

## Q1 2003 Market Review

4/15/03

The first quarter of 2003 proved once again how the financial markets detest uncertainty. After a strong first few weeks in January with the S&P up over 4%, the early optimism was tempered by numerous factors looming over business and the economy as a whole. The geo-political uncertainty surrounding the situation in Iraq and North Korea restrained business and consumer spending while the surge in oil prices and decreasing consumer confidence further mired the capital markets. Through early March, the S&P 500 had slumped 9%, dragging all 10 of its sector indexes lower. Centurion's investment strategy allowed us to generate positive returns in this depressed market where the cloud of uncertainty surrounding Iraq -- if, and when, the U.S.-led coalition would engage Saddam -- was the main contributor to the market's weakness.

War was the imminent decision but it was attempts towards resolution that cleared the way for the market rally. On March 13<sup>th</sup>, stocks had their biggest gain in 5 months after the White House said it may extend diplomatic efforts to disarm Iraq, adding to speculation that war would be delayed. On March 17<sup>th</sup>, the coalition announced it would bypass the Security Council to go into battle and the market, in its own wisdom, rallied even higher with the layer of uncertainty removed. Once war in Iraq became imminent, the Dow industrials rose close to 1000 points on an eight day surge, wiping out earlier losses and sending both benchmarks up for the year. Centurion was able to profit from this move and better position itself from a relative value standpoint.

Ending the market's uncertainty, however, is not the same as ending all of our economic problems. The economy has continued to struggle with a recessionary overhang that has businesses, consumers and governments watching their wallets: Many companies are still trying to reduce their debt, a strain that has discouraged new capital spending. State and local governments -- compelled by law in many states to balance their budgets -- have been raising taxes and cutting spending programs, providing another drag on the economy.

Despite these underlying factors, the war effort will continue to drive the markets in the foreseeable future. As a benchmark, many investors are looking to the performance of the financial markets following the Gulf War in 1991 as a guideline -- a perspective we at Centurion view with slight caution.

The global economy is in worse shape today than a dozen years ago, meaning that U.S. companies can't count on demand in Europe or Japan to compensate for a weaker domestic market. And since the U.S. is launching this fight without clear backing from the United Nations, Washington will be responsible for a bulk of the ever increasing war costs.

At the same time, the U.S. has moved from a current-account surplus in the first quarter of 1991 to a widening current-account deficit. This increases U.S. dependency on foreign capital, but it also suggests that the dollar will continue to weaken, which discourages foreign investors from buying U.S. stocks.

While the Federal Reserve aggressively cut interest rates in 1991 and 1992 -- cutting the federal-funds rate 13 times, to 3% from 7% -- the situation today is much trickier. Now, that rate is at 1.25%, leaving the Fed little room to cut rates again if the war runs into trouble or if the economy weakens further.

U.S. military challenges won't be over at the end of Iraqi freedom. The U.S. still faces a threat from global terrorism, and other potential international crises loom in North Korea and Iran.

Even after the three-year bear market, stocks remain expensive from a valuation perspective with current price-to-earnings ratio based on trailing 12-month earnings for the S&P 500-stock index of 31 -- about double that of 10 years ago.

On the positive side, President Bush offered Congress a two-pronged way to attack economic slumber: Enact immediately the income-tax cuts in marginal rates as outlined in the 2001 tax law and end the double taxation of dividends. The House passed Mr. Bush's \$2.2 trillion budget outline last week, and though the Senate reduced the proposed tax cut's in half, they will still add a significant and necessary economic boost over the next two years.

So where does that leave stocks? Individual investors still stinging from the prolonged bear market continue to view the market with trepidation. Over \$11 billion was pulled from stock funds in February, the eighth month out of the past nine in which investors took more money out than they put in. This results in an active, volatile trading environment where our investment philosophies have proven to be extremely successful.

We believe the market will mirror the success of the war effort in the near term but the uncertainty of duration and cost of the war will keep domestic spending in check. A relatively short conflict will likely give consumer and business confidence the opportunity to recover. More important, spending by consumers and businesses will improve at least gradually after the war, lifting pricing power and economic growth. This will provide the impetus for individual investors to re-enter the market and provide the support necessary for the market to appreciate. What's more, President Bush's stimulus package, which probably won't be passed until the war is over, will support the economy later in 2003 and help accelerate its growth in 2004.

As welcome as the rally is, we understand it is driven by war news and so expect many short-term bumps and bounces that we should profit from. Over the longer term, victory will create the possibility for stability in the terribly unstable Middle East. Along with sending the strongest possible message to terrorists and states that shelter them, the war will allow a democratic Iraq. Both will be an enormous boost to U.S. and global economic growth.