John Guarino
President
(908) 879-4090

April 2003

Investment Outlook Second Quarter 2003

The prelude to war followed by the actual start of Operation Iraqi Freedom dominated first quarter headlines. It has become clear that the war with Iraq, the sharp rise in oil prices and record gasoline prices took an obvious toll on business and consumer confidence in the quarter. Harsh weather in February and the emergence of the SARS epidemic in Hong Kong and mainland China also hurt. The latest data from the Institute for Supply Management indicated that manufacturing activity fell to 46.2, its lowest level since November 2001. In the past, when this number has fallen below 45, it's been a good indicator of recession. Taken alone, one number may not be entirely revealing, but together with lower construction spending, disappointing early signs for first-quarter earnings and incipient signals that the housing market is cooling, it all points to weakness and evidence that even a quick resolution to the war may not prevent us from teetering with economic contraction.

Higher energy prices have taken a toll on many economic sectors with crude oil prices peaking at $40/barrel just prior to the start of the conflict. While oil prices have since retreated to under $30/barrel, the price is still far above the level of a year ago and is hurting a wide range of energy-intensive manufacturers, such as steel, paper, rubber, plastics and glass companies. Transportation has been another hard hit industry sector including railroad and trucking companies and airliners. In addition to higher oil prices, the airline industry has suffered from a decline in travel with domestic bookings down 20% and international bookings down 40% since the first week of the war.

Recent reports confirm a faltering economy beyond just the business sector as consumer confidence fell to its lowest level since 1993. Beyond the uncertainty concerning the war, amongst the most important reasons for waning confidence by the consumer is employment insecurity. While economic sluggishness continues, the job market has remained under pressure as indicated by employment declines of 465,000 over the past two months. Employment fell pretty much across the board with manufacturing, retail, and services all contributing and only construction showing a small gain. Temporary workers, very much a leading indicator of employment trends lost 48,000 positions in March alone. Retail sales have been particularly hard hit by these trends and by consumers staying home watching war coverage on television instead of heading to their favorite shopping destination.

Against this dreary economic backdrop, investors have been subjected to a roller-coaster ride in both the bond and stock market during the year's first quarter. As the year began there was cause for optimism by stock market participants. A strong manufacturing report on the second session of the new year drove stocks higher and bonds lower and sparked hopes that the long-awaited economic recovery was finally beginning to accelerate. In the first two weeks of January, stocks had gained 6% as investors began flirting with the notion that after 3 long years of declines, 2003 might finally snap the losing streak and deliver robust gains. Unfortunately those hopes were short-lived as it became clear by the end of January that the United States was headed into a diplomatic sinkhole over its Iraqi policy. As the US made clear its intention to enforce numerous United Nations resolutions crafted since the end of the Gulf War in 1991 (including resolution 1441 ratified unanimously by the Security Council in November 2003) requiring the disarmament of Iraqi weapons of mass destruction, some members of the UN Security Council disagreed with the pace of enforcement desired by the United States and Britain. Even as US troop deployment continued relentlessly week after week, the US was stymied time after time by the UN Security Council and the UN weapons inspectors who called for more time for inspections and a policy of containment assisted by the threat of military action. As the diplomatic stalemate continued, consumers and business leaders became more cautious and investors sold stocks and sought safe-havens such as US government bonds and gold. By mid-March, gold prices had soared to $385/ounce, oil prices were hovering near $40/barrel, 10-year US Treasury Notes stood at a 40 year low at just above 3.50% and major US stock indices had lost all their January gains and were down anywhere from 6.2% on the Nasdaq to 11.3% for the DJIA.

When it became clear that a diplomatic solution to the conflict over Iraq and UN Iraqi policies had failed, investors responded by dumping their safe-havens and jumping into stocks. Between the week before military operations began and one week afterwards, gold declined to $320/ounce, oil prices dropped to $27/barrel, 10-year treasury yields rose to 4.10% and US stock indices recovered all their yearly losses and actually showed small year-to-date gains by early April. Ever since the war with Iraq started, the stock market has responded positively on days when coalition forces were perceived to be making progress and has slumped upon perceived setbacks. Now that it appears the end of the conflict is in sight and none of the dire predictions have materialized, investor's attention is once again returning to the economy and corporate earnings. Prior to the war many fears existed concerning: 1) Iraqi use of chemical or biological weapons 2) hundreds of Iraqi oil wells being set ablaze creating economic and ecological horrors 3) Iraqi missiles being fired into Israel or Saudi Arabia, creating the potential for a broad regional conflict and 4) severe terrorist reprisals against the US or our allies. Thus far, none of these fears have been realized and the images indelibly ingrained in our minds will likely be that of Iraqi citizens celebrating in the streets, pulling down statues of Saddam Hussein and kissing US servicemen.

The success of Operation Iraqi Freedom by no means suggests the end of geo-political uncertainty. There are still battles to be fought in Iraq and significant re-construction efforts to follow as well as hotspots in other Middle Eastern countries, North Korea, Venezuela, Nigeria and other locations throughout the world. President Bush has repeatedly said that the war against terrorism will be with us for many years. Investors will confront the threat of terrorism for many years in the same way that prior generations confronted the risk of nuclear war with the USSR and the cold war. In this environment, it is reasonable to anticipate that investors will expect a higher risk premium to own stocks than that which existed in the period between the end of the cold war in the late 1980s and the terror attacks of 9/11/01.

Looking ahead to the balance of this year, we expect some churning action in the stock market surrounding tepid first quarter earnings reports just now being released as investors weigh current sluggish conditions vs. the anticipation of better times ahead due to the resolution of a successful war effort. It is also still feasible that a war resolution rally may materialize in the weeks ahead. We will be carefully monitoring consumer and business leader sentiment during the next several reporting periods as an indicator of the likely shape of economic recovery later this year. Other economic stimuli include lower gas and oil prices and the probable passage of tax reduction legislation encompassing marginal tax rate cuts currently scheduled for 2004 and 2006. While divisive election year politics can be anticipated as the year progresses and we head into 2004, historically election years have provided a favorable backdrop to financial markets. As expressed in our first quarter outlook, we do not believe equity valuation levels at this stage of the economic cycle are unreasonable given the current inflation and interest rate environment. Interest rates have in all likelihood seen their bottom for this cycle and are likely to rise further as economic activity resumes at a more normal pace later this year and into next year. We continue to find the financial marketplace filled with both opportunities and pitfalls and are working diligently on your behalf to navigate carefully until we return to a more normal investment landscape. As always, we welcome your comments or questions.