2003! What a ride it has been. The financial markets have moved up sharply, leaving the specter of the last three years behind. Respectively (through 9/30/03), the S&P 500, the Dow Jones Industrial Average and the NASDAQ are up, 14.72%, 13.15% and 33.80%. Our account equities have moved ahead, on average, 22.3% over this same period of time.

Our Fixed Income securities have also experienced positive results, moving up on average 7.35%. These strong results are, in part, due to REIT (real estate investment trust) holdings that provided a combination of income plus capital appreciation.

All in all, it has been a good year. The question remains, can the common stock rally continue? Is it sustainable long-term?

S&P 500 Index	**S&P 500 Earnings Per Share**	**S&P 500 Valuation**	**Price/Earnings Multiples**
2003 Earnings	$53.76	$1048	17x
2004 Earnings	$61.07	$1048	19.5x
Historical (since 1988)	*NA*	*NA*	*20x*

Many have been concerned that this rally is unsustainable and has caused the market to become overpriced. If nothing else, some say, the market has simply moved 'too far, too fast.' Although the latter may be true, Glenn and I would beg to differ with the suggestion that the market is currently 'overpriced' or that the current rally is unsustainable. As we write, the S & P 500 is priced at 1048. This suggests that it is trading at roughly 19.5 times this year's expected earnings ($53.76) and 17 times next year's anticipated earnings ($61.07). Either suggests reasonable valuation when compared to the historical average (since 1988) of roughly 20 times current earnings. Although the markets have risen dramatically, so have earnings expectations.

We feel much of this recent rally and newfound optimism can be directly attributable to the tax cuts on corporate dividends, capital gains, and personal income. Each of these fiscal policy moves has placed money in the hands of consumers. Add to these the tax rebates sent out earlier this summer and mortgage refinancing activity, and it is no wonder that consumer spending (roughly 66% of our economy) has taken off.

A more detailed examination of the fiscal stimulus package supports our positive outlook. First, the reduction in tax rates on distributed dividends has resulted in higher payouts by a number of corporations and initial payouts by others. During the three months ended September 30 2003, Standard and Poor's counted 418 dividend increases in a reporting universe of 7,000 companies. This is an increase of 40% over last year and 85% over the third quarter of 2002.[1] Two of our largest holdings, Microsoft and Wells Fargo, subsequently enacted dramatic dividend policy changes. Specifically, Microsoft declared its first annual cash dividend and Wells Fargo increased its dividend by 50%. Additionally, some of the corporate profit that had previously been used to buy back company stock is now being paid out in the form of dividends. All of this has resulted in cash flowing to shareholders rather than supporting excessive stock options granted to corporate management.

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[1] The Outlook, Standard & Poor's, October 8, 2003.

How about the tax rebate, something which many considered initially to be relatively "meaningless?" Retail sales continue to out-pace expectations, witnessed by the recent 28% year-over-year increase for the second quarter of 2003. [2]Retailers' profits (and stock prices) have moved ahead in response. Examples are Target, Home Depot, Chicos' and Michaels Stores. Meaningless? We think not.

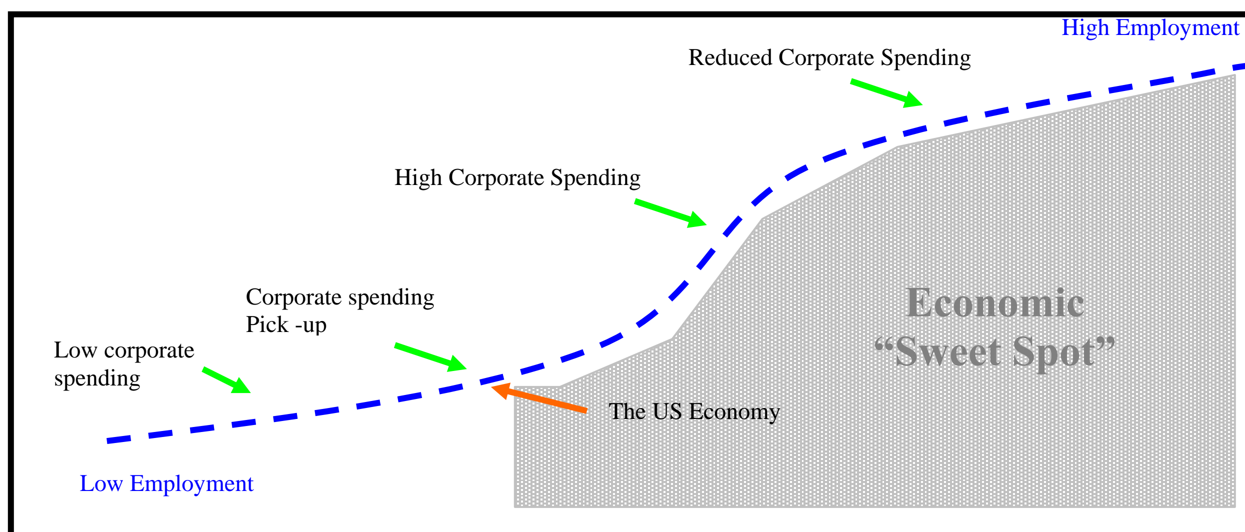
Certainly tax cuts have helped move the economy and the stock market, but so have lower interest rates and low inflation. In fact, economists have been concerned for some time about an extended period of low inflation (this is often referred to as "deflation" and reduces the pricing power of corporations). To fight this, the Federal Reserve has continued to maintain lower interest rates. It is their hope that this will increase spending and subsequently increase corporate pricing power. Some evidence of success in this area has recently emerged as prices of goods and services have begun to nudge upward. Glenn and I feel that the combination of these factors has left the market reasonably valued (with a number of stocks we hold under valued). The stage for further market advancement may be set.

All of this helps speak to the notion of a "jobless recovery," one in which the US slips back into recession yet again? Could it be that the transformation to a service/information-based society from an industrial society will leave our workers unable to contribute or spend for the long-term? Although there may be some merit to this argument, we think it may be a bit over exaggerated. The labor markets may be finally picking up some steam. Non-farm business payrolls rose by 57,000 last month, surprising Wall Street and ending a seven-month streak in which nearly 500,000 jobs were cut, the Labor Department said last Friday.[3] Business leaders at 383 privately held companies said the U.S. economy now has brighter prospects for the next 12 months, according to the latest Trendsetter Barometer survey from Pricewaterhouse Coopers, a professional services firm. In the survey, 54% of respondents said the economy is growing, up from 33% in the first quarter. Also, 70% said they planned at least some new hiring. This was the largest percentage since 2000, the survey said.[4]

Our thoughts may best be summarized by what we refer to as the "economic cycle." As consumers increase spending, there is an up-tick in corporate spending. This is usually followed by additional capital investment. Employees are then added to satisfy the pick-up in business activity (this has been somewhat muted, albeit exaggerated, in our current "information-based" economy). Finally, jobs and pay increases flow to the employee (consumer), resulting in a perpetuation of the Economic cycle. Glenn and I feel that the US may be just entering a period we refer to as the economic "sweet spot." This is outlined below.

Economic Cycle

Employment Rate Lags Corporate Spending



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[2] Standard and Poor's Web Site.

[3] Bureau of Labor Statistics.

[4] Pricewaterhouse Coopers.

Clearly, an extended (and more costly) conflict in the Middle East in addition to further terrorist acts, would have a negative impact on the US markets and the economic cycle. Still, we believe that we are well on our way to an economic recovery.

Finally, an improving employment picture added to tax and interest rate benefits should help the domestic economic recovery continue. Security valuations seem to be reasonable based on the fundamentals. We feel the markets should continue to trend upwards, absent unusual circumstances.