



The Centurion COUNSELOR

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Halftime

UNDERVALUED SECTORS (CONSIDER!)

- **LARGE CAP VALUE**
- **DIVIDEND STOCKS**
- **CONSUMER
DEFENSIVE**

OVERVALUED SECTORS (AVOID!)

- **INTERNET**
- **HOME BUILDERS**
- **CALIFORNIA
MUNICIPAL BONDS**

In our last Counselor, we foresaw the Dow reaching 10,000 during the year. At this point, we still believe this level remains achievable. The gain this year has been accomplished, in spite of sluggish growth, because of massive stimulus from the Federal Reserve. This has come in two forms, unprecedented rate cuts, and less obviously an increase in the supply of money. We do not believe that growth will pick up much in the second half of this year. However, we think 2004 is building up to be a barnburner once the actions of the Fed have time to take hold and the effect of the latest round of tax cuts work their way into the economy. Alan Greenspan is doing the opposite for Bush II that he did for his father because it is "the economy, stupid" after all.

There is no such thing as a free lunch and the cost of this stimulus will be a further weakness in the dollar against the Euro and the Yen. This will spell further trouble for their economies and their equity prices, but it will only help the value of their bonds. The weak dollar will not be dealt with until late 2004 or early 2005, which may lead to an additional 15 to 20% decline in the value of the greenback. At this time, the Fed will again start to increase interest rates, putting pressure on both bonds and equities. We see two clouds on the horizon that may have an impact on the markets later this year. Either or both could have a sharp but short lasting impact on the markets. The first is the situation in Korea. Like a petulant child not getting enough attention because of the news in Iraq, we believe that North Korea will do something in the next several months to attract attention.

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This could include testing a nuke to show proof that they do indeed have the bomb. This step up from saber rattling would be an attempt to once again extort food and money from the West. Bush, like any good parent, will dole out swift punishment, reducing their nuclear and missile capabilities and restoring confidence in the markets.

The second potential pothole for the market may be the Chinese finally bowing to U.S. concerns about their strong currency and allowing the renminbi to float against the dollar. Many economists believe that such a currency change would initially cause stock prices to drop. We believe this drop would also be temporary because many companies have substantial investment in China that would appreciate in value. This drop in value of the dollar versus the renminbi would make U.S. manufacturing more competitive in world markets. Currently the Chinese, because of their strong currency, are the leading exporters of deflation. The revaluating upward will help the United States and Europe and Japan.

Dividends or T-Bills?

At the end of the quarter more than 50% of the companies in the S&P 500 had dividend yields greater than the three-month T-bill. In fact, 20% of the companies had a yield greater than the ten-year Treasury. One might assume that the above fact is a ringing endorsement for the S&P 500 and a condemnation of Treasury bonds. In fact it is neither. It is a ringing endorsement for asset allocation. We have heard from the so-called experts that each Fed rate cut over the last two-years is the last one and each time they have been wrong. Bonds have been one of the best performing sectors in spite of the low yields for the past several years. This is because as rates drop existing bonds increase in price. However, in the quarter just completed, for the first time in several years, equities out-performed bonds.

**Growing & Protecting
Your Wealth...**



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Investors, as do Generals, tend to fight the last war. In this case, expecting interest rates to rise. It is possible that the economy is not heading either into deflation or inflation but is headed for a long period of low stable interests rates last seen when Ike was President. If this were the case, what would be the best investments? It may seem obvious that equities would perform well in this environment but we believe that only companies that pay dividends and have the potential to increase the dividend, will outperform. This is in no small part due to the recent tax cut. It is quite likely in this scenario that the after-tax return of equities will be higher than that of Municipal Bonds.

Slow & Steady Wins The Race

We have witnessed, time and time again, seemingly conservative investors who either wanted to take a flyer or who thought that they were smarter than the market and wanted to trade in securities with little or no information short of a tip or gut feel. A couple of successes would transform these mild-mannered folk from rational investors into traders rabid for the next big thing. Investment managers spend almost as much time talking clients out of risky trades as they do trying to help them meet their stated investment goals. Throw in a hot market such as the one we saw in the late nineties and the die is cast. With the advent of online and discount brokers, investors were given the opportunity to do what ever they chose, even if their financial advisor declined the trade.

Now that the market has had one very good quarter, we are seeing some of the same things we witnessed in 1998 and 1999. Investors must have the self-discipline to protect themselves, beginning with a sound buying strategy such as strategic asset allocation that we use at Centurion. It has always amazed us that as stocks rise dramatically; investors want to buy more. It's analogous to betting more on a favored horse after the race has started and holds an early lead. More often than not, the horse finishes out of the money.

**...To Ensure Your
Investment Future.**



The Fault Lines in California

Most of our clients know that we are not big fans of Municipal Bonds, especially California Bonds. The press has had much to say about California's financial woes of late. We believe that the situation may be worse than the press is reporting. We would agree with those who say that no lawmaker in California has seriously considered defaulting on the states general obligation debt. This debt carries the "full faith and credit" of the state, meaning that the state has pledged its taxing power to make sure it can meet its obligations. The real question is what will they be forced to do in the future.

Under the current system it is the taxpayers and recipients of state services who will feel the pain needed to balance the budget. The problem is Proposition 98, passed several years ago, requires, by the state constitution, that 40% of all general funds revenue be paid to California schools **before paying anything else**. After the schools get their cut, interest on the public debt comes next. What is not being covered in the press and certainly not being stated by the politicians is that any increase in taxes will have to be 40% greater than what is needed because of the Prop 98 mandate. This means if the \$38 billion budget shortfall is met with tax increases, taxes will need to be increased by approximately \$60 billion so the schools get their 40% cut of the top.

We believe that a \$60 billion tax increase (the projected tax revenue currently is only \$70 billion) is out of the question. Spending, excluding schools, is projected to be about \$65 billion. If state services are to be cut but school funding left untouched, a massive 50% reduction in state services would be needed. Frankly we don't think the voters in California would accept either solution, so that leaves only one dog left in the fight, the holders of General Obligation Bonds.

California is no longer just flirting with a budget crisis. We don't think that it will be called default; Prettier words such as an interest moratorium will be used, but the result will be the same. California has been digging this hole for a number of years and the ditch will not be filled overnight.