



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

July 2003

THE CHANGING ECONOMIC LANDSCAPE

Its Investment Implications

Four events occurred during the second quarter that impact the financial markets for the balance of the year: the conclusion of the war with Iraq, the fear of deflation, the sharp drop in the dollar, and the 2003 tax package. These establish a solid foundation for a sustainable recovery in the economy and equity markets.

Iraq. The stock market opened the second quarter with a decisive and swift conclusion to major military action in Iraq. With war uncertainties diminished, the equity markets rebounded sharply from pre-war March lows.

Fear of Deflation. Since the recession began in early 2001, there has been a deceleration in the inflation rate from 3.4% in 2000, to 2.8% in 2001, and down to 1.6% last year. The Consumer Price Index rose to 3.0% earlier this year with elevated crude oil prices associated with the upcoming war with Iraq but recently decelerated to 2.1% once crude oil prices returned to more normal levels.

Stable and positive inflation rates benefit economic growth because modest price increases generally pass through the economy smoothly. In a deflationary environment, however, when prices decline, it is difficult for businesses to reduce imbedded costs. As a result, unemployment and bankruptcies rise.

For this reason, Federal Reserve Chairman Greenspan has stated that even though the deflation risk is remote, it is a risk that the country cannot afford. In their attempt to prevent deflation, the Federal Reserve maintained a policy of monetary stimulus with aggressive growth in the money supply, in excess of seven percent. They also reduced short-term interest rates 13 times during the last two and a half years. Short-term interest rates are now at their lowest levels in 45 years. These actions should assure continuation of the current economic expansion.

The Dollar. The value of the dollar relative to other foreign currencies declined during the second quarter. Compared to the Euro, the dollar declined nearly 20%, but against other currencies in Asia and Latin America, it fared much better, declining less than 10%. Thus, the decline in the purchasing power of the dollar was largely a European phenomenon.

Nevertheless, the dollar decline impacts our economy in several respects. First, it strengthens the competitive position of American firms by making domestically produced exports less expensive overseas. And, a weak dollar increases the cost to us of foreign produced imports. This country has had a history of a trade deficit (importing more than we export), and this has had a negative influence on our level of economic activity.

Between 1995 and 2002, when the dollar appreciated over 45%, our trade deficit ballooned from \$89 billion to an estimated \$500 billion this year, a level that had never been seen before! With a declining dollar, our trade balance should revert back to more normal levels. A \$100 billion reduction in our foreign trade deficit from current levels could increase this year's economic growth by more than 1%.

Tax Package. During the second quarter, Congress passed a modified and reduced version of the President's tax proposal. The initial impact of this year's tax package is substantial and should stimulate consumer spending during the second half of the year. During the second half of this year, a typical household of a married couple with two children will receive a child tax credit of \$800 and a reduction in withholding taxes of \$100 to \$200, depending on income level. In addition, when their tax return is filed next spring, they will benefit from the elimination of the marriage penalty.

The tax plan also benefits individual investors, particularly upper income retirees, who derive a significant portion of their income from stock dividends and capital gains. The double taxation of dividends is reduced with most corporate dividends taxed at a maximum rate of 15% and the maximum long-term capital gains tax rate has been reduced to 15% (from 20%).

The combined impact of the 2003 tax package is expected to boost the economy's growth for this year and next by .5% - 1.0%.

INVESTMENT STRATEGY

Easing of global tensions, continued monetary stimulus, and the tax package, led to a sharp rebound in stocks during the second quarter. Bonds also benefited from a further reduction in shorter-term rates (See Table I).

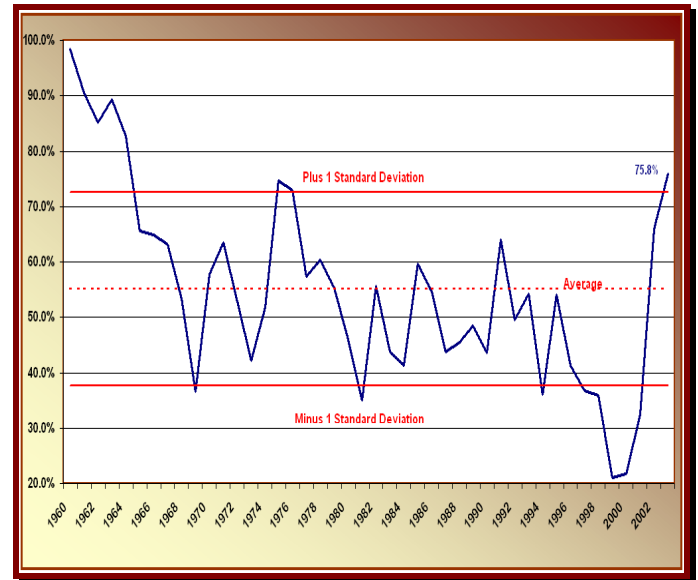
Stocks are expected to extend their second quarter gains during the balance of the year, even if in an erratic fashion. Tax rebates and the reduction in tax rates will flow through to consumer spending, which should, in turn, stimulate a recovery in capital spending. This should lead to a broadening of the economic recovery and further expansion in corporate earnings. For 2004, after-tax profits for the Standard & Poor's Index are expected to rise 10%, and should exceed peak levels achieved in 2000. Interest rates may rise, but not enough to jeopardize current price-earnings ratios. Thus, future stock price gains will be associated more with gains in corporate profits than a change in valuation parameters.

The tax package is also expected to impact investment behavior. First, holding periods for stocks should lengthen. The incentive to wait for long-term gains increased by virtue of a 5% reduction in the long-term capital gains tax rate versus a 2% reduction in the ordinary income tax rates. Second, investors are now more likely to find stocks more attractive than bonds. The reduction in tax rates for dividends and capital gains increases the after-tax return prospects for stocks, and reduces the relative attractiveness of bonds, particularly tax exempt bonds. Third, investors will be attracted to dividend paying stocks more so than before since the tax rate on dividends has been reduced.

Therefore, asset allocation should continue to increase the exposure to stocks. Stock valuations are not excessive. Measuring stock values by means of historical price-earnings ratios ignores the extraordinary drop in interest rates over the last several years. Chart I shows that today's stock dividend yields are as high, relative to interest rates,

as they were at the bottom of the 1974-75 bear market. As long as interest rates remain low, stocks should be able to maintain today's above-average price-earnings ratios.

CHART II
Ratio of S&P 500 Dividend Yield to 5-Year US Treasury Bond
1960-2003



While the risk in bonds is increasing, it is not immediate. Inflation rates are low and the Federal Reserve is committed to an "easy" monetary policy for an indefinite period. Looking further ahead, though, both Federal and local government deficits will increase, and this will adversely impact bonds. As a result, the strategy for fixed income investments should become increasingly defensive either through a reduction in bond holdings and/or a shortening of maturity.

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

MARKET INDEX	12/31/02	6/30/03	Return
Standard & Poor's 500	880	975	11.8%
Dow Jones Average	8,342	8,985	9.0%
NASDAQ	1,336	1,623	21.5%
EAFE Index	953	1,026	7.7%
3 Mth U.S. Treasury Bill	1.2%	0.8%	.6%
10-Yr U.S. Treasury Bond	3.8%	3.5%	4.4%
10-Yr AAA. Tax-Exempt	3.7%	3.2%	5.9%

*Estimate

Investment Management/Financial Consulting

7241 Southwest 168th Street, Miami, Florida 33157

Phone: (305) 232-4000 Fax: (305) 235-1920

www.earlfosterassoc.com