"Tax Cuts Bullish For Stocks"

Market Commentary – June 2003

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Geopolitical uncertainty continues to lessen its domination of Wall Street. The U.S. national terror alert level was raised to orange amid fears of a possible domestic terrorist attack. As forecasted in prior market commentaries, the financial markets are becoming increasingly desensitized to the possibility of terrorism. Uncertainty remains with Israeli and Palestinian negotiations regarding a new Palestinian state, North Korea's nuclear program, and the spread of SARS.

President Bush signed into law a $350 billion tax cut, slashing taxes on dividends and long-term capital gains. The bill reduces the top tax rate on dividends from 38.6%, the highest ordinary income rate, to 15% for any dividend earned since January 1, 2003. As well, the tax rate on long-term capital gains was reduced from 20% to 15% for any gain realized on or after May 6, 2003. Short-term capital gains will continue to be taxed as ordinary income. Such fiscal stimulus will likely prove favorable for stocks over the years to come.

The U.S. economy is slowly starting to show signs of life. Gross Domestic Product for the first quarter was revised up from 1.6% to 1.9%, confirming that the economy is indeed growing. On May 6, the Federal Reserve kept the federal funds rate unchanged at 1.25%, a 41-year low. Core consumer inflation fell to 1.5% year-over-year in April, the lowest level since 1966. Chairman Greenspan says that the Fed is watching closely for signs of deflation. The U.S. dollar is weak compared with foreign currencies, making American exports cheaper for foreigners to buy. A potential downside for American investors, however, is that foreign investors may be reluctant to buy dollar-denominated assets such as U.S. stocks.

Consumer sentiment is firming, fueled by a solid housing market. The Conference Board's measure of consumer sentiment hit 84.8 in May, a six-month high. The housing market is on fire, with new home sales rising 1.7% to a 1.03 million-unit annual rate (the third highest on record) and with existing-home sales rising 5.6% to a 5.84 million-unit annual rate (the fifth highest on record). A survey conducted by Bankrate.com reports the average 30-year mortgage rate at 5.39%, a level not seen since August 1958.

The bond market may be experiencing a bubble similar to the technology bubble in the late 1990s. Indicating a desire for safety, treasury yields have been driven to multi-decade lows. As of May 29, treasury yields were as follows: 3-month T-bill at 1.08%, 1-year T-note at 1.11%, 5-year T-note at 2.25%, 10-year T-note at 3.33%, and 30-year T-bond at 4.34%.

Market technicals are mildly bullish (more demand than supply), while fundamentals are neutral – therefore, we are neutral to mildly bullish on the market. As expected, the major stock indexes meandered higher in May. Nasdaq is the leading index, while the S&P 500 and Dow struggle with near-term resistance levels at 950 and 9000, respectively. We will become more bullish on market technicals once resistance is overcome. Until then, we assume that resistance will hold. Fundamentally, the market continues to be fairly priced.

Our portfolios are positioned to benefit from either a stock market rise or decline. As the markets approach resistance, we have limited our buying of stocks and have sold covered calls on many positions. If the market breaks out to the upside, then we will happily be called out of our positions over the summer and lock in excellent profits. If the market declines, we will enjoy the income provided by call premiums on our equity positions. Our portfolios are conservatively positioned with adequate cash. We look forward to putting more cash to work on either high volume breakouts or low volume declines. Should high volume declines occur, we will put our buying on hold for the time being.