



## ECONOMIC OVERVIEW

**AS WE MOVE INTO 2004, the economy is showing 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 continued low interest rates and the stimulative effect of the tax cuts and tax rebate checks contributed to rising retail sales reports. While the consumer has been the main support for the economy throughout the past two years, their financial condition remains 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 improved during this period. Given the low interest costs locked in by the wave of mortgage refinancing, the consumers' 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 corporate 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 building inventories over the next few quarters should only improve the current rate of gain. Capital spending is also showing improving trends as corporate caution is being offset by the need to reinvest in upgrading 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.

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 overall corporate spending and business investment. Economic growth for the full year 2003 is expected to be in the area of 2.9%. As we move into 2004, economic trends are expected to show continuing improvement with GDP growth increasing to an annual rate of 3.9%. Inflation should remain relatively sanguine and economic strength should be more evenly balanced between the consumer and corporate spending sectors.

### The Demand Side – Real GDP

Real GDP growth exhibited the strongest reading during the third quarter of 8.2%, setting a new twenty year record. Clearly this level is unsustainable, but it does represent the underlying strength of the US economy. The consumer, which represents 2/3 of GDP remains strong as unemployment has fallen under the 6% level.

During the first half of the year consumer spending will continue to be aided by low interest rates, improving employment trends, increased consumer confidence and the continuing stimulus of the 2003 tax cuts. Business spending will show improving momentum during the year as increasing corporate profits, business confidence and product demand, coupled with the temporarily increased depreciation guidelines, continue to foster renewed corporate spending on plant and equipment. While overall GDP growth

momentum is expected to slow during the second half of 2004, our current forecasts call for continued positive gains beyond next year.

## THE SUPPLY SIDE

Manufacturing activity is beginning to stir. The Institute for Supply Management is an organization that surveys durable goods orders in the US. In the fourth quarter, the ISM survey showed an improving trend over the three month period of September, October and November.

In fact, the November reading was up over 5 points to well over the 60 mark, indicating significant demand growth. The ISM survey is one more positive sign that economic conditions are improving in the corporate sector, which should be indicative of an improving employment condition in the United States.

## INTEREST RATES

As we have been writing throughout this year, interest rates along every point of the yield curve remain near 40 year lows due to "no or low inflation" economic environment. We forecast that in 2004, interest rates will rise gradually throughout next year as unemployment continues to fall reflecting a stronger domestic economy. We see the Federal Reserve Bank beginning to inch up short term rates toward the middle part of 2004. However, should inflation remain subdued for longer than anticipated, this move upward could get pushed out into late 2004.

## INFLATION

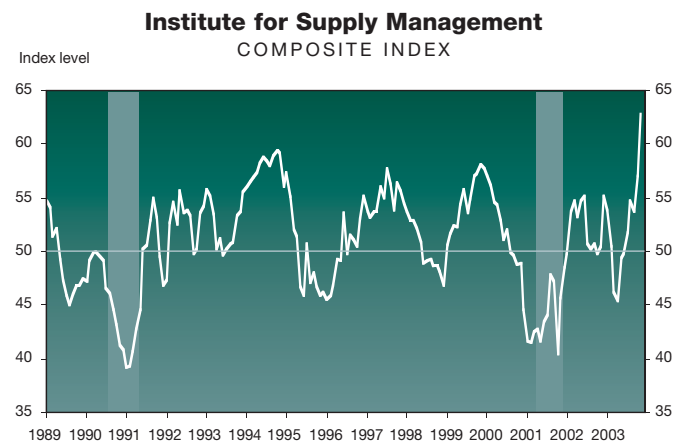
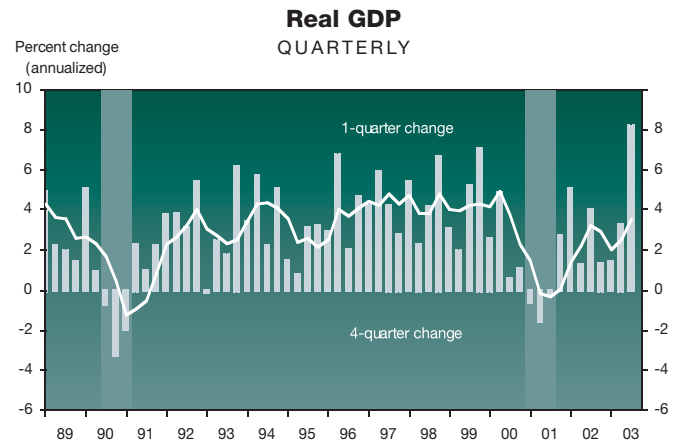
Inflation still remains very low, with the Core Consumption deflator (the Fed's favored inflation indicator) having risen only 1.2% on an annualized basis. Oil prices remain high as world demand increases. Volatile pricing is expected to continue as OPEC tries to adjust to expected increases in oil production in Iraq, Venezuela and Russia, where timing and actual volumes remain problematic.

Industrial commodity prices have strengthened modestly relative to other cyclical recoveries, an indicator of quickening cyclical activity and restrained supply, as well as a weaker dollar. Core CPI inflation should remain well below 2% for the balance of 2003 and rise at about the same level in 2004.

## IMPLICATIONS FOR EQUITIES

Equity returns have been buoyed by a more positive economic landscape, improving corporate profitability and an accommodative Federal Reserve. In our opinion, the driving force behind equity returns has shifted toward the recovery in earnings growth rather than repeated injections of monetary stimulus.

We maintain that the valuation of equities will be a function of earnings and earnings growth, rather than the expansion of pricing multiples, such as the price/earnings ratio. It is our view that the equity markets will remain vigilant with respect to valuation, both in the broad market and specific sectors and stocks.



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Further, the improved earnings picture indicates to us that stocks are still moderately attractive relative to debt instruments, such as money market and longer duration bonds.

Employment gains, although modest relative to previous recoveries, will continue to improve. The corporate sector experienced revenue growth of almost 9% in the third quarter. Balance sheets have been repaired, debt has been reduced and more favorably structured, costs have been slashed and productivity enhancements continue to be implemented. The outlook for capital spending is becoming more favorable and should extend beyond information technology-related spending. In this environment, earnings growth in the high single/low double digit area, coupled with historically low interest rates, should provide a favorable backdrop for equity performance in 2004.

## IMPLICATIONS FOR BONDS

The bond market was very volatile this year. The ten year Treasury has traded between a low of 3.11% on June 13th and a high of 4.62% on September 2nd. As we come to the close of this year, the 10 year area is up approximately .50% for the year, currently range bound yielding between 4.10% and 4.40%. Observing current economic and market conditions, we are looking for interest rates to move up 50 basis points (.50%) next year. The long run outlook is for the short end of the yield curve to rise more quickly than the long end as businesses ramp up production.

The Federal Reserve Bank has made it clear that deflation fears have been abated and the economy is indeed moving forward at a moderate pace. At the June 25th Federal Open Market Committee meeting, the target for the Fed Funds rate was lowered to 1.00% in an attempt to fend off fears of a post-Iraq economic stall in the U.S. economy. The catalyst was a substantial spending retraction around the height of the war in March. The Fed currently maintains a "balanced" stance which should keep short rates unchanged until at least mid-year.

The pursuit of yield has forced many fixed income buyers into non-government securities. As a result, corporate bond spreads have been significantly tightening over the last 12 months; non-investment grade securities (rated below triple-B) drawing the most attention. In other words, corporate bonds have outperformed Treasury and agency securities on a relative value basis. With the impending slowdown in the mortgage generation and refinancing market, we look at agencies to be solid performers for 2004.

## OUR THOUGHTS: A Longer Term Vantage Point | What a difference a year makes

It was less than one year ago that the financial markets were being buffeted by the geopolitical uncertainties created by the growing likelihood of a war in Iraq, saber rattling by North Korea and the continuing threat of international terrorism. Domestically, economic growth was sluggish, corporate spending and reinvestment was weak and unemployment was gradually increasing. Corporate malfeasance was becoming increasingly apparent and the federal budget, after several years of surplus, was once again returning to an increasing deficit balance as both domestic and defense spending overwhelmed current governmental tax revenues. In addition, investor psychology was continuing to be dampened by the most recent experience of three years of equity market declines.

In spite of these numerous concerns, our published forecast at the beginning of 2003 was for a positive market outlook over the year ahead:

“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.”... “In our view the geopolitical uncertainties are currently overshadowing the improvement in the broad economy and corporate earnings.”... “The improvement in earnings growth will continue, as global uncertainties abate. We believe that earnings growth will eventually move into a pattern similar to the longer-term rate of growth of approximately 7-8%. The growth in earnings will produce attractive equity returns.”... “With the S&P currently selling at approximately 17-18 times forward twelve month earnings, we do believe that the market is attractively valued...” >



As we move into 2004, the investment environment has shown a marked improvement. Geopolitical uncertainties, while still present, have moderated from the heightened levels of last year. Real GDP growth has shown accelerating growth trends and corporate spending, the missing economic stimulus last year, is now showing renewed strength. While corporate malfeasance has indeed been uncovered over the past year, the wide spread publicity and resulting reforms and indictments should result in improved quality of earnings and regulator scrutiny going forward.

While the economic underpinnings of the financial markets appear to be a good deal stronger currently than they were a year ago the markets' future trends are by no means more certain. The outlook has improved but so have the overall expectations of the investment community. Future markets trends, after all, are not dependent solely on fundamental results but rather the difference between the fundamental results and the pre existing investor expectations as to what those results will be. Over the past year the market has appreciated by over 20% as measured by the S&P 500. This appreciation could have already discounted much of the economic rebound that would be expected coming out of an economic recession and market correction. In our view the market continues to represent fairly good value at current valuation levels. Much of the earnings support over the past two years has been the result of above average productivity gains brought about by improved corporate efficiency in the face of sluggish revenue growth. As revenue trends improve, this improvement in productivity should result in above historic earnings leverage that could likely increase further the earnings gains of the market.

As we move into 2004, the general market appreciation will become less broad based and more selective as investors focus on those individual issues that may yet hold the capability to provide an earnings surprise in relation to already improved expectations. 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.

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FOOTNOTE: Davidson Capital Management Quarterly Review, March 2003.

## AT THE FIRM

We are pleased to announce that Cole P. Vastine and Bruce K. Bauder have completed their coursework for the Chartered Financial Consultant (ChFC) designation. The ChFC program focuses on the comprehensive financial planning process as an organized way to collect and analyze information on a client's total financial situation; to identify and establish specific financial goals; and to formulate, implement, and monitor a comprehensive plan to achieve those goals. We are very proud of this professional accomplishment. Congratulations to Cole and Bruce!

We are also pleased to announce that we will be improving our statement package in 2004...more on this news in January and February.

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

## DAVIDSON CAPITAL MANAGEMENT

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