



<u>1st Quarter 2004</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	10,357.70	0.9%
Standard & Poor's 500 Index:	1,126.21	1.3%
10-Year Treasury Yield:	3.85%	

Investment Outlook **March 31, 2004**

Dear Investors,

The first quarter of 2004 ended mixed, with most of the broad averages hovering near the unchanged level. The Dow Jones Industrial Average declined 0.9% for the quarter while the S&P 500 managed a 1.3% increase. The NASDAQ finally took a breather as it eased 0.5%. The benchmark 10-Year Treasury note returned 4.7% as interest rates dropped from 4.25% at the beginning of the quarter to 3.85% at the end of the quarter. I expect that bond investors just enjoyed what will likely prove to be their best quarter of 2004.

The focus and expectations of investors are now in transition. We entered the quarter with the stock market on a firm trend upward due to rapid corporate earnings growth, tepid jobs numbers and persistently low interest rates. Now, at the beginning of the second quarter, we still have strong corporate growth—S&P 500 earnings will likely be up nearly 20% for the quarter—but we are also preparing for higher interest rates. Thus, many equity investors are now turning their efforts toward uncovering the stocks that will be able to perform in a world of rising rates.

The global economic recovery continues apace into 2004. China's GDP growth remains strong, but huge increases in fixed investment and the burgeoning level of outstanding debt are beginning to stir global investors' concerns about an overheating economy. Japan is making slow but steady progress with cleaning up its banks' bad debt problem. Europe remains on a lower growth trajectory that either the U.S. or Asia, and consequently European equities are less pricey.

The U.S. economy continues to hit on nearly all cylinders. Two recent economic reports, in particular, highlight the growing strength of the economy. First, March retail sales grew 1.7% from the year-ago figure. Second, the March non-farm payrolls report indicated that the economy added 308,000 jobs for the month, the first substantial increase in jobs in many months. The markets are down since these reports. Why? These signals of economic strength portend higher interest rates, which are definitely bad for bonds and at least perceived to be bad for most stocks.

The struggle the market will face in the coming months will be due to two things: the timing and magnitude of interest rate increases and the effect these increases have on stock valuations. Corporations remain in good shape. The rate of corporate earnings growth, however, will begin to slow in the second half of this year—this is nearly certain after a full year of 20% quarterly increases. The real swing factor in the market will be the degree to which higher interest rates weigh on price-to-

earnings multiples. The overall market is probably fairly valued at today's level of interest rates, but P/Es may contract somewhat if long rates spike significantly higher.

Our equity strategy is not affected dramatically by the prospect of higher rates, but we will certainly be taking a closer look at companies whose stocks have historically done well in times of rising rates. Specifically, the energy and technology sectors can perform satisfactorily as rates climb. We continue to do bottoms-up analysis to find the companies that are building competitive advantages and outperforming their peers in their respective industries. We seek to invest in the stocks of such companies when they are trading at below-market valuations while sporting above-market earnings growth potential. Whatever should happen with interest rates, we believe this valuation-sensitive strategy will prove effective over the long haul.

As is the case every year, my updated Form ADV for 2004 is available to any clients that would like a copy. Please let me know.

I welcome your comments and feedback.

Best Regards,

Peter

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