



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

January 2004

OUTLOOK FOR 2004

Recovery Continues

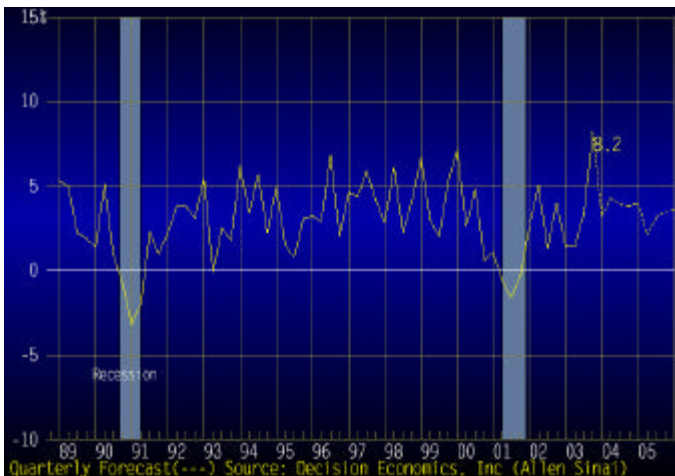
Acceleration that normally occurs during the initial phase of an economic recovery has been muted. In spite of last year's third quarter surge, the pace of the recovery averaged only 3.3% since it began in the fall of 2001. It has been punctuated by quarters of acceleration and deceleration with the economy expanding by less than 1.5% in three of the last nine quarters in spite of large doses of fiscal and monetary stimulus. Somewhat disconcerting to many has been lackluster conditions in the labor markets.

Excess capacity in manufacturing resulted from surpluses that developed in the technology sector several years ago. It also results from the increased purchasing power of the dollar in foreign markets that encouraged companies to outsource their manufacturing to overseas plants. In addition, consumers, flushed with funds from re-financing their homes at lower interest rates and the 2001 tax rebates followed by the 2003 tax cuts, used their valuable dollars to buy cheaper imports as opposed to more expensive goods produced domestically.

CHART I

GROSS DOMESTIC PRODUCT

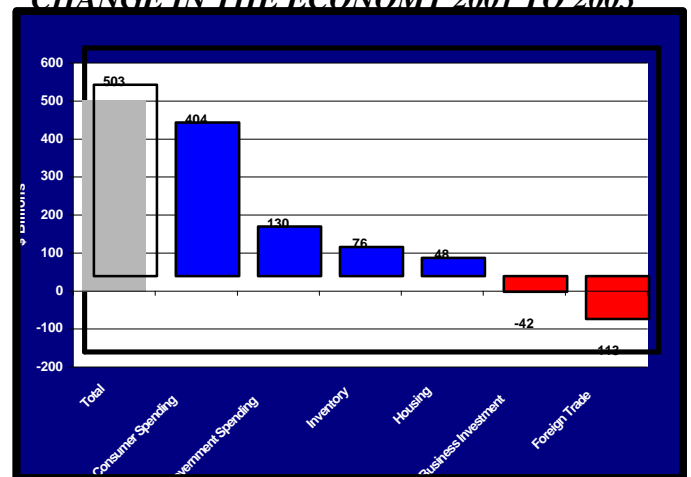
(% Change Seasonally Adjusted Annual Rate-1996 Dollars)



However, weak labor markets at this stage do not jeopardize the economic recovery. Hiring new employees normally lags a rebound in business conditions by as much as a year or more. The current lag, however, has been longer than usual due to two unique characteristics of this period: excess capacity in the manufacturing sector and a strong post-recession dollar through the early part of 2002.

CHART II

CHANGE IN THE ECONOMY 2001 TO 2003



Over the last two years, the economy grew \$503 billion, and Chart II summarizes the sources of that growth. The recovery was led by the consumer, who increased spending by \$404 billion, and accounted for 80% of the increase. However, that impact was muted by a surge in imports, which caused the trade balance to decline an additional \$113 billion. If the trade balance had not deteriorated, growth would have been close to 4%, not

3.3%! Government spending was the second largest source of growth with the war in Iraq a significant influence. Aside from an increase in inventories, business investment spending on new plant and equipment continued to falter, and that has led to paltry employment growth.

Nevertheless, prospects for the economy remain positive and recent data show the beginning of a rebound in our labor markets, and for good reason. First, the value of the dollar, vis-à-vis the currencies of our trading partners, has recently declined, and this will have a favorable impact on our balance of trade. Second, monetary policy continues to support economic growth. Money supply is expanding at a faster rate than the economy and short-term interest rates remain at extraordinary low levels. Both should continue to support the consumer throughout 2004. Third, stimulus from the 2003 tax package is not yet complete. Refunds from tax returns filed this spring will be particularly large and married couples will receive adjustments to their taxes with the elimination of the “marriage tax penalty.”

Combined, these factors should generate overall economic growth in excess of 4% for 2004 and maintain enough momentum into 2005 for the economy to grow an additional 3%. As the economic recovery gains momentum, it should be accompanied by productivity gains and improved capacity utilization. This should cause corporate earnings to rise in excess of 10% this year, but decelerate somewhat next year.

INVESTMENT STRATEGY

Stocks rallied sharply off their March lows. Double-digit earnings gains, low interest rates, and a reduction in taxes, especially for stock investors, fueled the rally. Both the Dow Average and the Standard & Poor’s Index generated returns of 28%. The extraordinary 50% gain in the volatile NASDAQ is a product of a rebound from unusually depressed levels and an initial recovery in that sector.

Bonds had mixed results in spite of an accommodative monetary policy. A rising Federal deficit led to weaker prices for Treasury securities and marginal returns for the year. Longer-term corporate and municipal securities, on the other hand, fared better with mid-single digit returns. The outlook for the financial markets for 2004 should be an extension of trends that prevailed throughout last year.

Returns from stocks are expected to moderate from last year’s surge. Nevertheless, percent returns in the range of high single digit to low double digit are likely. Interest rates should remain low enough so that existing price-earnings multiples can be maintained, and earnings growth sufficient to propel stock prices higher.

Within the stock market, sector returns could vary considerably. Last year’s rally was led by the consumer discretionary and technology sectors, while healthcare lagged. Notwithstanding last year’s stellar returns, the technology sector should continue to benefit from a recovery in capital spending. The NASDAQ, for example, is still 60% below its March 2000 peak even though its earnings are projected to be 45% greater. As the economic recovery broadens, the relative performance of the industrial sector should improve vis-à-vis the consumer. Also, the currently depressed healthcare sector offers a unique combination of value, quality, and earnings growth that could translate into significant price gains.

The outlook for the fixed income markets is for modest returns at best. The economy still has substantial capacity availability and projected growth for this year is unlikely to cause a significant acceleration in inflation and interest rates. Nevertheless, monetary policy should shift from its current accommodative posture towards a more neutral stance as the year progresses. This will increase investor apprehension that demand and supply forces in the financial markets could become less favorable for interest rates.

Therefore, bonds face a challenging environment in 2004. Treasury securities will be impacted by a further expansion in the Federal deficit and may not be able to achieve positive returns. Corporate and municipal bonds could also suffer price declines, and generate only low single digit returns.

TABLE I
MARKET PERFORMANCE COMPARISON
(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	12/31/02	12/31/03	Return
Standard & Poor’s 500	880	1,112	28.7%
Dow Jones Average	8,342	10,454	28.3%
NASDAQ	1,336	2,003	50.0%
EAFE Index	953	1,281	35.5%
3 Mth U.S. Treasury Bill	1.2%	.9%	1.1%
10-Yr U.S. Treasury Bond	3.8%	4.3%	.2%
10-Yr AAA. Tax-Exempt	3.7%	3.5%	5.1%

*Estimate

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