



A.R. Schmeidler & Co., Inc.

The Outlook

June 2003

As of June 5, 2003		
Index	YTD % Change	Market Value
Dow Jones Industrials	+8.4	9,041.30
S&P 500	+12.5	990.14
Nasdaq Composite	+23.2	1,646.01

The many points we made in our prior outlooks – dollar devaluation, persistently high energy prices particularly for natural gas, the expectation of further interest rate declines and the increasing emphasis on yield by investors – was far from consensus thinking. While these views have proven to be correct, the question now is, what is the outlook over the next six to twelve months.

With War Over, Investors' Attention Turn To Economic Fundamentals

With the war in Iraq "declared" over, it is time to once again note some of the key elements that support the U.S. economy and our financial markets.

- Consumer demand and business spending
At the present time, growth in consumer and business spending is likely to remain slow, but a positive trend has been all that is needed to result in better financial markets. However, it is important to note that the U.S. economy is being supported by the strength in housing and the ability of consumers to refinance their mortgages without which growth would be virtually nonexistent.
- Interest rates
We expect current inflation rates to decline further and the Federal Reserve to maintain short-term interest rates at historically low levels for the foreseeable future. Furthermore, recent statements by Fed Chairman Greenspan indicate a likely further reduction in short-term interest rates.
- Availability of credit, the difficult employment outlook, and prospects for a lower U.S. dollar are also important variables to consider in assessing the health of the U.S. economy and the financial markets.



The Current Structure Of The Equity Market

While stock prices are already reflecting a mild economic recovery in the second half of 2003, the structure of the markets suggests that further appreciation is likely to occur. The factors leading to this conclusion are as follows:

1. More than \$6 trillion of liquid assets barely earns any interest.
2. Dividend-paying common stocks are attracting significant capital flows as a result of the need for yield.
3. The new tax reduction act will provide some economic stimulus as well as lower the cost of capital as both the capital gains tax and the tax on dividends have been reduced.
4. The depreciation of the dollar will result in better business for exporters and can bring about higher reported earnings for U.S. multinational corporations.
5. **Hedge funds still carry near-record short positions on both the New York Stock Exchange and the Over-The-Counter market, and as they cover their short positions by buying in shares and also initiate new long positions, they can be a powerful force in pushing equity prices higher.**
6. If markets continue to rise, cash on the sidelines will be forced into being invested. The market is professionally dominated at the present time and investors are not willing to miss a rising market. In fact the latest mutual fund flows indicate that \$16 billion flowed into equity funds reversing many prior months of outflows.

The history of the stock market provides numerous examples of powerful, tradable rallies that are independent of whether a new long-term bull market has been established. These rallies reflect oversold conditions that can combine with temporary let-ups of negative pressures that attract both bargain hunters and momentum players. Such tradable bear market rallies can occur several times during the grip of an overall bear market.

The Housing Market Is Supporting The US Economy

While the growth in consumer spending is unlikely to reach the levels the U.S. economy had grown accustomed to in recent years, it is also unlikely to collapse. Home equity loans continue to fuel consumer purchasing power. Increases in property values and low interest rate home equity loans have left many middle-income consumers in good spirits. Access to additional credit is readily available and is being fueled by the Federal Reserve. However, it is vitally important that interest rates do not rise since consumers are being encouraged to take on considerably more debt. We believe this condition is fundamental to the Federal Reserve's concern, however remote, of the prospects of deflation.



The Outlook For A Sustainable Corporate Profits Recovery Is Muted

Over the remainder of the year, **we do not believe that GDP and corporate earnings are likely to grow rapidly enough to justify many common stock valuations.** Moreover, the most recent testimony of Chairman Greenspan, for the first time we can recall, focused attention on the high cost of natural gas and its likelihood of remaining expensive. Many companies will be burdened by high-energy costs that will mute their profit growth. (Interestingly, natural gas related share prices immediately strengthened after his statement and in some cases went on to make new highs.)

A cyclical recovery in the second half of 2003 has already been factored into equity valuations. **We think that the case for a new broad-based bull market is difficult to make. Nonetheless, companies with operating and/or financial leverage can do reasonably well in this environment.** Many of the equities that we follow will not need a strong consumer or business-spending environment to deliver an excellent total rate of return.

Why Tangible Assets Continue To Be Major Beneficiaries

The long cycle of disinflation and slowing growth has now taken us to the point where the continuation of such a trend could possibly tip us toward deflation. Under present conditions, central banks are turning up the dial with respect to pumping liquidity into the system to stave off such an outcome. A natural consequence of this concerted effort to reflate is a competition involving currency devaluations and a readjustment in the value of these fiat currencies against hard assets. This cycle is reinforced by the decline in the dollar that places additional pressure on European growth while the renminbi's peg to the dollar makes China even more competitive as they export their goods at ever-lower prices. Recently the increase in uncertainty associated with financial assets has lead to an increase in interest in tangible assets such as real estate, natural resources and gold. **On an historic basis the purchasing power of gold has notably deteriorated and this trend is likely to reverse due to the current dynamics of the world economy.**

Interest Rates Are Low And Will Likely Head Lower

The Federal Reserve is not in any hurry to raise interest rates. On the contrary Mr. Greenspan, in his latest testimony, raised the possibility, however remote, of a deflation scenario. **Under these circumstances, short and long-term interest rates would likely remain at historically low levels for an extended period of time.**

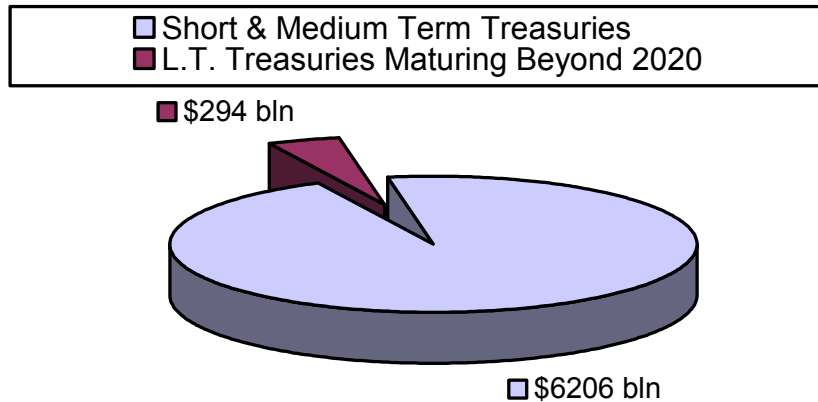
To give you a sense of how easy it would be for the Federal Reserve to lower long-term interest rates, we list below the national debt in the public hands beginning with the year 2016. Notice how few long-term bonds are outstanding.

Year	Billions
2016	\$39.0
2017	\$21.7
2018	\$11.6
2019	\$26.9
2020	\$28.5
2021	\$51.0
2022	\$14.4
2023	\$34.0
2024	\$8.0
2025	\$17.0
2026	\$28.0
2027	\$34.0
2028	\$35.0
2029	\$38.0
2030	\$15.0
2031	\$15.0
2032	\$4.9

As can be seen on the next page, the total national debt in the public hands from the year 2021 to 2032 is an astonishingly small \$294 billion out of the total national debt of \$6.5 trillion. **With so few bonds comprising the long end of the market it would not take many dollars to influence rates.** As of the end of 2002, the average maturity of the national debt was only sixty-six months. Since there is so little long-term Treasury debt outstanding that one can purchase to lock in a reasonable return, with total liquid assets in excess of \$6 trillion earning almost no interest, demand for yield has had a significant impact on raising Treasury prices.



Total US National Debt: \$6.5 Trillion



Federal Tax Relief Is A Short Term Positive For The Financial Markets

Most U.S. taxpayers and businesses will get some tax relief from the new \$350 billion tax relief package. However, **investors appear to have the biggest benefit since the tax bill reduces the tax rate to 15% on stock dividends and long-term capital gains.** Another feature of the tax relief legislation accelerates the write-off for new business investment allowing companies to depreciate 50% of the cost of new capital purchases in the purchase year. Given the depressed level of capital spending due to lingering overcapacity this will likely represent a mild positive at best. Additional positives come from both a downward adjustment in tax brackets for couples filing joint returns (eliminating some of the marriage penalty) and an increase in the child tax credit to \$1,000 from \$600. While the financial markets reacted to the legislation in a positive way, it is questionable as to how much it will actually help the economy. **The tax bill has been controversial from the start and the economic stimulus it provides will be partially offset by state and local governments as they raise taxes and cut spending to close their rising deficits.**

The Challenge Of Predicting The Future

Who ever would have ever imagined two years ago, that U.S. interest rates would decline to 1% while at the same time the vast majority of US workers would remain employed? Clearly, something is occurring during this cycle that has not occurred in prior cycles. The primary difference that is driving this divergence is that we have been exporting high wage base jobs to low wage base nations at an accelerating pace. The global trading system is now more open than in any time in history while capital is more fluid as deregulation and price controls have given way to free market mechanisms. This must be considered with great care when comparing to past cycles and extrapolating

those cycles in to future outcomes. Finally, given the growing importance of the global trade of goods and services, economic activity and the flow of capital will be highly influenced by exchange rates.

Conclusion

While noting the significant technical positives in the market, the underlying fundamental difficulties in the U.S. and global economy are still with us. World growth depends too heavily on the American consumer, Western Europe's labor structure needs reform and the dollar's depreciation is further weakening Europe's economies making them less able to purchase U.S. goods. As a consequence the U.S. trade deficit will remain unsustainably large. **For significant improvement to occur in the world economy, the Euro Zone and Japan will have to do more to stimulate their domestic consumption and not depend on just the American consumer.**

As of this writing we expect the European Central Bank to lower interest rates and the dollar to continue to depreciate over time. It is important to recognize that overseas' economies which are running trade surpluses with the United States can purchase U.S. Treasury bonds to prevent their currencies from appreciating too rapidly and damaging their export industries. This process tends to lower U.S. interest rates. At the present time, the two-year Treasury is yielding 1.22% or less than the federal fund's rate of 1.25% suggesting another decline in the federal fund's rate is in the offing. **We believe we are currently in a powerful bear market rally where the opportunity to capture substantial capital gains can occur.** Many investments that we continue to favor are beneficiaries of the current rally but are also in secular up trends – an important distinction as it is impossible to know with certainty when the rally will exhaust itself.

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