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**WESCAP's Review of 2003 and Outlook for 2004**  
(reprinted from January quarterly report to WESCAP clients)

2003 Year in Review

After a short period of concern early in the year due to the Iraq conflict, worldwide economies and stock markets moved ahead strongly when it became clear that Iraq was not going to be a long, drawn out conflict. The rest of the year was mostly good news regarding growing economies, expanding earnings, cessation of job losses and continuing low interest rates and inflation. Equity investment valuations surged as one would expect in a cyclical rebound, following the dissipation of the combined effects of recession, corporate scandals, war concerns and fears of deflation and recession.

After three straight years of consecutive declines for the S&P 500, the index rebounded 28.7% in 2003. As we pointed out in our letter of one year ago, "Very low inflation and interest rates, plus an S&P 500 expected 2003 P/E of 15 to 18 (using operating earnings, excluding write-offs and pension losses) indicate that the stock market is a little undervalued,..." The stocks of companies that investors were most worried about in 2002—technology, highly leveraged firms and firms with no earnings—did the best in 2003, in the form of a powerful relief rally. Growth stocks outperformed value stocks for most of 2003.

Other investments that are sensitive to worldwide financial health also did well during the last quarter and the year. The U.S. high-yield bond sector reversed itself from the prior few years. High-yield bond defaults peaked in January 2002 and dropped substantially over the past two years. According to Lipper Analytics, high yield bond mutual funds made 24.3% for the year.

Emerging markets stocks were up 55.4% for the year. For the second year in a row they outperformed developed world markets. The pick-up in growth worldwide had a disproportionate positive impact on emerging markets given their economically sensitive manufacturing base or natural resources based economies.

Higher quality bonds struggled in 2003, following three prior years of better-than-average returns. In our letter at this time last year, we stated "The long-term bull market in bonds may also be coming to an end—just 3 years behind growth stocks." This indeed seems to be the case. The shift back to stocks, concerns about future government deficits and the fading specter of deflation reduced demand for high quality bonds. U.S. government long-term bond mutual funds made a meager 1.4% (including interest) in 2003. Corporate, municipal, and mortgage bond funds did modestly better.

For the last three years, both low short-term interest rates and a rapid increase in the money supply have continued to provide a boost to home and big-ticket consumer purchases. Unlike previous years, infrastructure and capital goods spending by firms has picked up recently. While factory utilization rates look low at about 75%, this doesn't take into account obsolescence of outmoded factories and technologies. To compete in a low cost labor world, new, highly-efficient facilities and processes are needed. Thus, we can expect to see a continuation of the recent growth in business and capital equipment spending, despite still low reported factory utilization rates.

Small-cap "core" stock funds returned 44.2% for the year. Real estate funds continued a multi-year run with a return for 2003 of 36.8%.

The U.S. dollar weakened 16.7% against the Euro in 2003 (on top of a 2002 15% decline), which made Euro bonds quite a good investment again in 2003. The dollar fell more modestly against the Yen and declined 10% on a U.S. trade-weighted basis. The Chinese Renminbi has remained pegged to the dollar, fostering a large trade imbalance and trade policy unrest that nearly resulted in protectionist measures. China's economic growth and use of raw materials played a key role in the 2003 worldwide economic recovery. China's impact on world trade and currency policies is likely to grow further.

#### 2004 Economic Outlook

**The global economic outlook for 2004 is quite strong.** U.S. and worldwide economies are continuing to expand at a robust pace. Production of goods and demand for services is continuing to increase. Low inflation and interest rates, lower tax rates and higher than average money supply growth is good news for the consumer. Higher profits and improved balance sheets are good news for business spending.

Like last year, productivity per employee should continue at a higher than average pace. Further strength is expected in the formerly weak manufacturing sector. In November, the average factory workweek hit a 3-year high of 40.8 hours and overtime has risen 10% since June. The downside for the economy is that demand for *new* employees is still low. Fewer employees are needed per unit of output. Offshore outsourcing of manufacturing, and to a lesser degree services, means U.S. labor markets continue to lag the growth of the economy and pricing power in many products is limited due to lower offshore costs. However, the flip side means greater economic strength in emerging markets and low inflation in the U.S.

The low level of current inflation allows for continued monetary stimulation. However with the recovery well underway, monetary stimulus is needed less. Allowing too much growth in the money supply may fan inflationary pressures in late 2004 and 2005. A recent change from the last few years is that money supply growth has slowed markedly the last 3 months, with annualized growth of M-2 at only 2.7% (through November). Slowing the flood of new money may curtail future inflation, though the rise in real estate prices and stocks in 2003 likely owe much of their appreciation to this extra monetary

growth. More subdued market results may be forthcoming if the slower growth rate persists.

Strong employee productivity growth has offset much of the higher commodity prices and slightly higher import prices due to the recent depreciation of the dollar. The weaker U.S. currency also provides an extra stimulus to domestic exporters as U.S. products cost less now in Europe, much of Asia and other parts of the world. Overall, productivity growth is a strong net positive for our economy by lowering inflation pressures and allowing interest rates to stay low while production and services continue to ramp up.

Current low interest rates, along with lower tax rates and higher average wages for individuals are expected to allow consumers to continue to boost the economy via higher spending, even without a large reduction in the unemployment rate.

Europe's economy appears to be improving too. Due to restrictive labor practices and a stronger currency, its economic growth is expected to lag U.S. expansion. Japan appears to be out of intensive care, though it is still in a fragile recovery mode. However demand in China and other Asian countries should help Japan more than the U.S. and Europe. A key change in Japan is that banks have reversed their dismal multi-year contractions. Major Japanese banks have reported record earnings recently, thus freeing up capital to lend to credit worthy borrowers. Interest rates and the Yen have risen there as well, indicating that the deflation and successive recessions of more than a decade are over. As the world's second largest economy, this is good news for the world.

The emerging markets in Asia are the prime beneficiaries of worldwide growth due to their sensitivity to manufacturing demand. Internal demand is also growing as workers' and companies' incomes rise at faster rates than the rest the world. Trade and currency policy disputes are likely to continue until U.S. job growth accelerates or until a depreciating dollar and internal growth of these countries begins to reverse trade imbalances. A major trade embargo or punitive tariffs could be a big shock to worldwide growth, but the recent elimination of steel tariffs by the U.S. bodes well for rationality in tariffs. One factor to note is the recent rise in U.S. exports, which in October grew at a 2.6% annualized rate, faster than the 2.1% growth of imports. Since the level of exports is lower than imports, it will take some time before the trade deficit actually declines, but this recent trend favors not curtailing trade via pre-emptive tariffs and embargoes.

#### 2004 Investment Outlook

**The investment outlook for most equities is still positive.** Over the past year, U.S. companies have become more careful about creating expectations; some no longer give updates to analysts. Analysts have been burned recently and with less corporate guidance are uncharacteristically restrained. Over the past few quarters, earnings for most corporations have expanded at or better than analysts' expectations. For the third quarter 2003, S&P earnings advanced by more than 18.7% over the prior year and beat analysts' estimates by almost a 5% margin. Since July, analysts in aggregate have not raised their earnings estimates for the 4<sup>th</sup> quarter of 2003, despite these recent quarterly positive

earnings surprises (Prudential Equity Group, Investor Weekly, 12/17/03). Thus the probability is good for better-than-expected earnings growth rates for the next several quarters. This would put 2004 S&P 500 price-earnings ratio at about 17, which is not excessive given low inflation and interest rates. These conditions, if they persist, would be good for U. S. stocks.

Smaller stocks, which have outperformed larger stocks, may be on parity with large stocks going forward. It is hard now to argue that smaller stocks are cheaper than large ones. In fact smaller stocks need to continue to have faster earnings growth compared to large firms to justify owning them over larger stocks. Analysts expect them to grow their earnings about 16% in 2004 as compared to 13% for large stocks. This is not a large margin of difference. Plus many larger firms will get the export benefit of a cheaper dollar not generally available to small firms. If this trend continues, along with a lessening of pension funding costs and the benefit of more financial leverage of larger firms in a recovering economy, it will tend to favor larger firms over the next few years.

**However, not all is rosy.** One significant concern is the high level of insider sales relative to purchases. A case can be made that there is pent-up demand to sell from insiders stretching back nearly four years, but it is still a troubling sign. The same can be said for the extremely low volatility in stocks (e.g. VIX index near 16). Over the last three years, levels of very low volatility coincided with market tops. Complacency in any market is dangerous. Of course, compared to several years ago, there are many more fundamental reasons why an investor should be cautiously optimistic. Thus if warranted optimism is substituted for blind complacency, there is good reason to expect lower volatility. Nevertheless, the margin for error appears smaller now, since a lot of good news is already factored into stocks. The next few quarters of earnings will show whether this optimism is warranted.

Not much risk is being priced into equities right now. Of course war, terrorist attack, SARS breakout, or some new negative surprise may cause a tumble in worldwide equities. Such an occurrence could be a buying opportunity, since the impact on worldwide growth would be expected to be temporary. If stocks become clearly overvalued again (via excessive appreciation, cessation in growth, much higher inflation or interest rates), then any negative event could trigger a much larger decline. This is more a concern for late 2004 or 2005 than currently.

Presidential election year history suggests that 2004 should be a good year. Only two out of twelve election years were negative (since 1952) and the average gain was 10.4%. Only the year prior to an election (as in 2003) was better. The two years following elections tend to have below average, but still positive, stock market returns.

For foreign markets, the weaker dollar can be expected to be an earnings drag for some larger European export-focused firms and thus may favor smaller firms. While earnings growth in Europe is not likely to match the U.S., the expected Euro currency boost

should add to returns for U.S. dollar-based investors. Moderate growth in the European economies, plus the currency strength should help Euro bonds.

Real estate, via REITs, is still not expensive when compared to both high and low quality bond yields. However, fundamentals, like employment growth, have been slow to improve prospects for most income producing real estate. Additionally, many REITs now trade at significant premiums to the estimated underlying values of their properties. Some REITs, like office and industrial, do seem to offer good value, and shopping centers are showing robust earnings growth as consumers continue to spend.

High yield bonds appreciated strongly last year. However, this also means their yields *going forward* are reduced. Thus they are not as attractive as a year ago. Nevertheless, with default rates continuing to decline, with interest rates 3% to 4% above high quality bonds, with much shorter average maturities, and less sensitivity to rising rates, we expect to retain a significant weighting to this asset class. As other assets become more attractive, we will likely reduce our high yield weighting. This could accelerate further if the amount of new high yield bond issuance continues its recent rapid expansion. A flood of new bond issuance often precedes difficulties two to three years hence in the high yield market.

**High quality, long-term, U.S. bonds**, particularly government bonds, continue to offer more risk than we would like to see, given their still relatively low yields. Until yields rise to compensate for future inflation risk and interest rate risk, our exposure to these bonds is expected to remain underweight. Inflation-linked bonds are high quality and should react more favorably if inflation begins to escalate.

Given the large rise in stock prices and the low margin of safety in both stocks and most bonds, for more conservative investors a shift back towards hedged and alternative investment strategies makes increasing sense. For example, merger-arbitrage spreads (and profits) are improving with the pick-up in corporate activity. Further, this strategy is largely insensitive to stock and bond market changes. Other strategies that are less sensitive to general stock and bond market conditions are also available and will be used.

Overall, we believe that worldwide economies and equities will show positive results in 2004. However, the attractiveness of certain bonds and alternative investments means we want to continue to own these in sufficient amounts to provide adequate diversity and as a hedge against the unexpected.

Please contact Joel Edstrom, Mark Gleason or Rick Weinlein if you would like to discuss this in more detail.