



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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THE STOCK MARKET RECOVERY

Its Prospects

Last year ended with apprehension. The economic recovery lost momentum with an abridged Thanksgiving-Christmas holiday shopping season that was less than robust, weak consumer confidence, an increase in unemployment rates, rising tensions with Iraq and North Korea, and capital spending still at depressed levels.

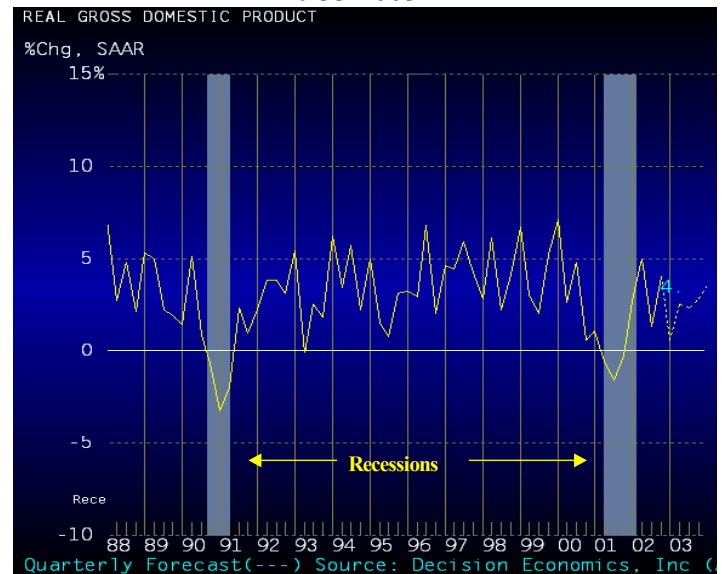
The Economic Rebound Nevertheless, the recovery is underway, but the underlying growth rate in the economy has only been in the 1% - 2% range, very modest compared to prior recoveries. Growth rates in last year's first and third quarters of 5% and 4%, respectively, were aberrations propelled by tax rebates, a drop in interest rates, and spending for consumer durables funded by re-financed home mortgages. Of the \$298 billion increase in the economy over the last four quarters (ending September 30th), \$110 billion came from an expansion in consumer durable spending (which normally accounts for about 10% of the economy) and \$77 billion from an adjustment to inventories. The balance of the economy grew at a mere 1.4%. Thus, the deceleration recently experienced with the close of 2002 is not a surprise.

This pattern of acceleration and deceleration is not unlike the rebound following the 1990-91 recession (see Chart I). In 1993's first quarter, the economy declined marginally before continuing on to become one of the longest economic expansions of the 20th century.

At the outset of this year, the combination of war uncertainties and weak consumer confidence could cause the current recovery to "sputter" during the first half. But, a "double-dip" recession is unlikely. Low interest rates and government spending growth in excess of 4% should, in the near-term, maintain some expansion in the economy. By the second half of the year, when war risks have subsided, the expansion should broaden into the industrial and capital spending sectors. When that occurs, the growth rate should accelerate to a pace in excess of 4%. For the year as a

whole, though, the average rate of growth should be in the 2% - 3% range.

CHART I
REAL GROSS DOMESTIC PRODUCT
1988-2003

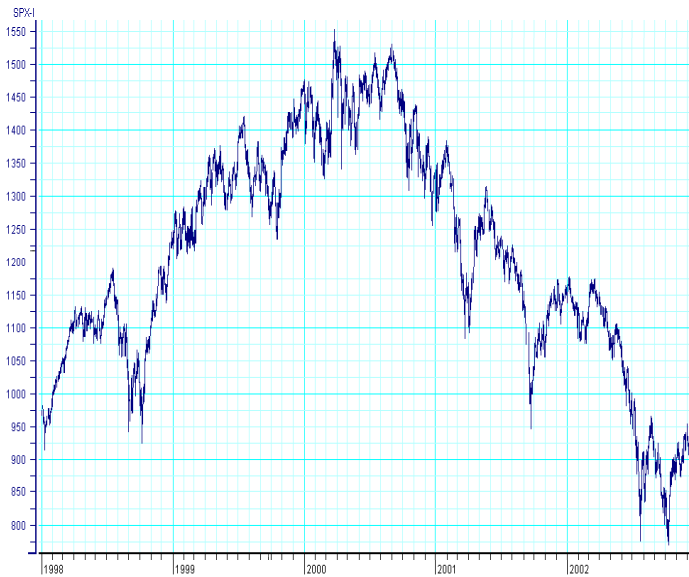


Corporate Profits Corporate profits should follow the fluctuations in the economy. During the recession, earnings declined 20%. They only partially rebounded last year, by an estimated 5%. Two factors inhibited profit growth in 2002. First, business conditions were not strong and broad enough to allow revenue growth to materially outpace the normal increase in operating costs. Second, profits were curtailed by increased pension costs. For the last three years, investment returns from retirement plans have been well below assumed actuarial return rates. As a result, many plans became under-funded and required additional contributions. Accounting rules will make this expense more pronounced in 2003.

Profit growth during the first half of this year will, therefore, again be modest. During the second half, when companies can leverage on higher operating rates, the rebound in profits should be more vigorous. Then, profits could expand at a double-digit pace. However, it will not be until 2004 that profits for the Standard & Poor's Index finally surpass the levels attained in 2000.

INVESTMENT STRATEGY

**CHART II
STANDARD & POOR'S 500 INDEX
1998-2002**



Stocks declined in each of the last three years with a 40% cumulative decline for the Standard & Poor's Index. The peak to trough decline exceeded 50%. During that same time, bonds appreciated with the ten-year Treasury returning more than 30%.

For the first time in four years, stocks should have a positive return and out-perform bonds. This is premised on the following:

1. stocks, when adjusted for low interest rates, are reasonably valued;
2. rising earnings later in the year should support higher stock prices;
3. the cloud of uncertainty represented by a potential conflict with Iraq should lift in the coming months;
4. bonds could come under pressure as the economic recovery gains momentum.

Thus, the conditions for a cyclical rebound in stocks are established and the closing lows of last October 9th of 7,286 for the Dow and 777 for the Standard & Poor's 500 Index may very well represent the trough for the bear market. On this basis, stocks should embark on a cyclical recovery.

The magnitude of the initial rebound, however, will be muted. Valuations did not become as inexpensive as in prior bear markets nor will the initial rebound in earnings be as vigorous. In this respect, stock price gains will be limited to earnings gains because valuation parameters are unlikely to expand.

Over the next four years, the Standard & Poor's Index is expected to rise to the 1100 – 1500 level, below its March 24, 2000 peak of 1527. That translates into a projected average four-year return in the range of 8% – 20%. Quarterly and annual returns can be well above or below that range depending on world tensions, short-term acceleration/deceleration in the economy, and shifts in monetary policy.

The prospects for bonds are less sanguine. Interest rates, which are at the lowest levels in nearly a half a century, could rise as the economic recovery gains momentum. Consequently, bonds are unlikely to generate the returns of the past few years, and could suffer price declines from time-to-time if inflationary pressures develop. Bond returns will be limited on the upside to their coupons. Their returns could be lower if interest rates should rise.

The risk/return prospects now favor stocks. While future stock market gains will be modest compared to the prior bull market, those gains are expected to significantly exceed bond returns. During 2003, investments in common stock will require a focus on long-term objectives and patience with near-term volatility and market risk.

**TABLE I
Market Performance Comparison
(Including Interest and Dividend Income)
Year to Date***

MARKET INDEX	12/31/01	12/31/02	Return
Standard & Poor's 500	1,148	880	-22.1%
Dow Jones Average	10,022	8,342	-15.0%
NASDAQ	1,951	1,336	-31.6%
EAFE Index	1,155	953	-17.5%
3 Mth U.S. Treasury Bill	1.7%	1.2%	1.8%
10-Yr U.S. Treasury Bond	5.0%	3.8%	14.9%
10-Yr AAA. Tax-Exempt	4.4%	3.7%	10.2%

*Estimate

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