A.R.Schmeidler & Co., Inc.

The Outlook

December 2002

As of December 11, 2002		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	-14.3	8,589.14
S&P 500	-21.2	904.96
Nasdaq Composite	-28.4	1,396.59

The most significant changes from our last Outlook, aside from an eight week recovery of the market after six straight monthly declines, have been the Federal Reserve Board's reduction of interest rates by 50 basis points which we indicated would likely occur if the economic data came in weaker than expected, and the Bush administration's strong interest in an economic stimulus package that includes the elimination of the double taxation of corporate dividends. It is a move that the White House hopes will boost both the U.S. economy and the stock market. Economists have long argued that dividends are taxed twice. Companies pay dividends from the earnings left after paying corporate taxes, and then shareholders pay income taxes on the dividends they receive. However, corporate interest payments are deducted from income before taxes. This unequal treatment has encouraged companies to take on debt, which has tended to weaken their balance sheets.

Individual holders of common stocks, especially those in higher tax brackets, have generally preferred capital gains to cash dividends. Investors can keep a larger portion of their profits from realized capital gains after taxes than they are allowed to keep from interest and dividend income. Because of the unequal tax treatment of interest and dividends, growth stocks have tended to be popular and generally overpriced relative to high-yielding dividend paying stocks.

Over the years, corporations have focused less on dividend payouts and more on boosting earnings per share. The pressure to show regular double-digit earnings growth to drive stock prices higher contributed to the recent corporate accounting scandals. For quite some time business groups and common stock shareholders have been pushing for a change in federal tax policy towards dividends.

To end the double taxation of dividends, the administration could eliminate either the corporate or the individual tax. We believe that the President prefers eliminating the tax at the individual level. The individual tax option is cheaper since about one-half of dividend recipients are taxed-exempt entities, such as foundations, pension funds, and IRA accounts. A new tax break would not be beneficial to taxed-exempt entities and for that reason it would not lead to as great a reduction in federal tax-revenues.

Reducing the individual federal tax on dividends would make dividend-paying stocks more attractive to taxable individual investors. Corporate dividend-tax reductions to companies would increase business investment and improve balance sheets by encouraging companies to issue equity rather than debt. According to a White House study, either change should foster enough economic activity for the federal government to recoup about one-half of the tax-revenue loss.

Monetary Policy

The Federal Reserve Board's recent decision to lower interest rates 50 basis points brings the federal funds rate down to 1.25 percent, a forty-one year low. In spite of the stimulus the Fed has provided through twelve rate reductions, the economy is not growing fast enough to prevent unemployment from rising. As can be seen in ***Appendix A***, the Federal Reserve has been aggressively expanding the money supply to stave off the strong deflationary headwinds facing the U.S. economy.

For those concerned that the central bank has little ammunition left to lower rates further should the need arise, a November 21st speech by Federal Reserve Board Governor Ben Bernanke to the National Economic Club in Washington D.C. is noteworthy and remarkable. We quote some of his speech as follows:

> *"With inflation rates now quite low in the United States, however, some have expressed concern that we may soon face a new problem--the danger of deflation, or falling prices. That this concern is not purely hypothetical is brought home to us whenever we read newspaper reports about Japan, where what seems to be a relatively moderate deflation--a decline in consumer prices of about 1 percent per year--has been associated with years of painfully slow growth, rising joblessness, and apparently intractable financial problems in the banking and corporate sectors. While it is difficult to sort out cause from effect, the consensus view is that deflation has been an important negative factor in the Japanese slump."*
>
> And he goes on to say, *"So, is deflation a threat to the economic health of the United States? Not to leave you in suspense, I believe that the*

chance of significant deflation in the United States in the foreseeable future is extremely small, for two principal reasons. The first is the resilience and structural stability of the U.S. economy itself. Over the years, the U.S. economy has shown a remarkable ability to absorb shocks of all kinds, to recover, and to continue to grow. Flexible and efficient markets for labor and capital, an entrepreneurial tradition, and a general willingness to tolerate and even embrace technological and economic change all contribute to this resiliency. A particularly important protective factor in the current environment is the strength of our financial system: Despite the adverse shocks of the past year, our banking system remains healthy and well-regulated, and firm and household balance sheets are for the most part in good shape. Also helpful is that inflation has recently been not only low but quite stable, with one result being that inflation expectations seem well anchored. For example, according to the University of Michigan survey that underlies the index of consumer sentiment, the median expected rate of inflation during the next five to ten years among those interviewed was 2.9 percent in October 2002, as compared with 2.7 percent a year earlier and 3.0 percent two years earlier--a stable record indeed.

The second bulwark against deflation in the United States, and the one that will be the focus of my remarks today, is the Federal Reserve System itself. The Congress has given the Fed the responsibility of preserving price stability (among other objectives), which most definitely implies avoiding deflation as well as inflation. I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief.

Lower rates over the maturity spectrum of public and private securities should strengthen aggregate demand in the usual ways and thus help to end deflation. Of course, if operating in relatively short-dated Treasury debt proved insufficient, the Fed could also attempt to cap yields of Treasury securities at still longer maturities, say three to six years. Yet another option would be for the Fed to use its existing authority to operate in the markets for agency debt (for example, mortgage-backed securities issued by Ginnie Mae, the Government National Mortgage Association).

Historical experience tends to support the proposition that a sufficiently determined Fed can peg or cap Treasury bond prices and yields at other than the shortest maturities. The most striking episode of bond-price pegging occurred during the years before the Federal Reserve-Treasury

Accord of 1951. Prior to that agreement, which freed the Fed from its responsibility to fix yields on government debt, the Fed maintained a ceiling of 2-1/2 percent on long-term Treasury bonds for nearly a decade. Moreover, it simultaneously established a ceiling on the twelve-month Treasury certificate of between 7/8 percent to 1-1/4 percent and, during the first half of that period, a rate of 3/8 percent on the 90-day Treasury bill. The Fed was able to achieve these low interest rates despite a level of outstanding government debt (relative to GDP) significantly greater than we have today, as well as inflation rates substantially more variable. At times, in order to enforce these low rates, the Fed had actually to purchase the bulk of outstanding 90-day bills. Interestingly, though, the Fed enforced the 2-1/2 percent ceiling on long-term bond yields for nearly a decade without ever holding a substantial share of long-maturity bonds outstanding. For example, the Fed held 7.0 percent of outstanding Treasury securities in 1945 and 9.2 percent in 1951 (the year of the Accord), almost entirely in the form of 90-day bills. For comparison, in 2001 the Fed held 9.7 percent of the stock of outstanding Treasury debt."

Governor Bernanke continues, *"To repeat, I suspect that operating on rates on longer-term Treasuries would provide sufficient leverage for the Fed to achieve its goals in most plausible scenarios. If lowering yields on longer-dated Treasury securities proved insufficient to restart spending, however, the Fed might next consider attempting to influence directly the yields on privately issued securities. Unlike some central banks, and barring changes to current law, the Fed is relatively restricted in its ability to buy private securities directly. However, the Fed does have broad powers to lend to the private sector indirectly via banks, through the discount window. Therefore a second policy option, complementary to operating in the markets for Treasury and agency debt, would be for the Fed to offer fixed-term loans to banks at low or zero interest, with a range of private assets (including, among others, corporate bonds, commercial paper, bank loans, and mortgages) deemed eligible as collateral. For example, the Fed might make 90-day or 180-day zero-interest loans to banks, taking corporate commercial paper of the same maturity as collateral. Pursued aggressively, such a program could significantly reduce liquidity and term premiums on the assets used as collateral. Reductions in these premiums would lower the cost of capital both to banks and the nonbank private sector, over and above the beneficial effect already conferred by lower interest rates on government securities.*

The Fed can inject money into the economy in still other ways. For example, the Fed has the authority to buy foreign government debt, as well as domestic government debt. Potentially, this class of assets offers huge scope for Fed operations, as the quantity of foreign assets eligible *for purchase by the Fed is several times the stock of U.S. government debt."*

U.S. Economy

The flexibility and resilience of the U.S. economy is encouraging for the future. The Conference Board said its consumer confidence index rose to 84.1 in November from 79.6 in October. Sales of new homes continue to run at strong levels with a seasonally adjusted annual sales rate hovering around 1.7 million units. The Commerce Department reported that third-quarter inflation-adjusted gross domestic product rose at a surprisingly robust annual rate of 4.0 percent. The government also reported that the GDP, the value of the nation's output, grew faster than initially estimated in the July-September period. These are significant pieces of evidence that the U.S. economy has stabilized and may even be on an expansion track. However the U.S. unemployment rate jumped to an eight-year high in November. The manufacturing sector lost 45,000 jobs; it was the sector's 28th consecutive monthly decline. Despite the poor performance in the manufacturing sector there are signs that the U.S. economy is firming. Stocks and corporate bond markets have rallied and the service-sector economy strengthened in November.

Worker productivity grew faster in the third-quarter than originally thought. Its growth over the past 12 months was the fastest pace since 1966. This is a positive signal for the country's standard of living. Productivity is the ultimate determinant of how well Americans live. Gains in productivity enable companies to pay workers more without raising prices and the economy to grow faster without inflation. For most U.S. companies top line revenue growth has been extremely difficult to achieve. Weak revenue growth has forced companies to make the most of advanced technology in order to become more efficient and sustain their profitability. If companies remain committed to improving worker productivity, profits will improve once demand for their products and services picks up. Regrettably improving productivity for now has largely been a defensive effort to stay ahead by keeping costs down.

A subdued global economic recovery may not be far off. The European Central Bank's (ECB) 50 basis point interest rate reduction is an attempt to strengthen one of the world's weakest regional economies. Europe's lack of flexibility with labor has meant that even when demand falters their companies are not able to respond by cutting wages and reducing staff. This has kept the ECB from cutting interest rates anywhere nearly as aggressively as the U.S. Federal Reserve. Asia minus Japan is on track for nearly 6 percent growth this year. Japan, the world's second biggest economy, is still mired in a decade-long recession. While it began to crawl out of recession early this year, it slipped again in the past few months amid skepticism over the health of their banking system. China has emerged as the real engine of growth for Asia.

The challenge which faces the administration in promoting a more aggressive fiscal stimulus program in conjunction with a loose monetary policy is made more difficult by the need for state and local governments to eliminate their deficits which could total in excess of $80 billion and which will subtract from any federal government stimulus ultimately approved by Congress. The economic risk in the United States is that consumer spending weakens before business spending accelerates resulting in slower growth for the U.S. economy. Since the United States consumer is the principal engine of growth for the world economy, any stimulus will tend to increase the United States' trade deficit, which could easily put downward pressure on the dollar and raise the perception if not the reality of increasing inflation. As can be seen in ***Appendix B***, the current account balance is approaching $500 billion, and one could argue that this cannot go on indefinitely without resulting in a devaluation of the dollar.

Conclusion

Judging from the daily trading volumes of the exchanges, the markets seem to be dominated by institutions including a vast number of hedge funds. Their time horizons for investments tend to be short to say the least, and consequently we believe that market volatility will remain high. Companies can have wide trading ranges offering significant rates of return when purchased during periods of pronounced market weakness. There will be occasions for us to take advantage of opportunities that will be created under these circumstances.

With respect to any changes in the double taxation of dividends, at this time 30 percent of the S&P 500 companies do not pay dividends, and the yield of the S&P 500 is currently 1.7 percent. Should these tax changes occur in favor of greater dividend payouts, we would expect to see many corporations favor greater current returns to shareholders which we believe will have a positive impact on their valuations.

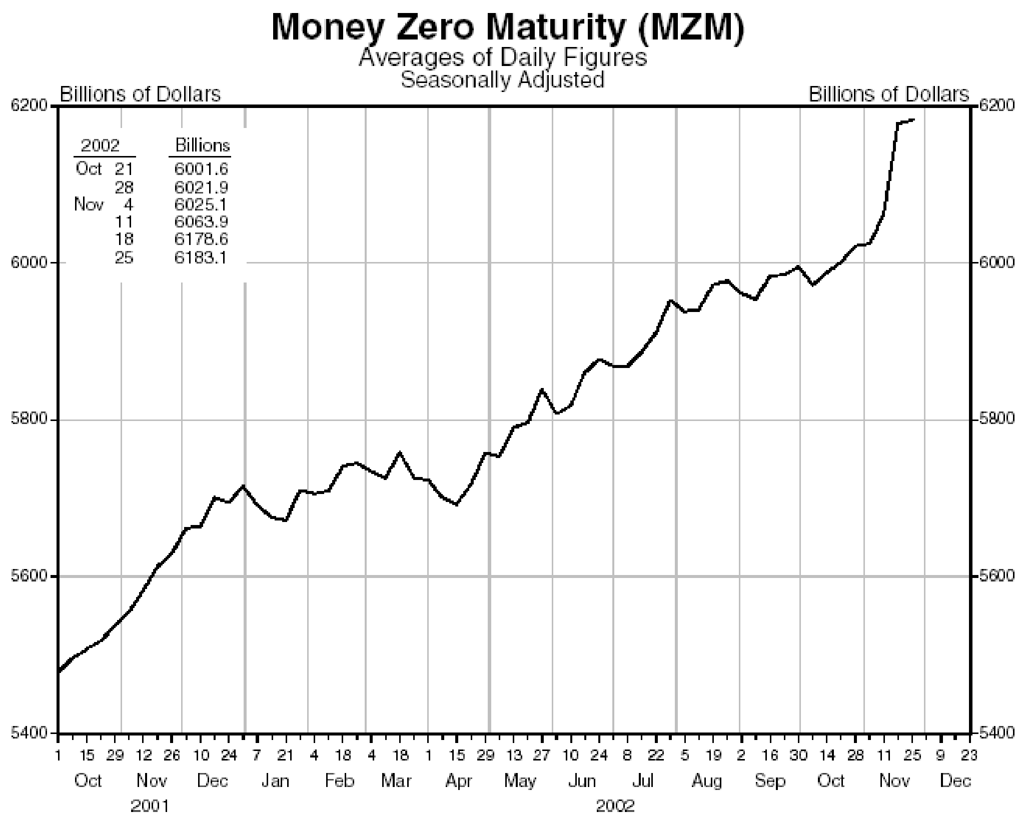
In our view portfolio strategy must encompass multiple scenarios since specific outcomes are a question of probabilities. Some of the areas which we believe must be part of a well-constructed portfolio include high-dividend paying securities, bonds, energy companies, defense companies, select technology companies, natural resource companies, and convertible securities. This would enable a portfolio to benefit from any of several outcomes which are not predictable.

To reach the goal of compounding rates of return in order to build capital over time, good equity selection will be critical. The overall valuation of the equity market remains expensive, but at the same time there exist some outstanding investment opportunities. The short interest on the New York Stock Exchange and the Nasdaq still remain at high levels, notwithstanding the markets' rise since the low of October 9th.

The period from November to April is seasonally the strongest period of the year for equities, and next year is the presidential cycle year which invariably is a positive year for stock market returns. We should not assume that this coming year will be true to form. However, we believe the administration will make every effort to produce a better '03 than '02 to ensure the reelection of President Bush.

We wish our readers a Healthy, Happy and Peaceful New Year!

Appendix A



MZM is M2 minus total small denomination time deposits, plus institutional money funds, which are included in the non–M2 component of M3. Each component is seasonally adjusted.

Money Zero Maturity (MZM)

Compounded annual rates of change, average of four weeks ending:

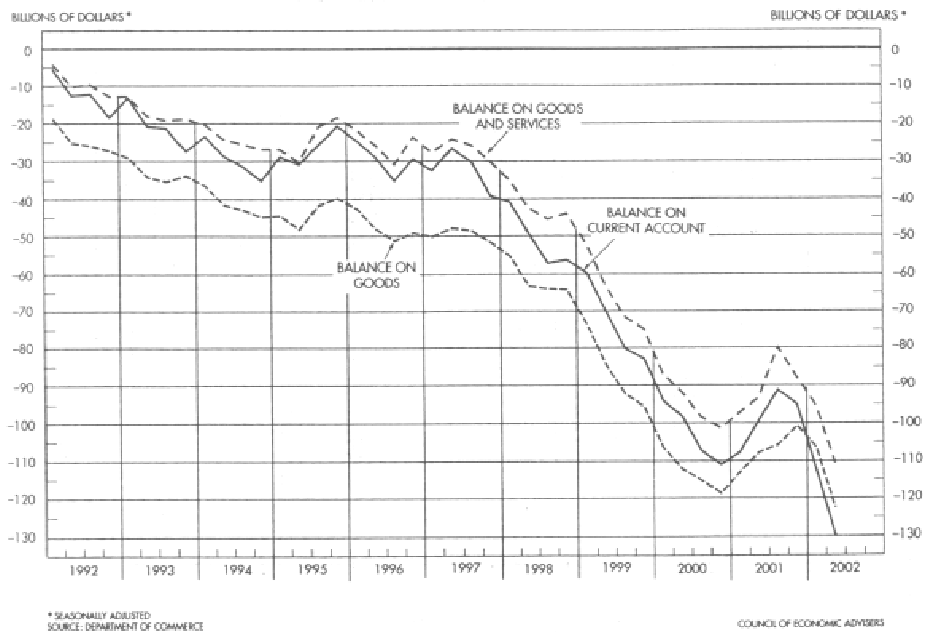
To the average of four weeks ending:	11/26/01	2/25/02	4/22/02	5/27/02	6/24/02	7/22/02	8/26/02	9/23/02
4/22/02	5.1							
5/27/02	7.3	5.0						
6/24/02	7.7	6.3	14.2					
7/22/02	8.0	7.0	12.9	10.4				
8/26/02	8.7	8.3	13.1	11.7	12.1			
9/23/02	8.2	7.6	11.2	9.6	9.2	8.9		
10/28/02	7.8	7.1	9.9	8.4	7.9	7.2	3.8	
11/25/02	9.2	9.1	12.2	11.3	11.3	11.6	10.8	14.5

Prepared by the Federal Reserve Bank of St. Louis

Appendix B

U.S. INTERNATIONAL TRANSACTIONS

In the second quarter of 2002, the goods deficit rose to $122.6 billion, from $106.4 billion in the first quarter. The current account deficit rose to $130.0 billion in the second quarter, from $112.5 billion in the first quarter.



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