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April 2004

Investment Outlook Second Quarter 2004

Financial market participants experienced a rollercoaster ride during this year's first quarter. Stock prices and interest rates took divergent paths out of the starting gate with stocks surging to new two year highs and bonds plummeting on renewed expectations for strong economic growth. While stocks held their early January gains through mid-February, the bond market quickly reversed course as investors began to concern themselves with the lack of job creation and the sustainability of robust economic activity. The 10 year US Treasury Note started the year with a yield of 4.25%. After peaking at 4.38% on January 2, the yield declined steadily and was hovering around 4% until a disappointing February employment report was released on March 5. In the subsequent two weeks, bonds rallied and the ten-year yield shrunk to a low of 3.60%. Bond prices completed their rollercoaster ride back to a 4.20% level when prices plummeted and yields soared following the surprisingly strong March employment report released on April 2. US stock prices had a similar experience as investors focus alternated between the unequivocal strength in the US economy on the one hand and sluggish job growth and world-wide terrorism on the other hand. While all major US stock indexes ended the quarter relatively flat, the intra-quarter volatility is best observed by noting the Nasdaq composite performance. The composite stood at 2,003 to begin the New Year, rose to a peak of 2,153 on January 26, tumbled to 1,898 on March 23 and recovered to 1,994 by quarter-end, a range of nearly 13% notwithstanding the relatively ho-hum quarterly decline of 0.5%.

Transitioning to the positive and negative indicators we see in the economy and financial markets, we believe that, in general, conditions are pretty good. Spurred by the end of the Iraq war, accommodative monetary policy, and another round of federal tax cuts, real GDP growth of 6.1% in the second half of last year was the strongest economic growth in this country in twenty years. Consumer spending has rebounded sharply from last year's first half and industrial production and manufacturing activity has surged to levels not seen since the economic bubble burst in 1999. With corporations hesitant to invest aggressively in capital equipment and labor, productivity growth has shown incredible strength and corporate profits are poised to spike to record levels this year. Inflation and interest rates tentatively remain at low levels even as profit growth, economic activity and many commodities prices have ascended.

On the negative front, terrorism remains a serious threat as evidenced by the continued turmoil in Iraq and Israel and the recent train bombings in Madrid. Unfortunately, it appears that this threat is likely to remain a cloud over our heads for a long time. Rising commodity prices have failed to filter through to producer or consumer prices to date, but it is only logical to expect that as economic growth continues, capacity utilization rates will rise and inflation pressures will build. Similarly, with GDP growth expected to average 4.5%-5.0% this year and the employment picture finally brightening, interest rates almost certainly must rise. Could rising inflation and interest rates derail the economic and stock market recovery? The answer is that it depends on the timing and the magnitude of the rise.

Consensus expectations now call for the Federal Reserve Bank to begin lifting the fed funds rate by August. With the rate still at a forty year low of 1%, there is plenty of room for the Fed to raise short-term rates without choking off the recovery. Our expectations are for the fed funds rate to increase to approximately 2.5% during the 12-18 month period beginning in the second half of this year. As this process proceeds, it is reasonable to anticipate a flattening of the yield curve where short-term interest rates rise much more than longer-term rates.

Other concerns include rising energy and health care costs, both of which act as a tax on consumer pocketbooks. In both cases, pure demand/supply considerations are at play. Strong demand in China and other developing nations in southeast Asia combined with rising industrial production in the US and a weak US dollar have pushed oil prices near an all time high. This roaring demand has not been met with increasing production, primarily due to OPEC policies. The oil cartel has been smarting over the declining value of the dollar which reduces dollar-denominated oil revenues and increases the incentive to keep supplies tight. Health care costs are actually a much more complex issue as an aging US population demands increasing amounts of health care but political considerations are likely to stall any viable reforms from slowing price inflation for the foreseeable future. While higher energy prices and health care costs are clearly a drag on consumer spending, there are positive offsets in terms of economic activity and employment within the health care and energy sectors. We believe the market has been adjusting to the changing landscape in these two sectors for a number of years now and unless significant shocks occur, the economy is resilient and strong enough to absorb these conditions.

The most serious issue investors have been debating is the lack of job creation during the past few years. Is this a "jobless" recovery? Is outsourcing (sending jobs to other countries) a serious threat to our economy? We have discussed this issue in our previous two investment outlook letters and are more convinced than ever that significant job creation in our economy is just around the corner. We firmly believe that with the economic growth realized in the second half of 2003 and continued strong growth this year, it is inevitable that job growth at a pace above 200,000 a month should be the norm by the time summer rolls around. To reiterate our point of view from previous letters, we believe changing employment trends have made it difficult for the government to accurately track employment statistics. Self-employed labor and new business employment continues to grow in value and numbers in our economy, and these jobs are not counted by the Payroll survey. According to the Household employment survey by the Bureau of Labor Statistics, we've added 1.59 million jobs since January 2001 if you include self-employment and new business related jobs. The "outsourcing" debate in our opinion is nothing more than election year politics. Any serious economist will admit to the overall positive benefits to our economy attributed to the outsourcing of jobs to cheaper labor locations in China, India and elsewhere around the world. We could write several more pages on this topic, but we believe the real debate should focus on job retraining for dislocated workers as opposed to outsourcing. The March employment report revealing 308,000 jobs created and 513,000 jobs created in the first quarter should quiet skeptics who have been concerned about the durability of this economic recovery.

While some of these issues represent legitimate concerns confronting our financial markets, we maintain our belief that stock prices and interest rates are likely to rise further. Given our convictions, we will be pruning some laggard stocks and replacing them with faster growing, better performing stocks in attractive economic sectors. Until interest rates rise to more normal levels, we will continue to invest fixed income securities in short-dated, stable principal type investment vehicles. In our next letter we will attempt to examine the likely implications of Presidential and Congressional election results on US financial markets. As always, we welcome your comments or questions and look forward to speaking with you in the near future.