



3 <sup>rd</sup> Quarter 2003	Close	Performance
Dow Jones Industrial Average:	9275.06	3.2
Standard & Poor's 500 Index:	995.97	2.2%
10-Year Treasury Yield:	3.93%	

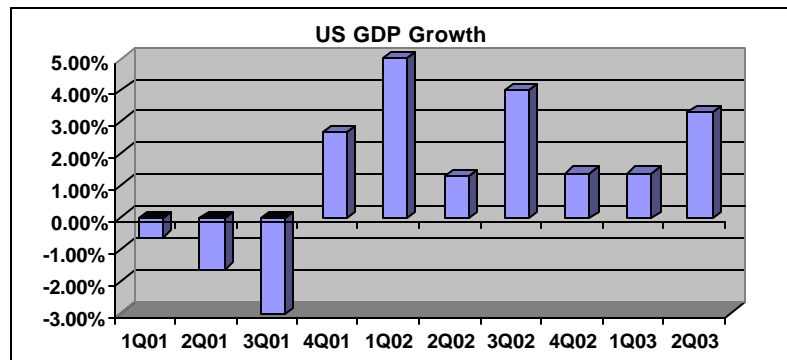
## Investment Outlook September 30, 2003

Dear Investors,

The third quarter of 2003 proved rewarding for equity investors and hair-raising for bond investors. For the first time since the first quarter of 2000, the S&P 500 posted back-to-back quarterly gains. Year-to-date gains are strong, and the market appears to be headed for its first positive finish in three years. By quarter's end, bonds had declined modestly, with the yield on the benchmark 10-year Treasury note increasing 0.41% during the period. This was, however, bonds' most volatile quarter for many years.

The U.S. and Japan are leading a global economic recovery. Japan's second quarter GDP growth, at 3.9%, eclipsed even that of the U.S., and data suggest that at least non-Japanese investors are regaining confidence in Japan. The Nikkei has performed very well this year—it rose 12.5% in the third quarter alone. Japan is not out of trouble yet, however. The yen has recently strengthened significantly, increasing the prices of Japanese exports, and the banking system is still choking on an estimated \$390 billion dollars in non-performing loans. Europe has remained the laggard, both in terms of market performance and economic growth. Investors are expecting European GDP growth of only 0.5% this year, well behind most other regions of the world. Sentiment in Europe continues to improve, however. Germany's Ifo business confidence index has risen for five consecutive months, indicating that market participants expect an improvement in conditions next year. All in all, the global economy appears to be in much better shape than one quarter ago.

The U.S. economy is regaining its footing. The second quarter GDP growth rate of 3.3% indicates an economy beginning to come to life and third quarter corporate earnings will likely be excellent. Companies have been cutting costs and improving their productivity for many quarters, and their income statements are now very sensitive to any uptick in growth. Cost-cutting and productivity growth will only take the stock market so far, however, because

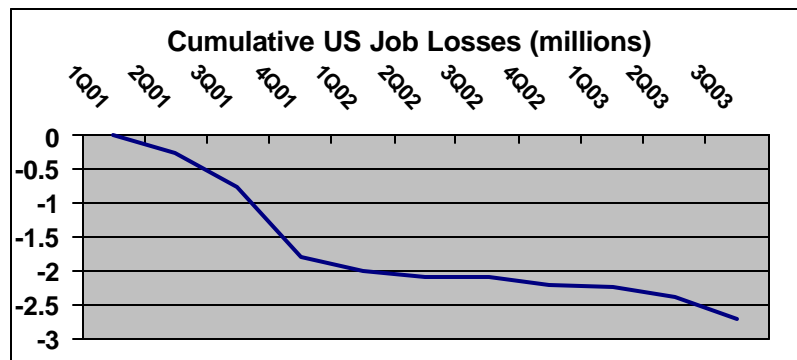


earnings gains resulting from cost-cuts alone are one-time events. (You can only cut a cost once.) Corporate America is thus badly in need of revenue growth.

U.S. bond markets had an eventful quarter. Positive economic data and turmoil in the mortgage-backed securities markets put long-term bonds into freefall in July, turning it into the single worst month for the 10-year Treasury note in two decades. (It declined 7.08%.) As September rolled around, however, many fixed income investors regained their skepticism about the resilience of the recovery, and subsequently sent bonds higher. The prudent positioning for bond investors now is to keep maturities short to preserve their capital, as long-term interest rates are likely to move higher over the next couple of years.

U.S. equity markets face two major issues now. The biggest potential stumbling block for our recovery is the persistently weak labor market. Consumer spending has held up surprisingly well in the face of a job-destroying recovery that has sent nearly 3 million American workers to the unemployment lines since the beginning of 2001, but it cannot be expected to remain robust indefinitely unless there is a change in the current trend of job losses. Indeed, an improving labor market is the lynchpin to a sustainable recovery.

Home mortgage refinancing and strong home prices have helped consumer confidence. But now refinancing is slowing and home prices may have peaked in many



markets. Consumers now need jobs! Historically, job creation lags the onset of a recovery by six to nine months, but this recovery began about two years ago. In September we got the first good employment news in some time as non-farm payrolls increased by 57,000. This is the first time the economy has added jobs in eight months and may mark a turning point.

The second issue is the dollar. The dollar has been weakening recently—particularly versus the yen. A weak dollar cuts two ways for U.S. investors. A U.S. company that sells its products abroad enjoys a weak currency because its products become more competitive. In the short run, however, decreased confidence in the dollar is problematic for both equity and bond markets. The reason is that foreign investors hold roughly \$9 trillion in U.S. financial assets—including 38% of all U.S. Treasury securities. If foreign investors foresee significant weakness in the dollar, they could create a stiff headwind for the markets by shedding some of their dollar-denominated assets. Furthermore, the U.S. federal budget deficit, expected to top \$550 billion this year alone, may also weigh on the dollar. Why should investors want to hold U.S. assets when they know that in order to cover our debts we will simply dilute our currency by printing more money? This yawning deficit will also put upward pressure on interest rates, as investors require a larger payout to hold what is likely be an eroding currency.

After a powerful rally that began in March, the U.S. stock market is not cheap. The S&P 500 Index now trades for 18 times 2004 expected profits, a level 20% higher than the historical

multiple of 15 times earnings. Bulls will argue that today's P/E ratios are reasonable due to low interest rates and the sharp economic recovery that is just around the corner. Bears will respond that 2004 growth estimates already have a recovery baked into them.

The broad market has rallied sharply since March, but its single biggest propellant has been the technology sector. There are many signs that speculation has returned to Wall Street. First, the Nasdaq is up 33.8% in the first three quarters of 2003, well ahead of the broad market indexes. The Nasdaq-100 Index now trades for 37 times 2004 earnings estimates—a generous valuation by most historical standards. Second, the amount of money investors have borrowed to invest has increased sharply of late. Margin borrowing has increased 25% since the beginning of the year, and the data indicate that much of the borrowing is being done by individual investors chasing technology stocks. Third, much of the blistering Nasdaq performance has come from marginal companies with negligible earnings whose stocks have gone from \$2 to \$4. While this is a huge move in percentage terms, a quick move back down to \$2 could happen overnight.

The good news for investors ready to put fresh capital to work is that plenty of opportunities remain. While technology and consumer stocks are pricey after a sharp run-up, the healthcare, energy, and financial sectors still offer many attractive stocks. Much of the institutional money that has pushed the Nasdaq up in such a hurry has left the healthcare, energy, and financial sectors—causing them to underperform the market. This is where patient investors can now find gems that will deliver excellent 3-5 year returns.

Drug and healthcare service companies have not participated equally in the recent rally, but most continue to post solid financial results while trading at valuations below their historical averages. Energy companies, now benefiting from firm oil and natural gas prices, have prodigious cash flow and are using their cash to buy back their own stock and/or distribute hefty dividends. Should the recovery gain steam, energy consumption will increase and prices should remain high. A number of financial companies are also trading at depressed valuations due to investor expectations of the end of the refinancing cycle and rising interest rates. Several pay solid dividends while offering double-digit earnings growth potential. As always, the investments most likely to pay off handsomely in the long term are those that are out-of-favor at present.

As usual, I welcome your comments and feedback.

Best Regards,

Peter

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