A.R.Schmeidler & Co., Inc.

The Outlook

May 20, 2004

As of May 19, 2004		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	**-4.94**	**9,937.71**
S&P 500	**-2.09**	**1,088.68**
Nasdaq Composite	**-5.25**	**1,898.17**

The recently announced U.S. payroll numbers indicated a strengthening labor market that is likely to lead to an interest rate increase of a quarter of a point in June at the next Federal Reserve Board meeting. **The Federal Funds futures market is now indicating that the Central Bank will raise interest rates by 100 basis points or a full percent by the end of 2004.** This would bring the Federal Funds rate to 2% from the present 1% level. Moreover, by the end of 2005 the market is anticipating a rate of 3.5% thereby bringing the Federal Funds rate, according to Federal Reserve Board Governor Robert Parry of San Francisco, from a 45-year low to the minimum level considered to be at the low end of a neutral interest rate range. **If the period of cheap money is over, it is possible that the market has not completely priced in either the extent or the duration of this new interest rate cycle.**

China's Economy

At the same time that U.S. interest rates are rising, China has begun tightening its monetary policies in order to slow its torrid growth rate to a more manageable 8% level. Investors and economists are also trying to decide whether China's economy will undergo a hard or soft landing as its leaders attempt to cool down the growth rate. Because China has contributed significantly to world growth, a soft landing of the Chinese economy is important to prevent the world economy from markedly slowing.

A Significant Rise In Energy Prices

Considering the significant rise in energy prices with oil costing over $40 a barrel and natural gas more than $6 per mcf, an increase in inflation rates beyond the expectations of the Federal Reserve cannot be ruled out. Oil

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prices are now at the highest levels since the 1980s. Prices at the pump for gasoline are expected to peak well above $2.00 a gallon in June, up substantially from previous Energy Department estimates.

The Market's Reaction To Higher Interest Rates

The market's reaction to the rise in interest rates, and this includes the currency markets, commodities markets and stock and bond markets, has been a consequence of the reversal of the carry trade. The implementation of the carry trade involved the purchase of commodities, equities, currencies and high-yielding securities with short-term borrowed funds at almost no cost because interest rates were so low. This was also considered to be a re-flation trade, where an investor could profit from the aggressive attempt of the Federal Reserve, through its cheap money policy, to re-flate the U.S. economy, thereby creating an economic upturn. **The Federal Reserve, in its recent communications, has taken pains to provide the markets with the knowledge that its moves will be measured so that the unwinding of the carry trade could take place over a period of time rather than suddenly, which would be destabilizing.** With over $1 trillion in more than eight thousand hedge funds this investment strategy had wide-ranging appeal, but could only work as long as monetary policy stayed decidedly stimulative. As monetary policy becomes less accommodative, all these transactions must be reversed. Initially these transactions often involved selling dollars to purchase foreign currencies and securities where rates of return were higher than in the U.S. The effect of these transactions was to force the U.S. dollar down and to strengthen major foreign currencies; it propelled commodity prices higher and made high yielding securities in general rise in price. Now the effect of reversing these transactions has tended to strengthen the U.S. dollar against major foreign currencies and put downward pressure on some commodities as well as high-yielding securities.

While we are on the subject of the strengthening of the dollar, it is important to note that the appreciation of the dollar against the Japanese yen has removed the need for the Japanese to embark on currency intervention to prevent their currency from rising. The effect of the Japanese intervention had been to increase demand for U.S. Treasuries, which had the effect of putting downward pressure on our interest rates. Since the Japanese demand for U.S. Treasuries has been reduced, U.S. deficits now need to be financed from other sources thereby tending to put more upward pressure on U.S. interest rates.

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Hedge Funds and Individual Speculators

Hedge funds and individual speculators have relied on borrowed money to leverage their capital. As we described earlier, hedge funds employ carry trades by borrowing dollars at low interest rates and investing the proceeds in higher-yielding assets. However, with interest rates rising, many of these trades are threatening to become unprofitable. As a consequence of reversing both the carry trades and other speculative strategies, some investors are being forced into making hastened and sometimes irrational investment decisions that can needlessly drag markets down.

U.S. Monetary Policy Has Shifted

The Federal Reserve has clearly signaled a change in monetary policy. The Federal Reserve has acknowledged that a stronger U.S. economy, higher energy prices and the recent up tick in inflation could soon lead them to lift interest rates**. We think the Federal Reserve will go slowly and move cautiously on any policy shift. We do not expect any sharp rate hikes that could choke off the U.S. economic expansion, but we now expect one or more rate hikes in 2004.**

Recent data showed that the U.S. economy's gross domestic product rose a healthy 4.2% in the first quarter of 2004. Growth would have been even stronger had it not been for a deceleration in inventory investment. **Inventory accumulation will likely help the U.S. economy's growth going forward, as production ramps up to meet a projected strong seasonal shopping period in the second half of the year.** Corporate earnings in the first quarter were strong, with profits generally better than forecasts. The May 7th report of a rise of 288,000 people in April's non-farm payrolls is also further evidence of the U.S. economy's strength.

The outlook for Federal Reserve Board policy is very straightforward. If the employment data continues to remain strong, the Federal Reserve Board will raise interest rates. If, on the other hand, the employment data starts to show some weakness, they probably will be hesitant to raise interest rates. To make matters a little disconcerting, financial markets are beginning to reflect the influence of a significant increase in energy and commodity prices. Companies are starting to pass on some of the increased costs of energy and raw materials. Therefore deflationary pressures have begun to moderate. Rising commodity prices are increasing the costs of finished goods, and price deflation from China has now given way to an accelerating inflation.

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Keep in mind that Federal Reserve Chairman Alan Greenspan has said repeatedly that strong productivity growth and falling unit labor costs have been key factors allowing the Central Bank to keep interest rates low. Labor costs in the U.S typically represent about two-thirds of the overall cost of producing goods and services. **Unfortunately the first-quarter saw an increase in labor costs due in part to the rising costs of providing healthcare and pension benefits to workers. If this trend persists, the rise in unit labor costs is another reason for the Federal Reserve Board to raise interest rates.**

The Oil and Natural Gas Industry

In the most immediate time frame the energy sector probably offers investors one of the best possibilities for substantial capital gains. The pace of global economic expansion in 2004, the business recovery in the U.S., China's booming economy with soaring auto sales and construction, and Eastern Europe's brightening prospects are all putting considerable upward pressure on energy prices. Turmoil in some of the oil producing countries is also leading to higher energy prices. The petroleum and natural gas industry is now benefiting from much higher price realizations, and we believe they will likely continue to do so in the months and years ahead. It is interesting to note that many of Wall Street's senior energy analysts did not anticipate rising energy prices and have been reluctant to increase their earnings estimates for oil and natural gas companies fearing that high-energy prices may only be an anomaly. We believe that global energy demand has outstripped supply, and this condition is likely to last for the foreseeable future. Alternative energy sources, more efficient use of oil and gas, infrastructure investments, and a different national policy will be required to prevent further upward price pressures over time. Although the price of oil and gas can decline we believe a new level has been put in place.

The Food Processing and Alcoholic Beverage Industry

We like the valuations and fundamentals of the Food Processing and Alcoholic Beverage industries. These industries are likely to post solid revenues and profit gains in 2004. They are benefiting from pricing power, volume gains and successful cost cutting. The food processing, beer, wine and liquor industries are reaping the rewards of a favorable price environment and volume improvement due in large part to a shift in consumer preference toward more upscale, premium products. In addition, branding and product innovation will remain a central theme to their success. Companies that are able to fashion their products to reflect the realities of modern living and the international markets can grow their sales and earnings considerably. We find current valuations attractive, and the fundamentals should keep improving in

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these industries as companies seek savings by leveraging fixed distribution networks, demanding better deals from retailers and expanding their businesses abroad. The low-carb craze likely only represents a mild negative for the companies that we favor.

Conclusion

For several weeks investors have struggled with the impact of a stronger economy and higher interest rates. Equities now face many obstacles, including sagging bond prices, which have pushed up the yield of the 10-year Treasury note to close to 5.0% from recent lows of 3.71%. While renewed economic strength means better corporate earnings, it also means higher interest rates that will tend to reduce price-earnings multiples on common stocks.

If interest rates continue to rise this year, the financial markets could experience an unusual degree of volatility. In an attempt to reduce their risk exposure financial institutions sell their long-term fixed-income securities. Borrowing short and investing long often works well when interest rates are falling. However, leveraging long-term assets on short-term borrowing can be disastrous in a rising interest rate environment. The carry trade could be a critical factor in how the financial markets behave for the rest of 2004. **Moreover, instability in the Middle East, high-energy prices and rising inflation have added to the financial markets' unease. Nevertheless, we continue to find appealing equity and fixed income investments that are benefiting from these conditions.**

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