A.R.Schmeidler & Co., Inc.

The Outlook

August 16, 2004

As of August 13, 2004		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	**- 6.0%**	**9854.92**
S&P 500	**- 4.2%**	**1064.80**
Nasdaq Composite	**- 12.3%**	**1757.22**

The Equity market is facing many obstacles including rising interest rates. While renewed economic strength has meant better corporate earnings, it also meant 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. Moreover, instability in the Middle East, high-energy prices and rising inflation are adding to the financial markets' uneasiness.**

Federal Reserve's "Measured" Plan In Raising Interest Rates

At the beginning of July the Federal Reserve raised its target for short-term interest rates to 1.25% from 1%. Federal Reserve Board Chairman Alan Greenspan's mid-July semiannual testimony to Congress on monetary policy also suggested that the Federal Reserve would continue to raise interest rates by a quarter of a point at each of its next policy meetings. The Federal Reserve Board was true to its word at their August 10th policy meeting when they again increased short-term interest rates to 1.50% from 1.25%. They see the economy continuing to expand and currently believe that inflation is under control. However, they emphasized the need to be careful about keeping inflation under control as the economy expands.

The Danger Of Unrealistic Expectations

While the positive corporate earnings guidance seems to be slowing after several months of very encouraging reports, strong earnings reports still outnumber earnings disappointments**.** The bulk of the positive guidance during the year came in before June. **By any objective measure, actual profit gains appear likely to be very positive for most S&P 500 companies this year. The problem is that as we have emerged from a recession where earnings performance has improved dramatically over the past eighteen months,**

investor expectations have risen accordingly. Investors may now have unrealistic expectations with respect to the pace of ongoing growth in revenues and profits.

Most companies are richly valued at present even assuming the sustainability of the economic recovery. In the late 1990's an Internet/technology driven business boom pushed the unemployment rate to record lows and economic growth to record highs. We do not feel that there is anything in the system today that can bring back so much economic excitement or investor optimism. **High oil prices, terrorism and the structural imbalances caused by large federal budget deficits and trade deficits have altered the economic landscape.**

The Debt-Fueled American Dream

Consumers have little room to take on additional debt and this will impact the ability of the US economy to continue to expand. Chronic monthly cash shortfalls in U.S. household income are often resolved with home equity loans and credit card debt. The ratio of household income to household debt in the form of mortgages, home equity loans and credit card debt in the U.S. are at all time highs. Economists and consumer activists have tirelessly warned of the dangers of elevated household debt and low savings rates that have caused many a tragic story of personal bankruptcy. The U.S. consumer is using credit cards for increasingly routine purchases with roughly 60% of credit card holders rolling over their balances each month, paying as much as 22% in interest charges. Credit card use has become so pervasive that consumers are losing the ability to budget household expenses. **For many households in America if they are not carrying a substantial home mortgage, a hefty home equity loan and several credit card roll over balances, they are effectively locked out of the American Dream.**

$40+ Oil Is Likely To Prevail For Some Time

World demand for oil has grown more than expected to approximately 82 million barrels/day while potential excess production capacity from OPEC is estimated at about 500,000 barrels/day and essentially from Saudi Arabia. Shipping and refining capacity is at maximum utilization and sources, such as Venezuela and Nigeria, have become less reliable due to a mixture of political and social discord. At the same time, China's imports are running at 2.5 million barrels/day and rising. When you add the threat of terrorist attacks on the oil storage and refining infrastructure in the face of below-normal inventory levels in the U.S., $40+oil is most likely to prevail for some time. Under these conditions it is no surprise that the energy sector thus far has been the best performing sector of the stock market this year.

It is noteworthy that many Wall Street firms have recommended an under weighting in energy and are now moving to a market weighting for portfolios. **Energy (oil and gas) represents approximately 7% of the S&P 500 while financials represent about 25% of the S&P. However, in 1980, when energy prices peaked, energy company equities were 25% of the S&P while financial company equities represented 7% of that index.** Today's valuations of energy companies, particularly among the independent producers in the U.S., sell for as low as 3 times cash flow from operations. Moreover some of the great beneficiaries of current high energy prices are paying dividends yielding 7%-10% per year and have the potential to raise their dividends in the future. **At a time when many investors are trying to increase their returns in a historically low interest rate environment, we still believe that investments in the energy sector are particularly attractive.**

<u>Uncertainty And Challenges Face The U.S. Economy</u>

While the U.S. consumes more than 20 million barrels of oil per day, it produces domestically only 5.7 million barrels per day. **Our growing need for imported energy is having a significant impact on our trade deficit, which is now more than $550 billion a year. Please note that this latest annual rate reflects the importation of oil at approximately $33.76 per barrel, which as of this writing is selling for over $45 per barrel. As our trade deficit worsens, we expect the U.S. dollar to come under further pressure.** A weaker U.S. dollar is likely to increase the price of imports.

While consumers continue to benefit from cheap Asian imports, goods and services that are produced in the U.S. are rising in price more than the official inflation statistics are indicating. **The overall price inflation view now suggests that consumer incomes are likely to get squeezed in the current environment. While corporations have been accumulating cash, paying down debt, buying back stock, and raising dividends, consumers are having to grapple with rising household expenses and heavy debt loads. Consumers may find it necessary to cut back on spending – particularly if interest rates keep rising.**

We are always dealing with uncertainty and a range of challenges when attempting to describe future economic outcomes. However, the combination of the U.S. government's fiscal and monetary policy becoming less expansive and record high oil prices suggests that the equity markets may well remain under pressure. Let's not forget that the 4% growth of GDP has been built on large U.S. fiscal and trade deficits totaling 10% of GDP (a very high percentage) and a forty-year low in interest rates. **Should we expect strong growth if energy prices remain high, interest rates rise, consumers find it necessary to cut back on spending and Washington attempts to rein in the deficit?**

High Stock Market Valuations

We believe that the period of high valuations in the equity market is approaching an end. To justify high stock market valuations corporate earnings will need to accelerate further. Although earnings are likely to rise over the next few quarters, the U.S. economy faces the prospect of less fiscal stimulus as the President's tax cuts lose their influence, interest rates are increased by the Federal Reserve, and more people are thrown into a burdensome alternative minimum tax category. The ability of U.S. investors to continue at the current level to direct funds into the equity market may come under additional pressure. This does not preclude rallies in the equity market; it suggests that at this time the economic headwinds are stronger than the tailwinds.

Conclusion

Sound investment opportunities always exist, but many are not likely to be found in the traditional and expected places. In our view the stock market has been taking its cue from daily oil and natural gas price movements. **Unfortunately the spotlight will stay on energy unless oil prices decline below $40 per barrel.** The companies we favor generally have extra cash on hand to allocate towards capital spending, dividends, share-buybacks and debt reduction. **As the U.S. economy comes to grips with rising interest rates, elevated consumer debt, high energy prices and the fiscal and rising trade imbalances that exist in the system, we believe that a portfolio focused on cash-rich companies benefiting from today's conditions will have a significantly greater probability of success in achieving a satisfactory rate of return than would otherwise be the case.**

Deflationary forces still lurk in the background and high energy prices will act as a tax on consumption while the tools of economic management—fiscal and monetary policy—are in the process of being reversed. High quality fixed income investments should also do well in this environment. We believe that most economists will have to revise downward their growth expectations including the most recent Federal reserve Board expectation of 4 ½ – 5% growth for the second half of 2004. From what we see many investors are not prepared for this change.