



<u>2<sup>nd</sup> Quarter 2003</u>	<u>Close</u>	<u>Performance</u>
Dow Jones Industrial Average:	8985.44	12.4%
Standard & Poor's 500 Index:	974.50	14.9%
10-Year Treasury Yield:	3.53%	

## **Investment Outlook**

### **June 30, 2003**

Dear Investors,

The second quarter of 2003 proved to be a joyful time for investors, as all major market indexes enjoyed powerful and broad-based rallies. During the period, the Dow gained 12.4% and the S&P 500 increased by 14.9%. Despite the pre-war sell-off during the first quarter, year-to-date gains are strong. The Dow is up 7.7% and the S&P 500 is up 10.8%. Bonds also performed well, with the bellwether 10-year U.S. Treasury note returning 3.5% for the period.

The long-awaited U.S. economic recovery has yet to gain traction despite the fact that monetary and fiscal gas pedals remain pressed to the floor. While GDP continues to grind out gains every quarter, economic growth has not yet been sufficient to inspire corporations to add workers. The June unemployment rate rose to 6.4%, a nine-year high. (Employment growth, however, typically lags an improving economy by about six months.) As shown by strong productivity numbers, companies are making due with fewer employees. On the bright side, the dollar has weakened significantly against most major currencies so far this year, thus giving U.S.-based manufacturers a much-needed boost. But what will drive the recovery? Unfortunately we cannot depend upon a surge in consumer spending to bring us out of this pattern of low-growth—for the simple reason that consumers never curtailed their pace of spending in the first place. Consumer spending has increased in every quarter since the beginning of the 2001 recession, the first time in more than fifty years that a recession has not resulted in at least one quarter of spending decline (year-over-year). Consumers have been buoyed by very strong home prices and record-breaking refinancing volume, so it is unreasonable to expect an acceleration in their spending. The best we can hope for, frankly, is that home prices and consumer spending hold up long enough for business spending to recover.

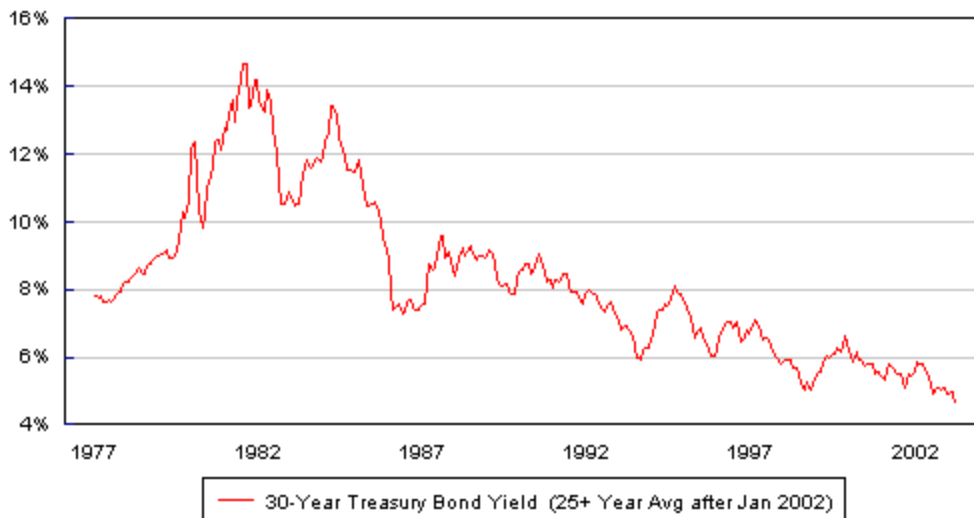
Globally, the U.S. is getting little help. The other two major engines of the global economy, Germany and Japan, are sputtering. Germany has slipped into recession, and its core inflation rate of 0.8% shows that deflation lurks just around the corner. Also, it is important to note that European economies slowed dramatically in the beginning of 2003, *before* the Euro's recent strong run against the dollar. Thus, the deleterious effects of a strong currency have yet to show up in the export accounts of the Euro countries. Overall, pressures on the Eurozone are coming from all sides: a strong currency, lack of momentum for structural reforms of the labor markets, and pan-Euro monetary policy that does a poor job of injecting liquidity where it is needed most—Germany. The second half of 2003 will likely be tough for Europe.

Japan's equity markets performed well during the period, but the country continues to suffer a vexing bout of deflation. Incredibly cheap money has done little to increase spending and

much to keep alive zombie companies that would have gone under were it not for generous financing terms and forgiving creditors. Such is Japan's Catch-22: government forgiveness of massive corporate-sector debt would further prolong Japan's dysfunctional allocation of capital, while a vigorous movement toward disposal of bad loans will likely cause an unbearable spike in unemployment. All in all, Japan's economic outlook remains bleak.

The U.S. stock market now expects a robust recovery and consequently boasts a generous valuation. Stocks now fetch approximately 19 times 2003 earnings estimates, well above the historical average of 15 times. Many argue that today's P/E ratios are reasonable due to very low interest rates—a contention in agreement with basic principles of finance. However, these same individuals must then agree that when the economy picks up and long-term interest rates rise, P/E multiples may contract if a large acceleration in earnings growth rates does not accompany the recovery.

Long-term interest rates, which have been declining since 1981, have provided support for above-trend P/E multiples. This trend will not last forever. (See graph below)



Rates are scraping 45-year lows and are now poised at what I believe is a critical inflection point. Further declines in rates will stoke deflationary fears, and an outbreak of deflation will pose severe problems for the stock market. During deflation, revenues and earnings for debt-laden consumers and corporations decline while their debts remain fixed. Historically, stocks have performed poorly during deflation. Rising rates, which I believe is the most likely scenario over the middle years of this decade, will also exert downward pressure on P/E multiples.

On the whole, global fixed income investments have performed extremely well so far this year. Rates have dropped in many parts of the bond market, and may now finally be bottoming. Bonds are now very high by historical standards and have attracted much money and attention of late. I believe that the best relative values in the fixed income markets are found in the municipal market. The turmoil in the finances of several states, particularly California and New York, has kept muni-bond yields relatively high. Investors in high tax

brackets will find that muni-bonds, many of which are AAA-rated, offer after-tax yields superior to comparable Treasury securities. I believe the prudent move for bond investors is to shorten their maturities and for the moment to tolerate lower, but safer, yields.

While I believe the overall market remains in a period of below-trend growth, significant opportunities exist in individual equities. Now, more than any time in the past two decades, a compelling argument exists for focusing on equities that pay high dividends. The federal government's decision to reduce the top dividend tax rate to 15% makes the harvesting of dividends a favorable after-tax proposition for investors. Companies that pay high dividends are often mature and lack compelling internal investment opportunities for their cash. However, a robust dividend policy demonstrates that such companies are 1) committed to sharing wealth with their shareholders and 2) have balance sheets that are strong enough to permit generous payouts of profits, even in this lackluster economy. Additionally, the after-tax yield on dividends has become even more attractive relative to bond yields, most of which have dropped precipitously over the past couple of years.

Selected growth equities also offer opportunities. In this time of rising unemployment and low business confidence, it pays to focus on companies with low cost structures that are prying market share away from their competitors. In healthcare, the generic drug and specialty pharmaceutical industries are benefiting from speedier FDA approvals for their products and a huge pipeline of branded drugs that are going off-patent. The aging of the Baby Boomers also bodes well for other niches of the healthcare sector, such as medical devices and care for the elderly. In the consumer discretionary sector, despite the country's excess of retail square footage, there are intriguing opportunities in retailers with good cost controls that are consolidating fragmented markets. In the technology sector, the best opportunities are not in companies that build computer hardware, but rather in companies that are taking advantage of the still-growing network of linked computers. Specifically, anti-virus and other computer security companies are finding their services more in demand today than ever before. Even in this slow economy, companies with attractive niches and shareholder-friendly managements can still generate attractive returns for their investors.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

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