



ECONOMIC OVERVIEW

THE YEAR 2002 ENDED AS IT BEGAN AMID A CLOUD OF UNCERTAINTY, SKEPTICISM AND SLOW ECONOMIC GROWTH RESULTING FROM A COMBINATION OF CONSUMER SPENDING AND CORPORATE RESTRAINT.

The resiliency of the domestic economy over the past year has been impressive given the negative implications of terrorism threats, corporate malfeasance, increasing unemployment, an increasing federal budget deficit and the third consecutive year of stock market declines.

During the first quarter of 2003 the economy and financial markets have continued to be constrained by the geopolitical uncertainties created by the growing likelihood of a war with Iraq, the North Korean situation and terrorism. While overall growth remains sluggish in the short term, the combination of accommodative monetary policy and historically low interest rates should have a positive impact on economic trends as we move through the year.

While the job market remains soft with the unemployment rate current at 5.7%, short-term interest rates, treasury yields and mortgage rates are currently at their lowest level in forty years. These low interest rates have resulted in the continuing surge of mortgage refinancing that has translated into increased consumer spending as lower mortgage payments translate into higher disposable personal income. These historically low interest rates, together with a fiscal stimulus package expected from congress this year, should add to increased corporate spending and inventory building later in the year once the near term uncertainties created by the potential for a Middle East conflict are resolved.

Our outlook for the remainder of 2003 is for modest economic growth with real GDP showing a gain of approximately 3% for the year. We see the pace of economic growth quickening in the second half of the year as impending tax reductions take hold and corporate purse strings are loosened. Corporate profits should exhibit mid to high single digit growth as many companies have been increasing efficiencies over the past two years in the face of weak final demand. Corporate balance sheets within most economic sectors remain relatively strong and given the heightened scrutiny of corporate finances, the quality of earnings should be higher going forward.

THE DEMAND SIDE

Real GDP continues to exhibit growth despite the various global threats that are upon us. The four components of real GDP, consumption, investment, government spending and trade were mixed when looking back into 2002.

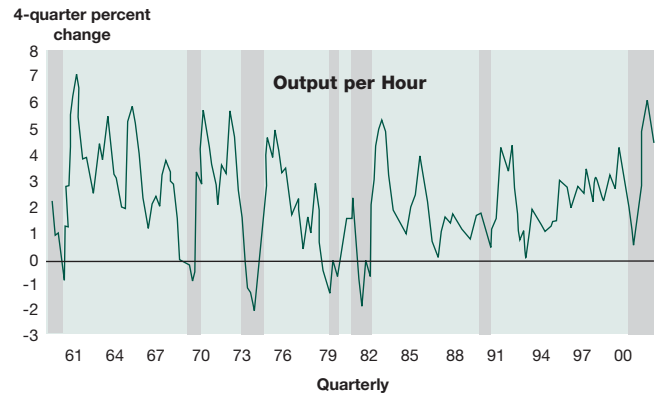
We know government expenditures are on the rise and the consumer is still spending. The consumer continues to be important to the economic picture because he represents two-thirds of GDP. Trade should improve as the U.S. dollar's weakness helps the price competitiveness of goods and services exported to other nations...another positive for Real GDP growth.

Investment may be the key to an accelerating GDP growth rate. Historically, investment has been a significant contributor of a growing economy. In fact, during the mid-late 1990's, business investment represented as high as 8.2% of real gross domestic product. After two years of declining investment by American business, look for a shift as the economic picture clears and business confidence gains traction.

THE SUPPLY SIDE

Productivity in the U.S. has been on a continually rising trend over the last two years in spite of the economic weakness as improved technology and aggressive downsizing have offset the effects of softening demand. Following a modest productivity decline in the fourth quarter of 2002, we are projecting the resumption in productivity growth as we move through 2003 and economic momentum improves.

As shown in the accompanying graph, the current economic environment has exhibited strength in productivity compared to previous periods of economic weakness. The improved productivity trend is important to profit gains going forward as current productivity levels will increase the impact of increases in final demand in an environment of limited pricing power.



INFLATION

The Federal Reserve feels confident that inflation is not on the horizon. Chairman Alan Greenspan continues to express his confidence in a slow yet steady economic recovery. The pace of the recovery itself should help to keep inflation in check.

Evidence of a non-inflationary environment can be found in the Producer Price Index (PPI) and the Consumer Price Index (CPI). The PPI has increased 2.8% year-over-year. In the same light, consumer prices have risen 2.6% during the same period. If we subtract out the two most volatile sectors, food and energy, the PPI has only increased 0.5% and the CPI by 1.9%. We are at historical lows for both indices!

Our concern is the rising price of commodities, such as oil and gold. Americans are already feeling pressure at the gas pump and gold is thought to be a safe haven, both reflecting concerns about possible overseas conflicts. Any dramatic price pressures on manufacturing are a temporary scenario, which should return to "normal" conditions as the geopolitical concerns are addressed.

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INTEREST RATES

Interest rates are declining as the market forces have sought safety. These concerns have overshadowed any natural tendency for the yield curve to shift rates upward in tandem with an economic recovery. The two year Treasury bond, yielding 1.52%, has become the investment of choice, dropping rates to levels not seen in a generation. The ten year Treasury note has a one month return of 1.9%! The Treasury yield curve will continue to drag down other bond yields over the near term as market participants focus on non-economic issues.

The Federal Reserve stands ready to maintain liquidity in the case of a conflict and support the economic recovery effort. We continue to look for interest rates to increase toward the end of 2003 as fiscal and economic stimulus take hold.

IMPLICATIONS FOR EQUITIES

Although the domestic recession officially ended last year the rebound has been relatively tepid on an historical basis. We do believe that the lower level of interest rates will provide a more favorable backdrop for corporate earnings and stock prices. Corporate balance sheets have experienced a season of repair, as higher cost debt has been refunded in favor of more favorable rates and terms. Further, corporations have significantly trimmed other variable and fixed costs, creating a platform for significant operating leverage from this point forward. This is critical as we believe that while near term pressures have created higher commodity prices, the prospects of raising prices will remain difficult over the intermediate term due to excess global capacity and the forecast for a more gradual acceleration in final demand.

In our view, the geopolitical events are currently overshadowing the improvement in the broad economy and corporate earnings. The improvement in earnings growth will continue, as the global uncertainties abate. We believe that earnings growth will eventually move in to a pattern similar to the long-term rate of growth of approximately 7-8%. The growth in earnings will produce attractive equity returns. Further, we believe that these fundamentals will drive equity prices over the next 3-5 years. With the S&P 500 currently valued at approximately 17-18 times forward twelve-month operating earnings, we do believe that the market is attractively valued, particularly given the current cost of funds.

IMPLICATIONS FOR BONDS

The bond markets are more concerned about an impending war than any near term inflation risk. Bond prices have continued to rise reflecting these concerns and investors desires for a safe haven, despite positive economic numbers. Globally, anti-American sentiment has taken its toll on American bonds. On the flip side, Americans have picked up the slack purchasing more domestic issues. As the U.S. Treasury increases their bond auctions by a total of \$60 billion this year, U.S. Treasury securities should begin to trade cheaper with the increase in supply and frequency of the auctions. We look for the agency sector to be the top performing sector of the bond market as mortgage demand slows leading to a decrease in the supply of government agency debt.

The corporate bond market has seen a rash of issuance by BBB or lesser credits trying to take advantage of low interest rates before the economic recovery moves into full swing with higher interest rates to follow. Better quality corporate bonds have begun to appreciate. This trend should continue as the bond market expects significantly less net taxable issuance this year. Floating rate securities and premium bonds will be the benefactor of rising interest rates as the fourth quarter picks up with the recovery.

OUR THOUGHTS: A Longer Term Vantage Point

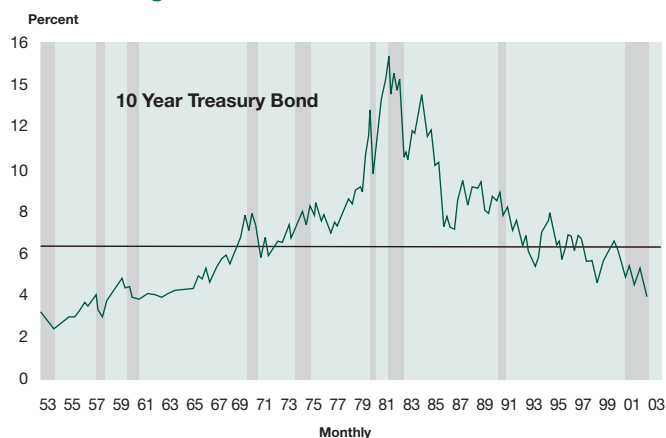
During the course of the last three years the stock market has experienced an overall decline of almost 50% as measured by the S&P 500 since its high in March of 2000. During this period there have been very few investment sectors or styles that would have given the investor a satisfactory rate of positive investment performance. A major exception to that generalization would be the fixed income market which has provided a positive total return of 42% as measured by the ten year US Treasury bond over the same period.

Since the beginning of the year, the bond market has shown above average volatility given investor nervousness about the general unrest in the international community. When assessing the outlook for the bond market going forward we should put the current level of interest rates in perspective. The last time interest rates on U S Treasuries were this low, President Dwight D. Eisenhower was in the White House. The chart above reveals the interest rates offered by U.S. Treasury bonds over the past forty years. The period has been characterized by two distinct long duration cycles. During the period from 1960 to 1980 the country was caught up in a trend of gradually increasing inflationary pressure. From a general inflation base of close to 1% in 1960, inflation as measured by the Consumer Price Index, recorded a series of gradually higher peaks and higher troughs as the economy moved through each succeeding business cycle. The twenty-year cycle ended in 1980 with both inflation and the Treasury bond yields peaking at percentage rates in the mid teens.

Since 1980 the economy and the bond market have enjoyed the benefits of a long cycle that has been the mirror image of the preceding period. Over the last 20 years, lower peaks and lower troughs in inflation and interest rates have characterized each succeeding economic cycle. The longer-term improvement in inflation rates and inflationary expectations has been one of the major components fueling the length and magnitude of the bull market that we have experienced in financial assets.

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Long Term U.S. Government Bond Yields



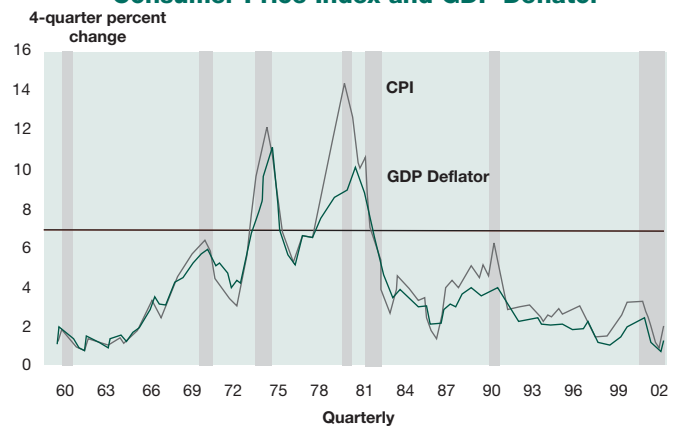
The value of financial assets, after all, is determined by the expected value of the future earnings and income stream that those financial assets produce. The underlying value therefore is a function of not only the earning power of the asset but also the present value of that future income stream. The lower the expected future inflation rate, the higher the present value of the future income stream. A gradual decline in inflationary expectations has typically resulted in a gradual price/earnings expansion that, from an equity valuation perspective, is the tide that lifts all boats.

With the longer term disinflationary cycle now close to its conclusion, future appreciation and growth will be much more dependent on the merits of the individual security and less a function of the valuation level being placed on financial assets in general. Each common stock will be directly tied to the individual fortunes of the company it represents. Within this type of environment, sound fundamental analysis of companies and a focus on individual security valuation levels will be increasingly important in providing attractive relative investment returns.

As we have stated in the past, stock selection will remain the key factor in successfully constructing portfolios. Our emphasis will remain focused on the stocks of successful companies that can consistently generate financial returns in excess of their cost of capital and have proven and well-articulated business models. We do believe that the prospects for normal historical returns for equity securities is bright, while fixed income instruments, particularly U.S. Treasury securities, will experience a more difficult environment, once the current safety premium is reduced.

As always, please call us with any questions. We look forward seeing you again soon.

Consumer Price Index and GDP Deflator



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AT THE FIRM

We are pleased to announce that **Malcolm C. "Skip" Wilson** has accepted our invitation to join Davidson Capital Management. Skip brings over thirty years of investment, trust and management experience to DCM. Skip will join Jim Davidson, Frank Grebe, Ernie Cecilia, Steve Klammer, Cole Vastine and Rob Lodge on the Management Committee as well as the Board of Directors of Davidson Trust Company. Additionally, Skip will serve as a portfolio manager and be responsible for providing equity research coverage of the financial stocks that are purchased on behalf of our clients. We are pleased to have Skip aboard and look forward to introducing him to you on your next visit to Devon.

In January of this year, **Mary Talbutt-Glassberg**, fixed income specialist and trader, was elected to the Board of the Philadelphia Council for Business Economists (PCBE). The mission of the PCBE is to educate finance professionals and corporate leaders on the state of the U.S. and world economies. The PBCE works closely with the Federal Reserve Bank of Philadelphia and is the local chapter of the National Association of Business Economists. We are thrilled that Mary was bestowed with this honor and look forward to her insights as a result of being on the board of such a prestigious organization.

Robert Lodge | *Managing Director* | Davidson Quarterly Review is a publication of Davidson Capital Management.

DAVIDSON CAPITAL MANAGEMENT

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