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Investment Outlook First Quarter 2004

After three grueling years the stock market finally reversed course finishing the year sharply higher, and with consumer confidence climbing, hopes are high for 2004. Reflecting upon the mood swing investment participants have experienced during the past 15 months may provide a history lesson in investor psychology. In October 2002, when fear was rampant and it appeared that stock prices were headed down for the foreseeable future, very few individual or professional investors were willing to confidently predict good times ahead for the economy or the market. The market bottom realized in October 2002 shared many similarities with previous bear market bottoms in terms of market sentiment. The lesson we have learned over these past four years is that when enthusiasm or fear is at historically high levels, the probability of a reversal in the trend is great.

Despite a slump during the first quarter of last year, touched off by worries over the war in Iraq, the Dow Jones Industrial Average finished 2003 with a gain of 2,112 points, or 25.3% at 10,454. The S&P 500 rose by 232 points, gaining 26.7% to 1,112 and the Nasdaq composite rose 668 points equating to 50% and closing the year at 2,003. The unaudited results of Covenant's model stock portfolio produced a 31.4% increase during 2003. Individual client portfolio returns may differ depending on client objectives, risk factors and timing issues.

As 2004 begins, the economy is in its best shape in many years. GDP growth, which meandered about at relatively low rates from late 2001 to mid-2003, surged during the second half of 2003. Monetary reflation combined with stimulative tax cuts and steadily improving consumer and business confidence ended the bleeding in the stock market and finally triggered a powerful economic recovery. With the Federal Reserve Bank committed to maintaining short term rates at current levels for "an extended period of time" and the President committed to maintaining or reducing taxes on income and capital, monetary and fiscal stimulus will likely overwhelm any other economic issues for the foreseeable future. In 2004, GDP growth is expected to range between 4 and 5% with the industrial sector of the economy beginning to contribute to growth and the consumer waning to some extent. Corporate earnings, having risen robustly last year, are likely to increase by double digit rates once again with rising demand contributing to already incredible productivity growth. Global economic activity is projected to improve, albeit at a slower pace than in the US.

Of the myriad factors that may affect financial markets in the US this year the ones anticipated to exert the greatest influence, in no particular order, are: job growth, the presidential election, Iraq and the war on terror, gold and commodities prices, energy prices and the US dollar. In our previous investment outlook, we elaborated our view of the confusing and often misleading employment statistics. Instead of repeating those views, we would merely share our observation that by this year's second quarter, the payroll survey of employment trends should begin to better correlate with the household survey reflecting job creation at a pace above 2 million annually. The trade-weighted value of the US dollar and gold prices are largely interrelated and reveal concerns about the size of the US budget and trade deficits. With an already material decline in the US dollar, improvement in the balance of payments between the US and our foreign trading partners has begun as indicated by last month's decline in the trade deficit. In addition, the US budget deficit is likely to improve modestly versus expectations of $500 million or more, due to the rapid recovery in corporate earnings, consumer incomes and stock prices. With better trends ahead for economic activity, and our dual deficits, the outlook for the US dollar should improve by the end of this year. This scenario would also suggest gold prices should soften in the near term, correcting a portion of its recent gains. We are concerned however, about rising inflation and its influence on gold prices in the intermediate term. More on this later. Energy prices have been sustained at levels above the range estimated by most economists for several reasons. Improving world economic conditions and cold winter

weather in industrialized countries as well as rapid growth in China is driving demand. At the same time, low worldwide oil inventory levels, a surprisingly disciplined OPEC and a slower than anticipated ramp of Iraqi oil to the world markets have constrained supply. Should these conditions continue, oil prices could pierce $40 before the winter ends. Prices above $35 are probably not sustainable as they could interrupt the global economic recovery. Oil prices between $24 and $30 are in the best interests of both oil producing and oil consuming countries, meaning that policies to drive prices lower can be anticipated.

Regarding the 2004 presidential race, it is important to state a few observations concerning the likely reaction of stock and bond market participants as election year politics begin to unfold. In the past, when an incumbent president, especially a Republican president appears likely to win re-election, the stock market has generally performed well, with full year returns averaging double-digits. When uncertainty exists or the incumbent appears likely to lose, the stock market has displayed only low-single digit returns during previous election years. In this year's race, the market can be expected to display a positive tone unless it appears that the eventual winner will move to repeal last year's tax cuts on income and capital, which helped fuel last year's rally. There has been widespread discussion concerning Fed policies in an election year. Conventional wisdom suggests that the Federal Reserve is influenced by politics and does not raise interest rates during presidential election years. A quick glance at history refutes this notion as the Fed has raised the federal funds rate target in six of the last eleven presidential election years. Further analysis indicates that the Fed has tended to raise and lower rates in response to economic and inflation conditions during election years similar to non-election years.

Digressing briefly from the current environment, we wish to share some longer-term concerns we are eying as they relate to the economy and financial markets. Government spending is soaring, business regulation is on the rise and protectionism is gaining some momentum. At the same time, overly accommodative monetary policy threatens to increase inflation. Although the historical reference is not precise, the US seems to be traveling a similar path to that of the mid-1960s when spending on new entitlement programs displaced private-sector investment, regulations created economic rigidities and the Fed held interest rates low. Big government and easy money is the perfect recipe for inflation. In the past two years, federal government spending as a share of GDP has climbed from 18.4% to 20%. So far, there are very few signs of damage to the economy as recent strong economic growth have masked the problems brewing beneath the surface. Vigilance is necessary to reign in the growth of federal spending, protectionist tariffs and business regulation to avoid an environment of economic stagflation (rising inflation coupled with slow real growth) similar to the 1970s.

So as not to conclude on a sour note, we offer our 2004 projections and assumptions. Much has been written about the current stock market rally attempting to depict it as the beginning of a new secular bull market or a powerful bear market rally. We are inclined to allow the history books to place the proper nomenclature on the current rally, but suffice it to say that even if this rally were characterized as cyclical within a secular bear market, it probably has at least another year and more double digit gains ahead. Our economic and market assumptions for 2004 include real GDP growth of between 4% and 5%, S&P 500 profit growth of 12%-15% and slowly rising inflation and interest rates. By year-end, we project the federal funds rate to be between 2% and 2.5% vs. 1% currently. The ten-year treasury yield, presently at 4% is anticipated to rise to approximately 5% and inflation, as measured by the consumer price index, is likely to rise from the current level of 1.5% to about 2%. Stock valuations appear more or less fairly valued at current levels. With this in mind, we anticipate stock prices to roughly track earnings growth this year. The major stock market indices are expected to rise by double-digit rates again this year, but perhaps at half the pace of last years robust gains. At the same time, we are reminded that the stock market has a way of surprising investors with both the heights of its rallies and the depths of its declines. We continue to be cautious on the bond market in both the short and long term as economic recovery should increase the demand for money in the short term and rising inflationary expectations are likely to pressure rates higher in the intermediate and longer term.

Please accept our best wishes for a very healthy, happy and prosperous 2004!