



## Three Cheers for the Recovery

January 12, 2004

As we forecast in our third quarter review, both economic and earnings momentum led markets higher during the fourth quarter. Three cheers for the recovery!!! After the traumatic losses of the three previous years, 2003's decisive market rebound helped make up for at least some of the pain investors endured from 2000 through 2002. The year started out on a cautious note, with investors fretting about the strength of the economic recovery and the impact of war with Iraq. But the mood quickly changed beginning in March, with the end of major fighting in Iraq, a 45-year low in interest rates, and the new tax-stimulus package helping to set the stage for a potent rebound. A significant turnaround in the U.S. economy helped, too. Quarterly GDP jumped by 3.3% in the second quarter and a better-than-expected 8.2% in the third quarter. Productivity growth was revised up to nearly 10%! Earnings per share also showed healthy gains during the year, fueled by both significant cost-cutting moves and top-line growth. We believe that the equity market advance is more than the proverbial "dead cat bounce," and that the combination of improved fundamentals, low inflation, low interest rates, and steadily increasing demand will mean continued improvement in corporate earnings. The fact that we are in an election year where equities have historically risen and that bond yields remain low bodes well for equity market gains. We believe that there is significant upside for equities in 2004. We also view the capture of Saddam Hussein as an indication that a stable, democratic future is possible for Iraq, and that we may see a lessening of international tension.

### U.S. Economic Summary

Like the stock market's performance, the economy's recovery in 2003 was stronger than many expected. Early in the year, indications for the economy were not all that promising, but the quick ouster of the Saddam Hussein regime in Iraq gave a boost to consumer confidence. The combination of a surge in mortgage refinancing encouraged by low interest rates early in the year and the Bush tax reforms later in the year gave consumers the means to express this confidence in a healthy rate of spending. Corporate profits were growing from the start of the year, although during the first half the better results were due to cost cutting rather than higher sales. In the third quarter, business spending, which had been a critical missing piece of a recovery that had just been limping along since it officially began in the fall of 2001, joined the party, driving third quarter GDP up at an 8.2% annual rate – the best rate in almost 20 years!

During the fourth quarter, inflation remained at its lowest level in 40 years. Headline inflation was down 0.2% in November and up only 1.8% this past year. Industrial production was up 0.9% in November for the fifth straight monthly increase. Capacity utilization went up to 75.7% from 75.1% in October. The Philadelphia Fed Survey, a measure of business activity, was at its highest reading since 1993, and far above its average for the year. The Institute of Supply Management Manufacturing Index was at 62.8 for November, which was the first time the reading was above the 60.0 mark since 1987.

The unemployment rate dropped to 5.9%, down from its summer peak of 6.4%. The job situation improved, but not nearly as much as the overall economy. Though mortgage refinancing slowed sharply, the effects of that slowdown on consumer spending were moderate. In part, consumers continued to take advantage of low interest rates to increase their credit card purchases without increasing the amount they spend to service their debt. While the rate of growth has slowed, housing strength remained at very high

levels. Though home-builders, buyers, and sellers all expect interest rates to increase in 2004, that fact has only slightly diminished the appetite for homes. The housing sector is contributing to continued strength in the economy.

The University of Michigan Consumer Sentiment Index was strong in November and reached a year high of 93.7 before pulling back to 89.6 in December. Consumers are feeling confident-ish, but not as confident about the economy or the future as economic data would suggest. Consumer spending continued to rise with incomes. The expectation of job security is a key reason why consumer confidence lagged during the fourth quarter and why people feel so uncertain about their financial future even as the economy registers robust growth in almost every sector.

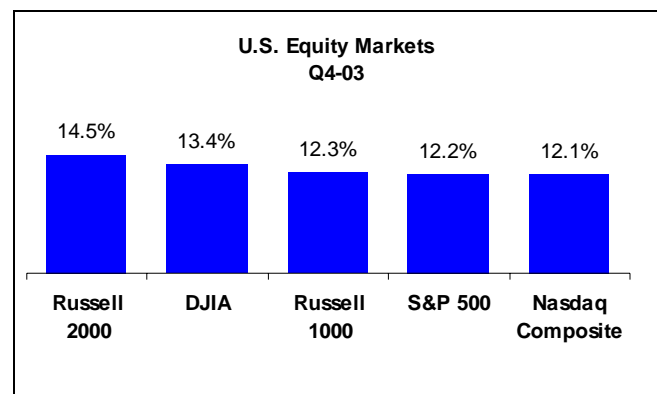
The U.S. economy is now a service-based economy achieving high productivity gains powered by information technology. It is the hub of the world economy, and growth and health are not purely domestic phenomena. Consumer appetites for low-cost goods are satisfied by shifting production to low-cost countries such as China. And in dozens of other ways, the U.S. economy is contributing to global growth through rising demands for imported products.

### U.S. Financial Markets:

The first weeks of December saw a small surge that brought the Dow over 10,000 for the first time since early 2002. During the fourth quarter, the Dow was up 13% bringing its gain for 2003 to 28%. The more broadly followed S&P 500 was up 12% for the quarter and 29% for the year.

Technology stocks led the market higher with the Nasdaq up 50% for 2003, 12% of that rise was during the quarter. However, unlike last year, where tech stocks led the market up in November and early December of 2002 only to come back down in late December and in January 2003, the

current tech rally is supported by a fundamental improvement in earnings and in the outlook for future orders. S&P tech earnings grew approximately 25% quarter-over-quarter in the third quarter, and should be about the same for the fourth quarter. Sales look to be up 9% in the fourth quarter, 6% for 2003, and 9% in 2004, with earnings projected to be up 33% in 2004.



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With stocks on a bullish path, the most aggressive names surged to the top of the charts in 2003. In the fourth quarter, small caps continued to outperform and value stocks pulled even with their growth counterparts. In addition, economically sensitive sectors that were considered 'old economy' sectors during the technology bubble, such as producer durables (21%) and materials & processing (22%), continued their strong run in the fourth quarter. In contrast, the technology sector (13%) took somewhat of a breather.

Valuation mattered in the fourth quarter, but for the year investments in high beta, cyclical stocks, regardless of style, dominated the market. Stocks were oversold at their 2002 lows, but it's still impressive that in just over a year the Dow and S&P 500 have risen about 40% from their lows, and Nasdaq was up 75%. Although the big three still have some way to go to recoup their 2000-02 losses, the S&P MidCap 400 and SmallCap 600 managed to make new all-time highs in December.

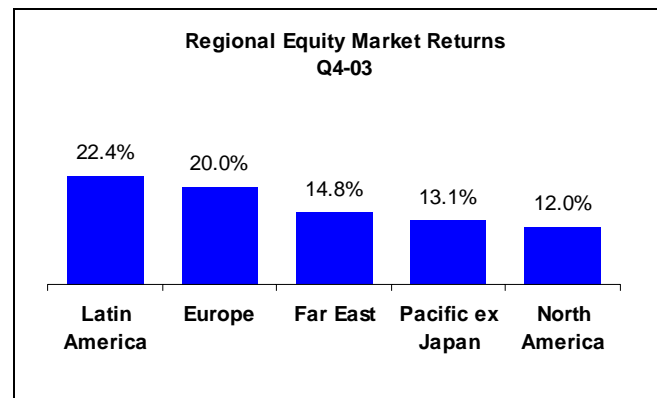
Considering the magnitude of the recovery in stock prices and the economy, the bond market turned in a creditable showing in 2003. The past year was a volatile one for bonds, with the ten-year yield ranging

from a low of 3.1% to a high of 4.6% before closing for the year at 4.13%. Coupon income more than offset modest price declines, and the Lehman Brothers U.S. Aggregate bond index ended up about 4% for 2003. That's not too impressive compared to stock returns (although bonds handily outperformed stocks in each of the prior three years), but it was still positive in real terms. Corporate bonds led the pack this past year, returning about three times the Treasury sector's 2% return.

While the good clearly outweighed the bad in the 2003 investment environment, there were some negatives that investors for the most part shrugged off. One was the persistent weakness of the dollar, which is trading at record low values compared to the euro and at a three-year low against the yen, with the downtrend showing no sign of reversing. In fact, it may be wrong to call the dollar's weakness a negative for 2003, since it probably contributed some to economic growth with a positive effect on exports.

### Foreign Financial Markets:

Stock markets across the globe sprang back to life in 2003, enjoying their first broad-based rally in four years and whetting expectations for more to come. Every region of the world participated. At the end of the year, Pacific equities were up 36% while European equities finished up 35%. Emerging market equities skyrocketed 52%, with stocks in Brazil, Thailand and Turkey up more than 100% for the year. Overall, the MSCI World ex U.S. index rose 39%, its best return since the inception of the index.



Similar to the 1990s, many technology-sector darlings led the pack in 2003, rebounding from depressed levels. German software company SAP AG, German chip maker Infineon Technologies AG and Dutch chip maker ASML Holding NV all returned better than 50% in 2003. But much had changed from the previous decade. The Russian market -- an international pariah after a debt default in 1998 -- continued a remarkable turnaround that saw Moody's Investors Service raise its credit rating on Russian government debt to investment grade. Moscow's RTS Index soared 58%.

China changed from a country that needed the U.S. to grow to one that was serving as a growth engine for other countries. Indeed, the world's largest initial public offering last year was a \$3 billion deal from China Life Insurance Co. Trading in New York and Hong Kong, the giant IPO seemed to underscore China's increasingly important role in the global economy. The Morgan Stanley Capital International China Index jumped 77% in 2003.

China's burgeoning consumer class generally helped boost Asian markets. Thailand's SET index soared 117%. Stocks in Asia's other awakening giant, India, did nearly as well with a 73% gain. Japanese stocks snapped back, thanks to strong foreign interest, led by big gains in producers of commodities such as iron and steel, as well as insurance and bank stocks. The government's decision to bail out Resona Holdings Inc. seemed to generate new confidence that Tokyo would take the steps necessary to clean up the banking system.

In 2003, Argentina's economy rebounded, while Brazil's new leftist President Luiz Inacio Lula da Silva proved he could ably manage the region's biggest economy. Brazil's Bovespa index rose 141% in dollar terms. Higher commodity prices and China's growing demand for resources helped Chile and Brazil, as well as the northern U.S. neighbor, Canada. However, China replaced Mexico as the No. 2 exporter to the

U.S. market, after Canada, and weak U.S. industrial output for most of last year hurt Mexico's export-fueled economy. Even though Mexican stocks went up nearly 34% in dollar terms last year, it was among the worst-performing major emerging markets.

For the first time in four years, investors in European stocks had a year of gains: the Dow Jones Stoxx 600 index of blue-chip stocks rose 18%. London's FTSE 100 Index was up 14% while the Paris CAC 40 Index, rose 16%. The Dutch market was Europe's worst-performing market in a year dominated by the financial problems at Ahold NV, the world's third-largest supermarket operator. The company was forced to restate several years of earnings after uncovering accounting improprieties, and the stock ended the year down 50%. Moreover, Europe wasn't immune from the kinds of scandals that rocked U.S. markets. In Italy, the year ended with investors wondering just what had happened to €3.9 billion (\$4.9 billion) that global dairy group Parmalat SpA put in a bank account that now appears never to have existed.

### Conclusion

As we stated in our third quarter review, the Presidential election, continued growth in the economy and in corporate earnings will dominate the investment environment for the next few quarters. While there are risks going forward in 2004, we expect that the recovery is on the verge of becoming self-sustaining. We've been saying that consumer spending and government spending can only sustain growth for so long. Corporate capital spending has been the missing element, and it has clearly been picking up. Across the Atlantic, European growth will depend principally on exports and improving private sector sentiment. European earnings are expected to surge 19% in 2004, according to a consensus of analysts' estimates compiled by I/B/E/S, outpacing the consensus call for a 12% rise in U.S. corporate earnings. Asia's markets are expected to continue their rallies at least for the first half of this year. The fundamental story for Asia remains attractive and valuations are still inexpensive relative to growth prospect for the region. As the global recovery gathers steam, cyclical economies such as Brazil and Chile should provide investors with investment opportunities. The Fed may raise rates sometime in 2004, but not enough to stifle the recovery, and more likely in the second half of the year. Please read "Front-end Loaded" for our complete 2004 Outlook.

**Quote for Thought:** "While we ponder when to begin it becomes too late to do." -- *Quintillian*

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