



A.R. Schmeidler & Co., Inc.

The Outlook

January 2004

As of January 29, 2004		
Index	YTD % Change	Market Value
Dow Jones Industrials	0.1%	10,468.37
S&P 500	1.5%	1,128.48
Nasdaq Composite	3.7%	2,077.37

GDP Growth At A Price

The recovery in the U.S. economy is the result of an inordinate amount of fiscal and monetary stimulus. Forty-five year low interest rates and the easy availability of funds have been stimulating consumer and business spending. Unfortunately job growth during this recovery has been sub par as the forces of globalization have accelerated manufacturing and service sector outsourcing to the Asian economies. GDP growth for the fourth quarter appears to have been at 4%, not sufficient in our view to accelerate employment growth. The price of this recovery is the fiscal imbalance that has been created which is now estimated at more than \$500 billion in the latest budget to be submitted by the administration. Federal Reserve Board Chairman Alan Greenspan will be testifying before Congress on February 11th, and we believe that he is greatly concerned about the U.S. federal budget deficit. Last Monday the Congressional Budget Office projected this year's deficit at \$477 billion. President Bush's new budget, which will be submitted next week, will now project a deficit in excess of \$500 billion and could be in the neighborhood of \$540 billion. We do not believe that this imbalance is sustainable and will result in some interesting fireworks between the political parties and within the Republican Party this election year.

The Federal Reserve's Most Recent Message

One of the consequences of our fiscal policy has been the weakening dollar. We suspect that the latest change of language from the Federal Reserve from "to keep rates low for a considerable period" to "the committee believes that it can be patient in removing its policy accommodation" had more to do with trying to stabilize or slow the decline in the foreign exchange value of the dollar by suggesting an end to its easy money policy than any desire to raise interest rates in the short term.



The inflation picture remains very favorable for a continuation of low interest rates. However, several factors are pressuring prices: medical/health costs are rising, local and state governments are increasing taxes, commodity prices are moving up across the board and the U.S. dollar is weak. However we still feel that the Federal Reserve will resist interest rate hikes until at least the third quarter of 2004 and probably into early 2005. Strong economic growth should not result in a rising inflation rate unless that growth is strong enough to generate much higher employment growth and significantly higher industrial utilization. We do not believe that industrial capacity will tighten enough to cause that to happen. The Federal Reserve will be able to remain accommodative for the majority of 2004, in our view, because of technology related productivity gains as well as deflationary manufacturing pressures from Asia.

Sectors That Can Contribute To A Well-Constructed Investment Portfolio

Over the course of the year, portfolio shifts will be determined by security valuations, the dynamics of the U.S. budget and trade deficits and changes in global capital flows. We now turn to some of the sectors that can contribute to a well-constructed investment portfolio as we start 2004.

Precious Metals

We believe strength in precious metals stocks was initially attributed in 2003 to the weakness in the U.S. dollar. With nearly a decade of neglect by the investment community, gold and silver was destined to quickly rise. The Federal Reserve's accommodative monetary policies, weakness in the U.S. dollar, low interest rates and continuing purchases by the Asian countries should drive precious metals prices higher in 2004. Unless there is an unlikely reversal in these factors, equities in this sector still have considerable room to advance. As unfashionable as gold and silver were just a few years ago they now remain one of the best hedges against a weak currency and large federal budget deficits. The fundamental supply and demand aspect of gold and silver is also favorable and offers support for prices. The under investment in mine projects over the last decade cannot be easily reversed.

Energy

There clearly is a case to overweight energy stocks in portfolios. The companies that comprise this sector have strong balance sheets and attractive free cash flows. The energy sector is also home to some well-managed companies that pay high dividends, and have excellent investment opportunities in their industry.



They should benefit from existing supply/demand imbalances in the U.S. and from rising demand from Asia.

The natural gas industry in particular should have another strong year in 2004. The National Petroleum Council recently released a study on natural gas supply and demand that projects that domestic production can only satisfy about 75% of future U.S. domestic requirements. Natural gas prices are likely to remain high and the government could encourage an increase in drilling and new pipeline and processing construction. Companies that supply natural gas to the U.S. market should continue to enjoy high profits and excellent free cash flows for the foreseeable future.

Select Technology

The technology companies have experienced one of their worst down cycles ever over the past couple of years. A weak U.S. and global economy resulted in a sharp drop in technology spending, which caused an unusually severe recession in the industry. While technology companies generally experienced a dramatic improvement in their equity values in 2003, they are still a long way from their all time highs. It now appears that the worst is over, and the spending cycle for these companies has turned positive. Select technology companies' profits will improve markedly in 2004. However for investors to do well in the coming year in this sector they will need to focus on the companies that will experience much higher revenues and significantly better profit margins. We favor the companies that have reduced expenses and streamlined operations during the down cycle, maintained their technological edge and have strong balance sheets. The introduction of new materials, smaller components, increased memory functions and faster speeds should represent a significant opportunity for a select group of companies in this sector. The caveat, however, is that investors will have to be sensitive to valuation which for some companies are quite extended.

Insurance

Over the last two years the insurance industry has steadily improved its profit margins. Looking ahead we believe that the industry has excellent growth opportunities in both its domestic and international markets. Due to the historically low interest rate environment the industry has been forced to increase its premiums on new business and avoid writing policies that do not make good actuarial sense. While we do not expect the Federal Reserve to raise interest rates significantly in 2004, slightly higher interest rates would benefit the insurance sector's profit margins. Looking ahead we believe that earnings in this sector could be stronger than expected if current insurance premium levels persist.



Defense Industry

Defense spending is likely to rise over the coming years; there will be a substantial need for new systems and advanced technologies. The federal government's budget deficits are not likely to lead to any substantial cuts in the funded portion of the defense budget. Even if the conflicts in Iraq and Afghanistan diminish, demand for military hardware likely will be sustained at high levels as our armed forces prepare for new terrorist actions and security threats. The companies that we favor in this sector have broad-based strength as Pentagon suppliers. They are generally well-positioned to maintain or improve their standing as preferred defense department contractors. On land, air, and sea the weaponry they provide has technological distinction and tactical superiority on the battlefield.

Hard Assets Including Real Estate And Industrial Metals

In recent years hard assets, which include the real estate and industrial metals sectors, experienced mixed equity appreciation. Things began to improve in the first half of 2002, but the U.S. economy stumbled, delaying a strong recovery in these sectors. This year, however, revenues and profits have begun to demonstrate sustainable strength, and we are optimistic about the coming quarters. Many of the companies that we follow that fall under this category have been reporting significantly better-than-expected results in 2003. Recently released housing data indicate that the home building industry is on a very solid footing. We have also become progressively more confident about the prospects for many industry commodities. Strong industrial demand and a weakening U.S. dollar against other major currencies have in particular helped copper and nickel prices. We expect companies in the home building and industrial metals sector to increase or initiate new dividend payouts and continue their aggressive share buybacks.

Healthcare

In late November, President Bush signed into law a new Medicare reform bill, whose centerpiece was a \$400 billion drug insurance plan. The legislation requires beneficiaries to pay \$35 per month and the first \$275 in annual costs, then Medicare covers 75% up to \$2,200 of these expenses per person. After that no coverage is provided until \$3,600, at which time Medicare picks up 90% of the cost. The drug industry posted weak profit numbers in 2003, and the stocks performed poorly, lagging the overall equity market by a significant margin. The passage of the industry-friendly Medicare Drug Benefit Bill should help investors change their perceptions about the industry. We are optimistic that the pharmaceutical companies will have a better year in 2004. In spite of the expanding Federal budget deficits and fiscal constraints on local governments,



population, demographic and socio-economic trends favor the profit margins in the healthcare industry. The pharmaceutical equities look particularly attractive at their current equity valuations.

Securities That Have Meaningful Dividends

A security's market value typically consists of two components: the contribution to value deriving from the profitable growth of earnings and the contribution to value deriving from the current dividend. The dividend contribution is enhanced to the extent that the contribution to equity value deriving from the retention of profits can generate an increase in future dividend payments. Significant capital can be built by purchasing securities that have meaningful dividends and above average yields. A key to success in this area is to identify and invest in companies that have strong finances and a payout ratio that allows for dividend growth. With these characteristics present, one should be able to expect both growing income as well as capital appreciation over time.

Special Situations

We are also always interested in investment opportunities in special situations. What can make for a special situation is an investment that is not highly correlated to its sector due to a combination of a substantial under-valuation and/or an event such as a corporate restructuring, an impending asset sale, or merger that will cause a significant change in its valuation. For illustration, in 2003 we began buying unpopular Sears at \$22 a share after the company announced its intention to sell its credit card operations. After valuing the company we determined it was selling for approximately 5 times earnings, 3 times cash flow and had a secure dividend that was yielding over 5% at the time. In addition, during what was a questionable retail environment it was aided by the home appliance business resulting from the housing boom. Some of our last sales of the equity were in the \$53 range, and clients received dividend income while the security was held.

Conclusion

In 2004 economic growth in the United States will continue to be dependent on the global economy and government fiscal and monetary stimulus. Employment growth will obviously be determined by the performance of the U.S. economy. A swing to a meaningful, sustainable pickup in the growth of well-paying U.S. jobs could alter the current economic landscape. A significant increase in economic growth would introduce additional consumer and business spending and new profit opportunities for the companies in the sectors that we favor. At this time the probability for such a major pick-up in job growth remains relatively low. Should job growth materialize, we expect the Federal Reserve to raise interest



rates sooner than later. However, no matter what the circumstances, the marketplace will always offer opportunities for capital appreciation and income growth.

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