

INVESTMENT UPDATE

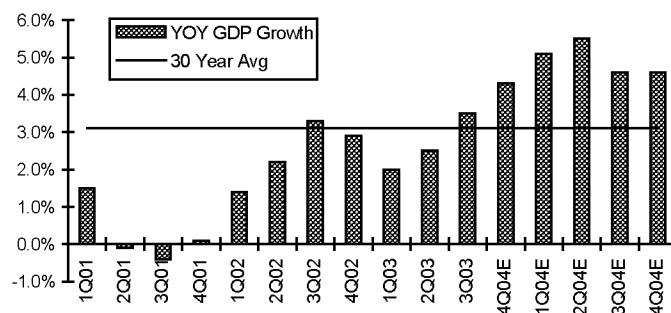
Executive Summary

- Strong third and fourth quarter GDP growth should continue into 2004. Robust corporate earnings growth will accompany this expansion.
- The missing pieces of a sustainable economic recovery are emerging as capital spending and new job formation are returning and inventory re-building is expected to start soon.
- Accommodative monetary policy will begin to be reversed in 2004 as the Fed starts to raise interest rates by mid-year.
- Although rising interest rates will eventually have some negative impact on equity valuations, this should be more than offset by strong economic growth, record earnings, and reasonable P/E ratios.
- A rising interest rate environment will make 2004 a difficult year for longer-term bond performance. It is suggested that bond durations be kept relatively short.

Economy

Critics of the economy have been silenced by its exceptionally strong +8.2% annual growth rate in the third quarter. The above-average momentum appears to be sustainable as fourth quarter GDP is expected to grow by nearly +5% sequentially followed by +4.5% growth for all of 2004. Assuming +4.5% growth in the fourth quarter, the economy will have grown at an annual rate of +5.3% over the last three quarters, well above the +3.1% 30-year average. More importantly, the year-over-year (YOY) growth has accelerated throughout the year as illustrated in Chart 1.

CHART 1: The Economy is Growing at an Above-Average Rate.



Strong real GDP growth of +4.5% for 2004 is a result of the stimulative effects of rising government spending and tax cuts (fiscal policy), extremely low interest rates (monetary policy), and two years of dollar weakness (currency policy). These growth-oriented policies have encouraged consumer and government spending and will soon shift business spending into high gear.

Increasing business confidence and capital spending growth are required to sustain this economic growth cycle for the next several years. Fortunately, we have seen clear signs of this in recent months as capital spending and job growth have turned up and look to be carrying growth momentum into 2004. In addition, inventory levels are so low that a restocking trend is almost inevitable this year.

The best leading indicator of business confidence is corporate profits. After falling in 2000 and 2001, corporate profits have increased by +18% in each of the last two years and have surpassed prior peak levels, giving businesses the confidence and the capital to begin spending for the future. Capital spending and new job formation are already on the rise, but inventories continue to fall. Businesses are currently meeting demand by reducing inventories rather than increasing production. Even with better inventory management techniques, at some point in the near future, production must be increased to meet demand and to rebuild inventories.

CHART 2: Employment Surveys Indicating Job Growth is Returning

