



4 th Quarter 2003	Close	Performance
Dow Jones Industrial Average:	10,453.92	12.7
Standard & Poor's 500 Index:	1111.92	11.2%
10-Year Treasury Yield:	4.25%	

Dear Investors,

The fourth quarter of 2003 finished in grand style, giving profit-starved equity investors their first positive year since 1999. All major U.S. averages and most international markets recorded strong gains. The Dow Jones Industrial Average rose 12.7% for the quarter and 25.3% for the year. The S&P 500 increased 11.2% for the quarter and 26.4% for the year. The NASDAQ, which had fallen much further from its peak than the broad-based averages, gained a blistering 50% in 2003. Bond investors, on the other hand, had to settle for their most measly results in four years, as the benchmark 10-Year Treasury note returned only 1.38%—less than its coupon. They should expect more of the same in the years ahead.

The global economic recovery gathered strength in 2003. China continues on its steep growth curve, and it is dragging along with it many of its Asian trading partners. Latin American markets soared, with both Brazil and Argentina returning in excess of 100% in dollar terms. Europe also posted strong results, with the Dow Jones Stoxx 600 Index returning 18% in local currency terms and 37% to U.S. dollar-based investors. Even Japan's Nikkei 225 delivered 24% to its beleaguered investors.

The U.S. economy is expanding rapidly. Third quarter U.S. GDP growth of 8.2% demonstrates that the massive fiscal and monetary stimulus enacted in 2003 and before has finally taken hold. Profits are booming as stimulus-induced demand has engulfed corporations that have cut their costs to the bone over the past few years. Productivity continues to improve as corporations foist more tasks onto their computers instead of hiring new workers. Indeed, one of the reasons why the labor market remains weak is that productivity is so strong—it was up 9.4% in the 3rd quarter. Corporations are simply generating more profits without increasing their workforces. Earnings are poised to continue rising strongly into the first half of 2004, however, and the U.S. equity market, for the first time in a long spell, seems to have the wind to its back.

In the second half of this year, however, earnings comparisons become more challenging and the fire hoses of stimulus (\$3 trillion in mortgage refinancing, a \$450 billion Federal budget deficit, interest rates at a 45-year low) will be turned to the "low" setting. For 2004, the table is set for strong earnings growth through the first half of the year, then a decelerating rate of growth as we moved in the second half of the year and face the tough 3rd quarter 2003 comparisons. The most important question that investors must grapple with is what segments of the markets will fare best when the enormous stimulus that has been fueling the economy begins to dry up.

In my September letter I addressed two major issues facing the stock market: the weak labor market and the weakening dollar. These two issues remain long-term concerns for the U.S. economy, but the stock market seems not to be bothered at the moment. Despite roaring GDP growth, the December unemployment report that our rapidly growing economy had only created 1,000 jobs is forcing investors to reassess the nature and sustainability of the recovery. A weak labor market is detrimental to the long-term health of the economy because it reduces aggregate demand, but it can be viewed in a somewhat positive light at the moment because it will allow the Federal Reserve to put off its plans to raise interest rates. Another year of low rates will put off the day of reckoning: when higher interest rates meet full price-to-earnings multiples.

For the dollar, which is scraping an all-time low versus the Euro and a multiyear low against the yen, the tipping point from good to bad is difficult to spot. A weak dollar is good for our economy because our goods become cheaper on world markets. However, a sudden plunge in the dollar's value would pose a serious threat to our economy. Foreign central banks and official institutions bought U.S. debt with a vengeance last year, increasing their U.S. Treasury holdings from \$686 billion at the end of 2002 to \$848 billion by December 2003. During a continuing downward spiral in the dollar, however, they could decide that holding dollar-denominated assets is simply a poor investment plan and begin to shed them. Should this happen, U.S. interest rates could move sharply higher and put a dent in our recovery.

Our dollar is still accorded ample respect—maybe too much—as a reserve currency. Meanwhile the Euro is gaining respect as a currency and it would surprise me if many international investors were not thinking that 2004 is the year they begin to allocate some of their currency exposure away from the dollar. The investment game-plan in the case of continued dollar weakness is clear: own the stocks of U.S. companies that do a significant amount of business abroad, own assets that are not dollar-denominated or own commodities that are priced in dollars. Commodities had a stellar 2003 as the dollar buckled, and this trend will likely persist into 2004.

U.S. bond markets had the first of what I believe will be many tough years ahead. 10-Year Treasuries eked out a gain of 1.38% for 2003, but I believe returns for long-term bond investors will likely be negative in 2004. The investment-grade bond universe in particular holds little promise for the coming years. In my view, the only areas in the bond market where rewards can approach risks are those parts that have already performed extremely well—namely emerging market bonds and junk bonds. Municipal bonds continue to offer slightly better after-tax yields than comparable-maturity U.S. government debt, but the prospective rates of return are hardly compelling. Fixed income investors that are interested in making a profit in 2004 should either be content with the safe but paltry returns ahead for Treasury Inflation-Protected Securities (TIPS) or otherwise keep their maturities short and consider shouldering additional credit risk.

In an equity market of more than 10,000 choices, there are still opportunities to buy attractive stocks. Overall, however, valuations have moved up substantially, reducing the long-term attractiveness of several sectors. Most industrial stocks seem to be pricing in a full economic

recovery, as do most of the large-cap technology stocks. Energy companies, however, are continuing to produce strong cash flow and trade at palatable multiples—even as gas and oil prices remain high. Many healthcare companies have under-performed the market in the past year and remain reasonable values. Some underperformance, such as that of the large-cap pharmaceutical group, is largely deserved, but some healthcare services stocks still appear attractive. Retail stocks mostly under-performed in the fourth quarter, and many still remain attractive. We continue to concentrate our retail investments in niche companies with solid finances that are safely out of the way of the steam-roller that is Wal-Mart. As always, we remain focused on investing in companies that are demonstrating strong operating performance and whose stocks trade at reasonable prices.

All in all, 2004 seems to hold promise.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

Peter C. Thoms, CFA
Orion Capital Management LLC
1330 Orange Ave. Suite 302
Coronado, CA 92118
Tel: 619-435-1701 Fax: 619-435-1706
www.orioncapitalmgmt.com