October 9, 2003

To our Clients and Friends,

Let us begin our review of the third quarter's activity with a tidbit of classic Americana:

> ***ECONOMY***, n.
> *Purchasing the barrel of whiskey that you do not need*
> *for the price of the cow that you cannot afford.*
> *- Ambrose Bierce, The Devil's Dictionary*

Though Bierce published his compendium of American cynicism in 1911, we find his work fits well with the current times. As a nation of have-it-now consumers, we splurge on the latest satellite radio receivers, flat-screen televisions, and digital cameras, while many of our necessities – health insurance, prescription drugs, soybeans, etc. – rise in price to unaffordable levels.

Yes, we did say 'soybeans,' often hailed as a "miracle crop" and a modern substitute for the dairy cow as economic metaphor. In recent days, soybeans topped $7.00 per bushel, a level not seen in over six years. If you didn't know, soybeans and their byproducts are among the most broadly used agricultural commodities, appearing in candy bars, coffee creamers, salad dressings, paints, pesticides, antibiotics, electrical insulation, diesel fuel and margarine, among hundreds of other items. As the price of soybeans (and many other foods) rises, so does our overall **cost of living**.

Which leads us to another handy metaphor from days gone by: **guns and butter**. Although the original phrase "guns *before* butter" was used by the Third Reich to represent a time of economic sacrifice, it was popularized with the conjunction *and* when then-Senator Lyndon Johnson challenged President Truman to explain the cost of the Korean War. Of course, guns-*and*-butter became Johnson's own policy during his term as president, as he assured the nation that we lived in a land of prosperity and could afford both. The economic consequences proved dire.

Accordingly, the current administration's guns-and-butter policy gives us **cause for concern** over the fate of the financial markets. It does not seem probable, given economic history, that we can have it all – tax cuts, a major new entitlement program (prescription drug benefits), increased government spending on technology, all while financing a costly battle against terrorism. At some point the bills must be paid, and our borrowings will likely result in higher inflation, higher interest rates, and slower growth. These are *always* the outcomes when we borrow from the future to pay for today.

In the meantime, fortunately**, the economy continues on the road to recovery**, with gross domestic product accelerating toward a 5% growth rate. The stock market has responded appropriately, with prices increasingly modestly in the third quarter following a solid expansion in the months prior. The employment picture has brightened, though this is often a lagging indicator and we think it is too early to expect the unemployment rate to drop much. Interest rates remain low in absolute terms, though they have risen from the levels reached in June. More telling is the steep yield curve (1-year T-bill at 1%, 30-year T-bond at 5%), which suggests a **continuation or even acceleration of economic growth** in the near term. For now, at least, it seems we can indeed have guns and butter, satellites and soybeans, the whiskey and the cow.

However, given the rise in both stock prices and long-term interest rates, **we now believe that stocks are at "fair value"** with some pockets of overvaluation. This is a marked difference from six months ago, when we suggested that stocks were relatively undervalued. As such, we expect more "normalized" returns going forward, i.e., substantially lower than they have been over the past year, but still positive. The **key risks**, as noted above, are higher inflation and subsequently higher rates. In the coming months we expect new inflation-protected securities to become available, and we will likely incorporate them in portfolios as a hedge against this long-term risk.

Sincerely yours,

Mitch Schlesinger
Chief Investment Officer