the securities markets. Stock and bond prices reversed their long-term declines, as the graphs clearly show. During these couple of years:

- Stocks ended their nearly 17-year bear market, during which prices had dropped 75% in real (inflation-adjusted) terms. In late 1982, the major stock market averages exploded upward, starting a 15-fold increase to a peak seventeen years later, in 2000.

- Bond prices finally ended their very long 37-year bear market. Interest rates started down (see graph), and bond prices started climbing in earnest.

- Money market rates, which had been rising since the 1950's, topped out at 17% and started their long decline to the 1% rate we have today.

- Gold hit \$800 an ounce. The price then began eroding, losing over two-thirds of its value to \$250 an ounce by 2000.

The long-term cycles that began in the early 1980's were *strongly positive* for stocks and bonds and *strongly negative* for money markets and gold.

So where are we now?

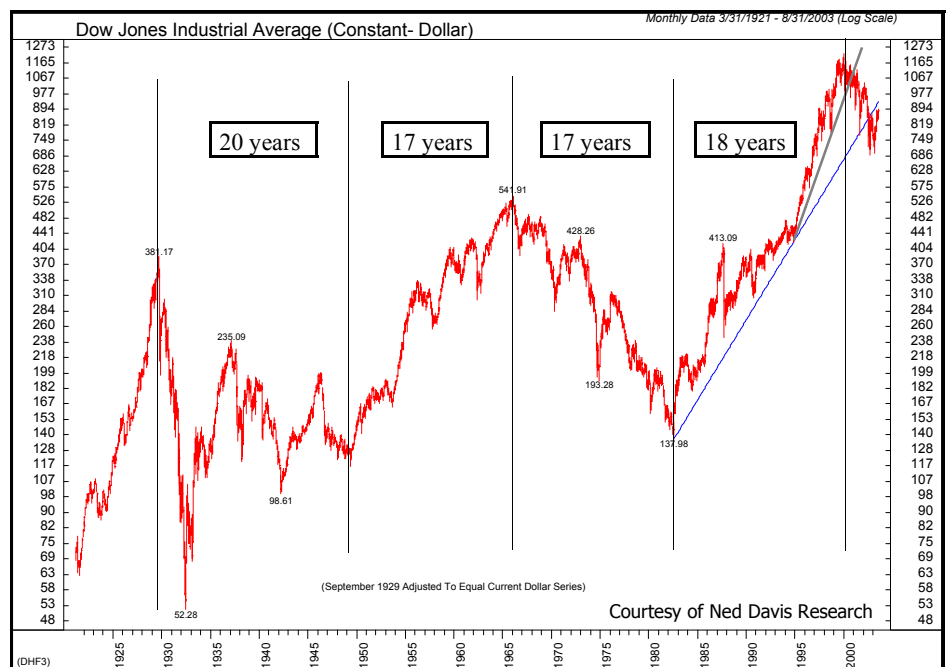
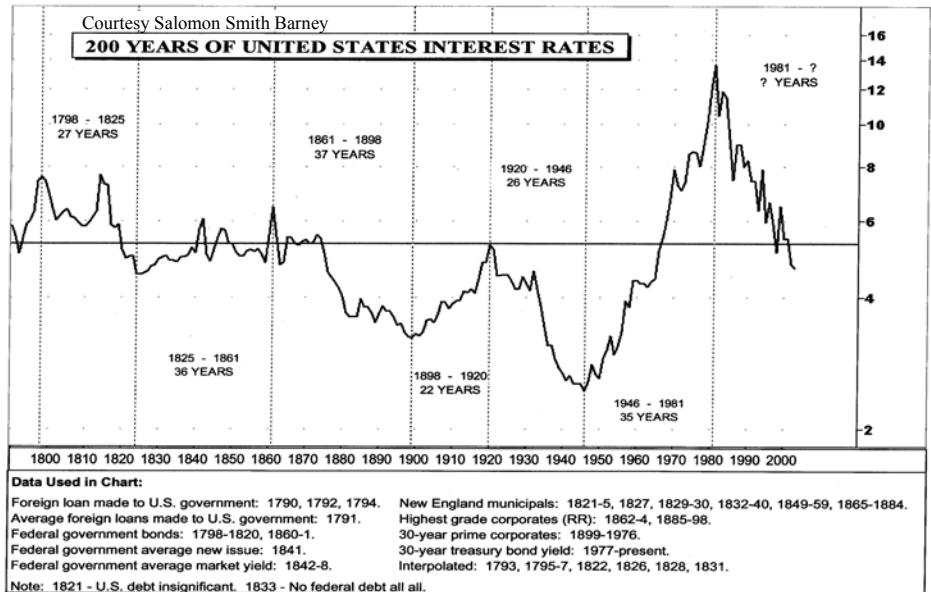
In the year 2000 the major stock market averages (DJ Industrials and S&P 500), dominated by the big blue chip, multinational companies, broke their long

term uptrends that extended back to 1982. However, this is not the whole story.

In March 2000, when the blue chips topped out and started down, money began flowing into other stocks that were relatively under-exploited in the late bull market. Since the March 2000 peak,

small and mid-sized companies not only have performed relatively better than their larger brethren; many have *risen* in price, while the big guys have gone *down*.

Why has this been so? There are several contributing causes. However, the overriding reason, in our opinion, is



GOING WITH THE FLOW...(Continued)

(Continued from page 3)

the vastly increased availability of funds seeking an investment home. In a nutshell, we have had inflation in stock prices: too much money chasing too few true investment opportunities. It has been difficult to let proceeds from stock sales sit in a money market fund earning 1-2% per annum, especially after we have grown accustomed to 28% per annum returns from the stock market (1995-99).

The price of gold also has broken its long trend (which had been downward, in this case). After building an extended base during the last several years in the \$250-\$290 range, an ounce of gold has been rising toward \$400; and gold shares and gold mutual funds have risen in price accordingly.

Again, why should this be so? There are many possibilities; but that gold has started a new bull market of its own seems apparent.

The two markets in which the long-term trends seem still to be intact are in bonds and money markets. Despite a sharp rise in bond interest rates from mid-June through July, bond prices have not declined sufficiently to break the long-term uptrend in prices. And 90-day Treasury Bill rates, at .935%, are barely above their all-time low of .895% set last July.

We have concerns about the bond market. With both stocks (at least, the major companies) and gold having

experienced major long-term trend changes, we are alert for the same in the bond and short-term money markets. With rates having declined for so long and to such absolute low levels, at least by the past fifty years' experience, there is no reason for complacency. The interest rate rise in the early summer may be a warning of changes to come. However, we are going *with* the flow—and the long-term trend is still down for rates (up for bond prices).

So...going with the flow, we are selectively buying, and holding, certain equities (but not big companies), including a few nibbles at gold stocks for the first time in twenty years. We are maintaining a maturity ladder in bond portfolios, whereby we replace bonds that mature or are redeemed early with issues at the long end of the maturity scale. In deference to the absolute low level of interest rates, in late 2002 we shortened the long end of the ladder from nine to seven years; and we are not fully investing proceeds in even seven year maturities, unless call protection is adequate. And we have higher than average cash and near-cash reserves.

We think this is an optimistic but careful approach, during a transition time in the markets, when visibility—both globally and in our economy—is unusually hazy.

Investment Rule No. 2: subject of next quarter's newsletter.

DIXON, HUBARD & FEINOUR, INC. INVESTMENT COUNSEL

PROVIDING INVESTMENT MANAGEMENT SERVICES FOR ...

INDIVIDUALS & FAMILIES
TRUSTS & ESTATES
RETIREMENT PLANS
ENDOWMENTS & FOUNDATIONS
BUSINESSES

WALTER M. DIXON, JR., CFA
W. STEBBINS HUBARD, JR.
EDWIN R. FEINOUR
C. WHITNEY BROWN, JR., CFA
WALTER M. DIXON, III
JONATHON E. GRACE

601 S. JEFFERSON STREET, SUITE 410
POST OFFICE BOX 2768
ROANOKE, VIRGINIA 24001-2768
TELEPHONE (540) 343-9903
FAX (540) 343-7684
E-mail: last_name@dhfinc.com