The Outlook

February 2003

As of February 12, 2003		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	- 7.0	7,758.17
S&P 500	-6.9	818.68
Nasdaq Composite	-4.2	1,278.97

Confronting Today's Investment Outlook

In confronting today's investment outlook, geopolitical issues play some part in establishing the direction of the markets in the short term, but by no means are these issues the determining factors. We cannot point to any convincing reasons to believe that a new bull market cycle can begin from these levels when the S&P 500 yields 1.9% and sells at twenty-seven times 2002 operating earnings. On the contrary, the economy's anemic growth (last quarter's real GDP growth was estimated to have slowed to a .7% annual rate) is insufficient to withstand the strong headwinds that will likely hit as state and local budget deficits swell. Municipalities must use a combination of borrowing and raising taxes and cutting services and employment to close their budget deficits. Economic weakness in Europe and Japan and high and rising energy costs are making matters even worse by undermining consumer confidence and corporate profits. The longer global economic and geopolitical risks linger, the longer the financial markets are likely to be under pressure.

Geopolitical forces including the loss of Venezuela's oil production, however limited in duration, have pushed up oil prices. We understand that significant reservoir and well damage has occurred in Venezuela. Venezuela's oil fields probably will require nearly $6 billion of investment to restore production to former levels. Oil prices have risen 75% over the past year and natural gas prices have risen over 70% since this past December. **We do not need to be reminded of the impact of energy shocks on the US economy, but this time the shocks will hit the system at a particularly weak point of the economic cycle when only consumer spending is keeping the economy growing**. The question is how long will consumers continue to spend and take on more debt before they will have to cut back.

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Anemic Business Spending and Investment

The outlook for business spending and investment remains weak. **Businesses want to see a clear path to higher revenues and improved earnings before committing to increasing capital outlays.** Companies also need to pay down debt and improve free cash flow in order to satisfy the rating agencies. They risk credit downgrades and increases in their cost of capital if they fail to improve their capital structures and deliver satisfactory results in this regard.

The outlook for business spending contrasts somewhat with the outlook for consumer spending. Cash flow generated by home-mortgage refinancing has effectively been able to keep consumer spending in positive territory. Consumers have used some of the interest-rate mortgage relief provided by refinancing to restructure their debts. This could indicate a long overdue start to the recovery in household saving rates. The above actions should provide a better foundation for consumer spending over time.

Pressures on Pension Plans

In recent years corporate America became accustomed to adding pension plan surpluses to their earnings or making only minor cash contributions to their pension plans. Investment managers have been reaching the actuarially assumed rates of return for their pension plans with oversized profits from equity investments. This has now come to an end. **The problem now weighing heavily on many companies, both domestic and European, and carrying over to the broad equity market is that companies must take significant cash charges against 2003 earnings in order to fund their benefit plans' bare minimum asset requirements**. In addition, the rating agencies are reviewing corporate balance sheets for possible credit downgrades if their pension and benefit shortfalls meaningfully impact their debt/equity ratios.

Public companies that had assumed rates of return on their pension and benefit plans of 9 – 11% have begun lowering their expectations and have had to inject cash and/or stock into their plans to meet their objectives. **Some companies have lowered their expected rates of return to 9%, but we believe that these return assumptions are largely unachievable for large funds given the present low-level of interest rates and stock market over-valuation**. **If this year proves to be difficult then we should expect a further lowering of expected rates of return next year and more corporate injections of cash and equity which will come out of profits**. These contributions will depress 2003 reported earnings and also are likely to result in further reductions of stock price multiples, particularly if further contributions will impact next year's earnings as well.

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Possible Mutual Fund Redemptions

After constantly adding money to mutual funds throughout the '90s investors redeemed a small portion of their equity mutual funds last year after experiencing almost three years of losses. Last July $51 billion exited equity funds. **If this year's equity returns continue to be negative, we would not be surprised to see a surge in mutual fund redemptions resulting in a significant market decline**. **Should this occur, we will have a major buying opportunity.**

For many years, the notion of relative performance and relative returns held sway. Institutions that beat their benchmark indices were considered by their sponsors and consultants to be adding value. **At the present time, fiduciaries can no longer be satisfied with good relative returns that nevertheless produce losses. Foundations, endowments, retirement funds, pension and profit sharing funds as well as individuals must confront their spending plans in the context of losses and forty-year record low interest rates**. Strains are being experienced by many organizations and even individuals' plans for retirement have been postponed. As a result, many are remaining in their jobs longer making it more difficult for new entrants into the labor market to find employment.

Federal, State and Local Government Deficits

Another issue that must be addressed for 2003 which requires careful consideration with regard to its potential to destabilize the financial markets is the fiscal condition of government at all levels. **The federal, state and local governments are now running substantial deficits because of the following: a weak economy has caused tax revenues to decline, state and local government pension assets have underperformed and employee health benefit costs keep rising**. President Bush sent Congress a $2.23 trillion fiscal 2004 budget that seeks a major spending increase for the military and slashes billions of dollars in taxes. It does not count the costs of a possible war with Iraq. The federal budget projects a deficit of $307 billion in 2004, up from the expected $304 billion in the fiscal year now under way. The White House estimates the deficit will be 2.8% of GDP in the current year, which ends in September 2003, and 2.7% in 2004.

The U.S. combined federal, state and local budget deficits are in excess of $400 billion and our current account trade deficit is approaching $600 billion this year. For state and local governments to bring their costs in line with revenues they will have to reduce the number of employees that currently total approximately 18 million people. **The U.S. economy has never run combined deficits of $1 trillion or 10% of GDP in one year**. **More so than in the past,**

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the administration's attempt to stimulate the economy will increase the trade deficit since increasing consumer spending will go to purchase foreign-made products particularly from China. We should expect the presence of such a high and growing trade deficit to result in a further depreciation of the dollar. **We believe the U.S. and global economy must adjust to these large and unsustainable imbalances**. **The only question is how and when**.

A Positive Outlook for Energy

Investment opportunities always exist no matter the outlook. The important question to ask is where will capital flow and how can one achieve positive returns in order to compound capital. Current inventories of U.S. crude oil supplies are at twenty-seven year lows and must be rebuilt to prevent possible supply dislocations, and as we said earlier the loss of Venezuelan oil production exacerbates supply shortfalls. In addition, increased natural gas demand and declines in drilling activity over the past two years have resulted in U.S. natural gas inventories now below the five-year average. Increased natural gas demand has been augmented by the cold weather. Our views are that higher energy prices are most probably going to exist for a longer period than many expect. At the same time equity valuations are discounting significantly lower oil and gas prices. Accordingly, we believe that investment in North American oil and gas producers at current depressed prices represent investment opportunity. Some of these companies are selling for as little as three times cash flow from operations and yielding over 4%.

A Positive Outlook for Precious Metals

A sector that has been neglected for more than twenty years until recently has been gold. The price of gold has appreciated against all major currencies since the start of the year as a result of the interaction between forces that relate to gold both as a commodity and investment vehicle. Renewed tension between the U.S. and the Middle East, weakness in the equity markets and the decline of the U.S. dollar have brought renewed interest in gold assets. In addition, **investment buying of gold is being driven by prolonged increases in the United States Federal and current account deficits and the continuation of a generally turbulent global economic and political climate. Uncertainty in the global banking sector and strong consumer demand in Asia have also been noteworthy factors affecting the price of gold. Finally troubled situations in Venezuela and other important economies in South America support the buying of gold as a safe haven.**

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Asian central banks have large and growing currency reserves. They hold almost $1 trillion in official reserves, and Japan has nearly $500 billion in central bank reserves. The United States is running large trade deficits with these countries so their central banks are continuing to accumulate additional dollars. **Their gold holdings are a minor percentage of their total reserve assets as seen below and are likely to increase over time.** Moreover, Malaysia has been discussing the creation of a gold-backed dinar – an Islamic currency for trade purposes. China opened its first gold exchange in Shanghai last October. **As the European Central Bank, the Japanese Central Bank and the Federal Reserve attempt to re-inflate their respective economies, we expect the interest in hard assets – precious metals and many commodities – to continue to increase**.

World Official Gold Holdings According to the World Gold Council

Gold's percentage share of foreign central bank reserves:

China	2.0%
Hong Kong	less than 0.1%
Japan	1.7%
Korea	0.1%
Kuwait	7.4%
Malaysia	1.1%
Russia	8.0%
Saudi Arabia	7.3%
Taiwan	3.3%

False Parallels Between the 1990 – 91 Gulf War and the Present

The great majority of strategists and market commentators appear focused on the parallels between the 1990 – 91 Gulf War and the present. They believe that once the Iraq situation is behind us a stronger market environment reflecting gradually improving economic fundamentals will result in a rebound of the equity market. Bearing in mind that deteriorating market conditions have been going on well before Iraq was an issue, our view is that there is more to the story than just geopolitical events in the Middle East. **Notwithstanding the fact that the fear of war has been hurting the global equity markets and that the absence or disappearance of these fears will result in equity-market rallies, there are significant differences between the world economy of the early 1990s and today's global economy**.

While it is always unwise to attempt to forecast the stock market, it is nevertheless apparent that the economic fundamentals for the U.S. and

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most global equity markets are weak at best. There is a reason why United States interest rates are at a four-decade low and money funds barely pay interest. As the Bush Administration targets the market with a proposal to eliminate the taxation of dividends, which may or may not pass, **the investment trends emerging involve a greater emphasis on absolute returns rather than relative returns. Dividend-yielding common stocks and high-yielding equity securities will be increasingly important as the reliance on capital gains alone may prove insufficient in compounding returns under present conditions.**

Conclusion

The underlying fundamentals point to a slow economic recovery at best. They favor a modest pick-up in business and consumer spending in the second half of 2003. The greatest immediate risk to this view is the potential danger associated with the pending showdown with Iraq. We think 2003 will be a difficult year for the U.S. economy and expect investors to favor stocks that pay substantial dividends, have strong balance sheets, predictable cash flows and have conservative business plans.

Should a market decline occur driven by investor capitulation that has not been present throughout this down-cycle, great values will appear. In the meantime it is important to be in a position to produce positive returns in a difficult environment by concentrating on investing in the following: asset-rich securities, high-yielding securities, and companies that can grow their revenues in a deflation-prone global economy. Maintaining good cash reserves should prove advantageous under present circumstances.

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