A.R.Schmeidler & Co., Inc.

The Outlook

April 2003

As of April 8, 2003		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	-0.5	8,298.92
S&P 500	-0.2	878.29
Nasdaq Composite	+3.6	1,382.94

Negative Economic Forces Persist

Wall Street's economists are being asked, "Will the economy recover when the Iraqi war is behind us?" The answer we hear is "I don't know." The reason given is that negative economic forces have been at work long before geopolitical issues over Iraq began burdening the economic outlook. **We have often indicated that despite a possible powerful, tradable market rally after Saddam Hussein's regime falls, fundamental U.S. economic issues will still have to be resolved, and it is these issues that are likely to prevent a strong market from being anything but temporary.**

Traditional investors are not driving current market activity. The stock market's gyrations have been the result of some 6,000 hedge funds attempting to take advantage of war-related short-term opportunities while investment funds for the most part have been sitting on the sidelines. The most recently published short-interest positions on the New York Stock Exchange showed an increase of over 4% amid speculation on higher oil, gold, and treasury prices as a result of the war. As the war comes to conclusion hedge funds are unwinding positions by buying back shares they sold short and selling bonds, gold, and oil to participate in what they believe will be a stronger overall market. We should also expect a temporarily stronger market environment as cash sitting on the sidelines gets invested and the war-risk is diminished. It is worthwhile noting that the week the war began, the Dow Jones average surged 1,000 points as hedge funds reversed their positions as described above.

Energy Prices Remain Strong

We continue to hold a minority view with respect to the outlook for energy pricing, particularly oil. Most analysts believe that the price of oil will decline to the low 20's and possibly into the high teens as occurred after the first Gulf War. However, today's conditions are different from the first Gulf War experience in the early 90s. Since our last *Outlook* oil supplies in storage in the United States have declined even further and are at twenty-seven year lows; and Nigeria, a two-million barrel a day exporter of high quality oil, has been experiencing civil unrest. Major oil producers, Shell and Chevron/Texaco, had declared force majeure on 40% of their Nigerian production, further tightening the oil market. In the Middle East we do not know how long Iraqi oil will be off the market, but formidable production difficulties keep cropping up. The challenge for United States producers will be to rebuild gasoline supplies for the summer driving season and at the same time rebuild inventories for next winter's heating season. As for natural gas, it is in tight supply and is likely to remain so for a considerable period of time.

Pressures Brought On By Growing Budget Deficits

The Administration's supplemental budget request of $75 billion for the war effort will add to the fiscal deficit bringing the total close to $400 billion or approximately 4% of GDP. Moreover, it is likely that another budget request will be submitted raising the deficit even further. **In spite of a significant increase in the total budget deficit over last year, some important programs are still being under-funded putting in question the size of future deficits. As an example, the government's costs associated with providing health, education and other human services are growing more rapidly than tax revenues and the potential long-term growth of the U.S. economy.**

The effect of federal government under-funding in combination with higher Medicare costs has resulted in a 12.4% premium increase for medical benefits in the private sector. These higher costs will be passed on to consumers and businesses putting a further burden on them. This is in addition to the economic and tax squeeze on consumers and businesses brought on by the need to eliminate state and local budget deficits.

Interest Rates Could Head Lower

We would expect the economy to do better eventually to the degree that it has been held back by the war. **However, once it becomes clear that the U.S. economy is still operating considerably below its ideal rate of growth, the**

probabilities for further Fed easing are high. Moreover, as we wrote in our December *Outlook*, **the Central Bank is prepared to use unconventional methods to reduce long-term interest rates.**

The prospect of a no-growth economy is not a comfortable scenario for the Federal Reserve. Since the amount of outstanding Treasury debt in the public hands which matures in twenty years or longer totals only about $235 billion, it would not be difficult to bring down interest rates should the Federal Reserve decide to intervene in the long-term Treasury market. In a speech supporting this possible course of action, Fed Governor Bernanke referred to Fed's capping long-term treasury yields at 2.5% in the 1940s.

In the private sector, companies are fast retiring high cost debt, which denies portfolios the opportunity of receiving the higher interest income. This is making high dividend-paying securities increasingly difficult to find. Consequently, there is a strong demand in the face of shrinking supply for high-yielding securities that is lifting their prices thereby increasing the total returns to their present owners.

Growing Pension Fund Liabilities Pressure Earnings

It is important to emphasize that, as we mentioned in prior issues of *The Outlook,* the pension fund liabilities of corporations are likely to be a significant depressant on corporate earnings for the following reasons:

- The SEC is concerned about many companies' pension rate-of-return assumptions. Rate-of-return assumptions range from 8-10% in many cases. If, or more likely when these assumptions are lowered, companies will have to contribute significantly more to their plans from their earnings.

- Companies are using discount rates in establishing their liabilities that bear no relationship to the rates of return currently prevailing in the financial markets. When more realistic discount rates are acknowledged, pension fund liabilities will increase.

- The government's Pension Benefit Guarantee Corporation, charged with insuring companies' pension liabilities, is currently under-funded by $3.5 billion. However, last year, it had a surplus of more than $7.5 billion. **The airline industries' pension plans are currently under-funded by $18 billion and overall U.S. defined benefit plans according to the PBGC's calculations are now actually under-funded by some $300 billion.** We expect that companies will have to pay higher fees to the PBGC. In addition, if the Financial Accounting

Standards Board changes the rules for pension fund accounting by requiring companies to reflect their pension funds' true liabilities on their financial statements, then earnings' predictability will be greatly diminished.

Weakness In Many Sectors Of The U.S. Economy

The unemployment situation deteriorated in February and March, and we believe that the labor market is still slowing. Moreover, it appears that the loss of jobs is part of a secular trend where manufacturing and service sector jobs are moving overseas. **Accordingly, weather, Iraq, and seasonal adjustments may be only part of the real underlying reasons for the economy's weakness. We cannot help noticing a pattern of weakness across many sectors of the U.S. economy. With consumer demand slowing, high-energy costs, and pricing power confined to only a select few industries, jobs are being cut to shore up margins.**

Finally, sudden acute respiratory syndrome is something to be watched closely since the recent outbreak of the SARS virus has geoeconomic ramifications. A great deal of manufacturing outsourcing is based in Asia, which also has been the fastest growing economic region. At the present time, growth rates are being lowered as travel has begun to be seriously impacted by the spread of SARS and manufacturing efficiencies are being reduced.

Our Portfolio Focus

Mutual funds that have broadly diversified portfolios will likely find the current outlook particularly difficult. Hedge funds account for a significant percentage of the overall market's trading activity and exacerbate volatility**. In this environment our portfolio focus continues to be on high-yielding securities with growth prospects and clear under-valuation.** Notwithstanding attractive exceptions to this, the ability to compound rates of return will be more dependent on the income flows that a portfolio generates than it has over the past several years.

In spite of a difficult economic environment, this continues to be a stock pickers' market where capital-building opportunities can be found. For example, we recently purchased an equity position in a multi-billion dollar retailer after they announced their intent to restructure by selling a major part of their business to unlock value. The shares have begun to appreciate sharply while still yielding nearly 3.5%, and we estimate a reevaluation well in excess of the current price. These are the kinds of investments that should be included in portfolios where suitable.

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