

April 7, 2003

To our Clients and Friends,

If Rip Van Winkle had gone to bed at the end of 2002, slept through the first quarter of 2003, and awoke on April Fool's Day to check his stock portfolio, he might conclude that not much had happened during his siesta. That we finished the quarter more or less where we began belies the **tremendous intra-quarter volatility** we experienced, some of it weather related, some war related, and some (believe it or not) tied to the financial goings-on at public companies.

As we suggested in our previous letter, **the stock market has cheered** what is shaping up to be a speedy resolution to the military action in Iraq, with no chemical or biological weapons having been used against the coalition forces to date. Bonds have also rallied as investors from around the globe sought the perceived safety of these instruments. We are increasingly troubled by the US Treasury market's high prices (read: **government bond yields at four-decade lows**;) but note that other sectors of the fixed income market offer relatively good value, by our calculations.

Crude oil has plunged 25% from its recent high and gold is off 12%;<sup>1</sup> we believe both moves are positive indicators for the economy and stock market. On the other hand, employment and manufacturing activity were punk in the first quarter, hinting at muted performance in the months ahead. The **key indicators to watch** are plant capacity utilization, profit margins, and both consumer and corporate spending levels. If Alan Greenspan is correct in his viewpoints, corporations are sitting on the sidelines waiting for the situation in Iraq to be resolved before they release their capital budgets.<sup>2</sup> When that time comes, **economic activity should accelerate**.

One of the more bullish signals we have seen is a decrease in the rate at which Wall Street analysts are cutting their corporate earnings projections. This suggests a more rational outlook which, according to Morgan Stanley, has historically been tied to a rising stock market.<sup>3</sup> Other business fundamentals, such as lower debt levels and stronger cash flow, also point toward higher equity prices, though certainly not to the levels reached in the late 1990s.

But the question that nags us, the issue we feel poses the greatest risk to market stability over the next several months, is this: The coalition forces will surely win the military battles in Iraq, but what if no "weapons of mass destruction" are found? (We do not mean a handful of al-Samoud II missiles, but rather the chemical and biological weaponry Iraq allegedly stockpiles – the sort of things over which one might go to war.) It is difficult to anticipate the political implications of such an outcome, even more so the economic ramifications, and yet we must give them due consideration.

At this point, **we believe the risks to the stock market are roughly in line with the potential rewards**. Were it not for the uncertainties that abound, we would find equities undervalued relative to bonds. Unlike Mr. Van Winkle, who, as you may recall, slept through the American Revolution in Washington Irving's tale, we recommend investors stay vigilant to the changes now occurring in the financial markets. We believe investors should maintain a moderately defensive position, with a diversified portfolio to help mitigate ongoing volatility, and be prepared to act as opportunities arise.

Sincerely yours,

Mitch Schlesinger  
Chief Investment Officer

<sup>1</sup> New York Mercantile Exchange, April 7, 2003

<sup>2</sup> CNNMoney.com, February 11, 2003

<sup>3</sup> Morgan Stanley, US Investment Strategy Chartbook, First Quarter 2003