



## ECONOMIC OVERVIEW

### AS WE MOVE INTO THE FALL OF 2003, THE DOMESTIC ECONOMY IS CONTINUING TO SHOW GRADUAL BUT STEADY IMPROVEMENT.

Fears of renewed recession and potential deflationary pressure have given way to increasing optimism and a growing consensus that 2004 will be a year of improving economic momentum. The official confirmation that the recession ended over eighteen months ago, coupled with the stock market's improvement of over 25% over the past year from October 2002 lows, has gradually overcome the investors' initial caution and skepticism.

During the third quarter, consumer spending trends showed a significant improvement as low interest rates and the stimulative effect of the recent tax cuts and tax rebate checks contributed to rising retail sales reports. As we have previously written, the consumer has been the main support for the economy throughout the past two years and their financial condition remains fairly strong. Overall consumer debt has outpaced the rise in disposable personal income over the past five years. However, substantially all of the increased debt has been due to an increase in mortgage debt. The share of higher cost installment and credit card debt has actually declined during this period. Given the low interest costs locked in by the wave of mortgage refinancing, the consumer's current carrying costs on their debt has actually declined as a percent of disposable personal income.

Corporate spending is also beginning to show improving trends following three years of downsizing and budget tightening. Total production by the manufacturing sector has shown consistent increases for three straight months and a transition from reducing inventories to rebuilding inventories over the next few quarters should only improve the current rate of gain. Capital spending is also showing improving trends as caution is being offset by the need to upgrade plant and equipment, especially in those areas aimed at enhancing production efficiency. Corporations are also beginning to take advantage of the temporarily enhanced bonus depreciation schedules on new capital purchases that were included in this year's tax legislation. The enhanced depreciation schedules are temporary and designed to accelerate the momentum of the capital spending cycle once it begins.

Our outlook for the remainder of 2003 calls for an acceleration of overall economic growth based on continuing healthy consumer spending trends coupled with a marked improvement in corporate spending and business investment. During this period the continuation of low interest rates, recently enacted tax incentives and increasing international demand based on the relatively soft dollar should also add to the improving economic trends. Economic growth for the full year 2003 is expected to be in the area of 2.7%. As we move into 2004, economic trends are expected to show continuing improvement with GDP growth increasing to a rate of 3.8%.

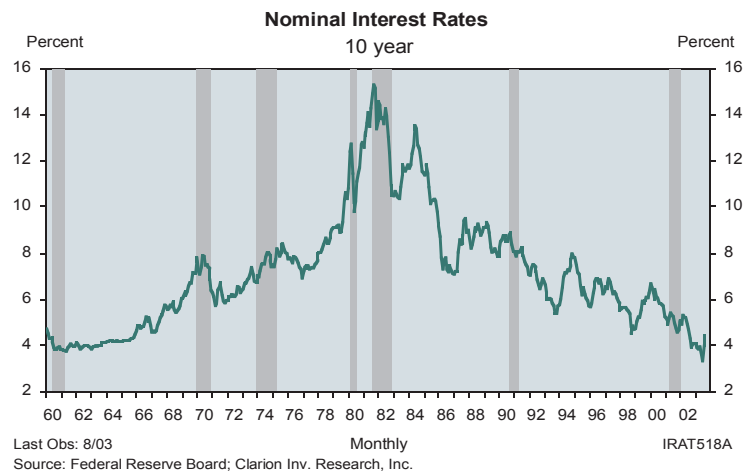
## INFLATION

What a difference a quarter makes. Just three months ago, the economic pundits of Wall Street were calling for a heightened risk of deflation that could only be avoided by additional interest rate cuts by the Federal Reserve. As we stated at the time, we viewed the risk of deflation as being remote and the markets' concern as being relatively short lived given the combined stimulus of tax cuts, low interest rates, rapid monetary growth and increased deficit spending by both the federal and state governments. Since the June lows, the yield on the ten year Treasury bond has risen by over 100 basis points (1.00%) and investors are being shown growing evidence of economic strength within the corporate and consumer sectors. It remains our view that the longer-term trend on inflation from current levels is more likely to be for a gradual increasing trend line over the next decade.

## INTEREST RATES

The ten-year Treasury bond yield reached a forty-year interest rate low of 3.11% in the second quarter of this year as the sustainability of the recovery was questioned and deflationary fears were being expressed. That period of investor concern and skepticism now appears to have been the low inflection point in what has been a disinflationary cycle that began in the early 1980's.

During the third quarter the ten-year Treasury recorded a price depreciation of -8.4% (at the time of this writing) as confidence in the viability of the current economic recovery has increased. While the degree of volatility is unusual within the Treasury bond market, it has in the past occurred at longer-term inflection points in the interest rate cycle. While the Federal Reserve has not yet increased short term interest rates from their lows, and may not over the near term, the rise in long rates has clearly shown the current view of the investment community that inflation rates are likely to move gradually higher from current levels.



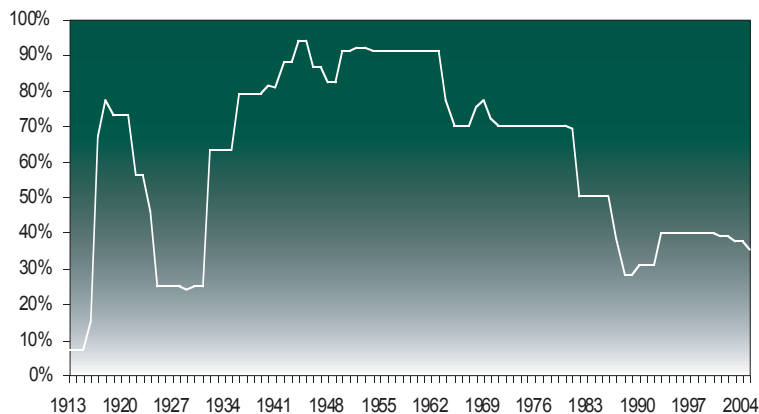
## OUR THOUGHTS: A Longer Term Vantage Point

During the past few months the economy has continued to show steady improvement in momentum in spite of continued concerns about lingering high unemployment levels, overcapacity, fears of deflationary pressure and international concern over potential terrorist attacks and continued conflict in the Middle East. Continued economic improvement has been the result of a massive stimulus package consisting of sharply higher governmental spending levels, historically low interest rates, above average monetary growth and large government tax cuts.

The recently enacted tax legislation that includes a 15% maximum tax rate on long-term capital gains and common stock dividends has pushed these tax rates to their lowest effective levels since 1941. These 15% tax rates compare to marginal tax rates that were as high as 90% during the 1950's and capital gains tax rates of 50% during the 1960's.

Highest Historical Marginal Income Tax Rates

(1913 – 2005)



Source: Eugene Steuerle, The Urban Institute; Joseph Pechman, Federal Tax Policy; Joint Committee on Taxation

While these current marginal tax rates are certainly attractive, they are by no means permanent. Ninety years ago, under the Revenue Act of 1913, the regulation that initiated personal income taxes in the United States, the top marginal tax rate was below 7%. Three years later, in the Revenue Act of 1916 the maximum rate was increased to 13%. From that low base it moved to 63% during World War I and back down to under 25% in 1929. For the next 50 years, from the early 1930's through the early 1980's, the top marginal tax rate remained at varying levels all in excess of 70%. It was only after 1984 that the top marginal rate fell below 60% and now it stands at 35%. These dramatic swings in the marginal tax rates

coupled with the shifting rates being applied to capital gains and dividend income are the net result of over seventy different pieces of tax legislation that have been voted into law over the past ninety years. Many of these specific changes in tax legislation have had a significant impact on the investors' potential after-tax investment return.

As we look into 2004, the Congressional Budget Office (CBO) is projecting a federal budget deficit of \$480 billion for fiscal 2004, following the estimated \$401 billion estimated for fiscal 2003. In March of this year, the CBO estimated that the federal budget would produce a cumulative budget surplus of almost \$900 billion over the next ten years. Currently, the CBO estimates the ten-year cumulative budget projection figure to be a deficit of \$1.4 trillion.

Based on the historic perspective of past revisions to the tax code and the speed at which budget estimates are revised, the only projection of future trends that is assured is that these marginal rates will continue to change going forward.

And another thing...

Based on current interest rate levels, money market funds provide a current yield of less than 1%. Adjusting for current tax rates and inflation, the real return of these assets is essentially close to 0%. By comparison, the general equity market, as measured by the S&P 500, has a current dividend yield of 1.6% and represents an income stream that over the longer term has grown with the inflation rate. In addition, the S&P 500 dividend payout ratio represents 33% of the market index earnings per share, a level that is well below the longer term average payout of 50%, therefore leaving significant room for improving payout levels. If an investor were to factor in the marginal tax rate of both the dividend income (and potential long term capital gains) of 15% as compared to up to a 35% tax rate for interest income, the equity market becomes even more attractive on an inflation adjusted, after tax basis.

Money market funds provide a current yield of less than 1%

The main caveat to this comparison is that the value of the equity market fluctuates while money fund investments do not. Should the fear of a further market decline gradually turn to the anticipation of an additional market increase, there is currently over \$2 trillion invested in money market instruments that may provide the incremental demand to move the market higher even given its current 19 times earnings valuation.

As always, we look forward to visiting with you soon.



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