"Economic Growth In Full Gear"
Market Commentary – September 2003

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Data now suggests that economic growth is strengthening, which the stock market anticipated when it began to rally in mid-March. Gross Domestic Product (GDP), a dollar value measure of all goods and services produced in the U.S. economy, grew at a 3.1% annual rate in the second quarter. Other indications that this growth will continue include:

- Consumer cyclical and industrial stocks have rallied over the past several weeks.
- Durables orders rose 1.0% in July, following a 2.6% rise in June. This is the first back-to-back monthly rise since February and March of 2001.
- Philadelphia Federal Reserve's survey of mid-Atlantic factory activity, a good gauge of national activity, has been strong.
- Retail sales rose 5.6% from last year.
- While inventories fell $17.9 billion in the second quarter, rebuilding inventories will help boost GDP once businesses are convinced that the pickup in demand can be sustained.
- The jobless rate dipped to 6.2%. While this level suggests that the economy still is not creating jobs, the economy should prosper as long as people do not stop spending because they are afraid of losing their jobs.

Interest rates refuse to pullback, suggesting the market is no longer too concerned with fears of deflation. The Federal Reserve held the fed funds interest rate steady at 1.0% and indicated it has no intention of raising it soon. It sees deflation as a "minor risk", but noted that "the probability of an unwelcome fall in inflation exceeds that of a rise in inflation." Despite rising interest rates, housing remains strong, with housing starts hitting a 17-year high in July. Builders believe that 30-year fixed mortgage rates near 6.25%, which are still historically low, will not hurt the housing sector. Time will tell.

Cost-cutting is driving earnings more than top-line revenue growth. With 89% of the S&P 500 companies reporting, those firms posted total year-over-year earnings growth of 9.3% with sales increasing 6.6%. In the first quarter, earnings advanced 11.7% and sales rose 9.9%. Another indication that firms are focusing more on efficiency is the boost in productivity, rising at an annual rate of 5.7% in the second quarter.

Market technicals are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The small and mid cap indexes have hit higher highs and higher lows – the definition of an uptrend. The large cap indexes have consolidated in a trading range. While the price action has been bullish, volume has been extremely light. Volatility is near the lowest level since 1998, as measured by the VIX (Option Volatility Index). It seems that the market is poised for a high volume move. We will learn after Labor Day whether we see a major reversal with a high volume decline.

We remain consistent with our strategy of buying undervalued stocks on low volume declines and selling covered calls on rallies. In addition, we continue to methodically realize gains and lock-in profits, while enjoying income from dividends and call premiums. The seasonal weakness in September and October is a cause for concern. With the approach of the second anniversary of the September 11 terrorist attacks on the U.S. and the mutual fund tax-loss selling season in September and October, we are holding on to some cash in our portfolios. This will allow us to buy at lower prices in the event of a drop in the market, thus profiting from the initial decline when the market eventually rebounds.