MONTGOMERY BROTHERS WEALTH MANAGEMENT

2003 Investment Outlook Update

"It's Good to be King!"- Mel Brooks
History of the World, Part I

We admit to running hot and cold on George *W.* Bush. Sometimes we think that he's the best president since his father but at other times we think he's the worst president since Louis XVI. In the past, when things were going badly, a King would take his country to war. War would rally the populace to "the cause," shift the focus off whatever was bugging the people, and, sometimes, even help the economy. But, no mas!

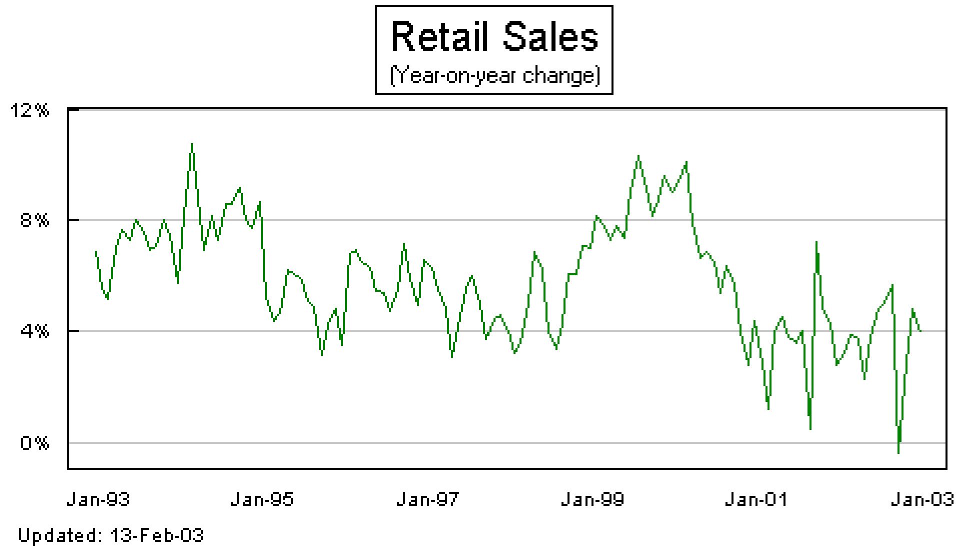
Montgomery Brothers is not sure why the President feels that now is the optimal time to take out Saddam. Given the economy and the "War on Terrorism," one might have thought that Bush would find our national plate to be fairly full. What's worse is that a war is unlikely to do much to stimulate the economy. The $100 billion or so it'll cost to run this war is a drop in the bucket for a $10 trillion economy. What little economic stimulus might be provided would likely be offset by the increase in the price of oil which acts to drain consumer incomes. Even worse, the interminable "windup" for the war is causing psychological and economic angst which is probably worse than the impact of any possible war would be. Additionally, we don't seem to be making many friends with our anti-Saddam policy. Few would argue that Saddam is not a bad guy but many argue what the U.S. should do about him, if anything. To many, President Bush appears to be a bit of a cowboy who seemingly tries to ride roughshod over friends and foes alike. Is this good leadership and/or bad politics?

When Kings would take their people to war, they would often throw a bone to the peasants in order to gain their support. Regardless of what you think about President Bush's tax/stimulus/economic efficiency proposals, the general consensus seems to be that it benefits "the rich." (You know? "The Rich." That amorphous group in which everybody wants to be, but that everyone thinks should pick up the tab.)

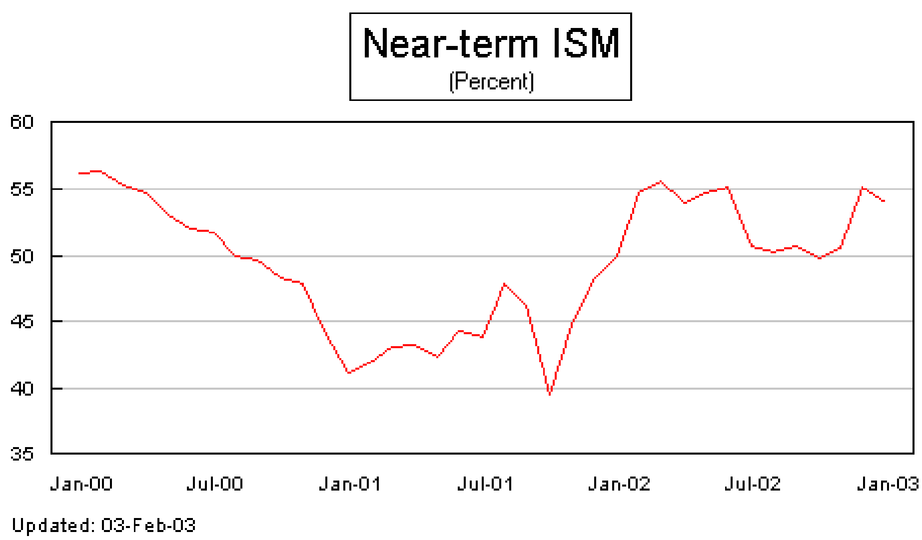
As former Secretary of the Treasury Paul O'Neill stated and President Bush's proposals imply, there is little that can be done to stimulate the U.S. economy over the short run. While MBI has seldom seen a tax cut it didn't like and applauds the possible elimination of the double taxation of dividends, we wince at the implied goal of trying to goose the stock market to help the economy. But what bugs us the most is the general acceptance of the idea that increasing discretionary spending 9% or 10% a year is okay but cutting taxes causes deficits! We don't expect that much of the administration's tax/stimulus/economic efficiency proposals will pass but we do expect that all of Congress' spending proposals will. Hello larger budget deficits and, probably, higher inflation.

Economic Outlook

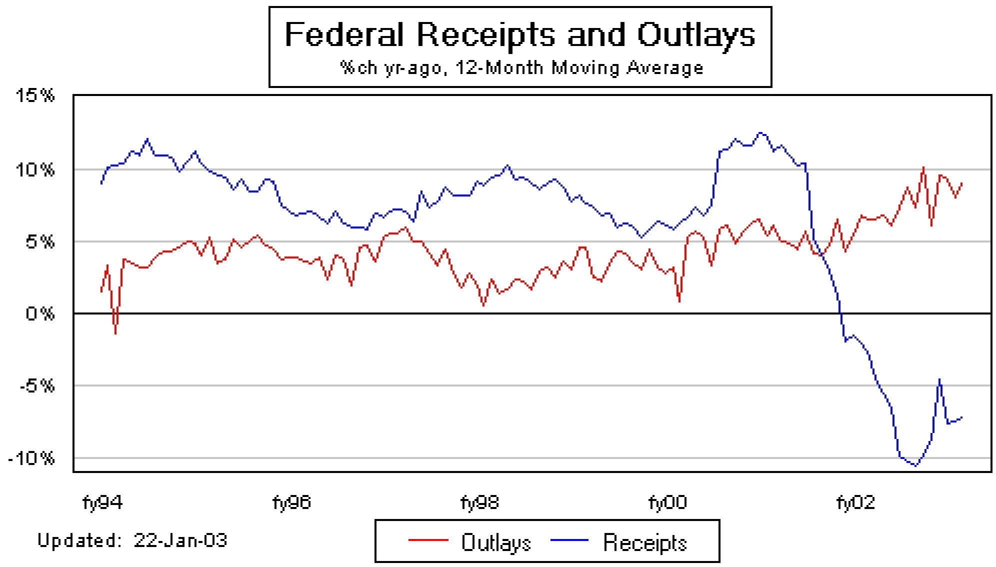
Everyone knows that the consumer is the King of the economy. Persistent rumors of the King's death have consistently proven premature. Long live the King! In spite of concerns about war, stagnant job growth, perceived heavy debt loads, slowing growth of incomes, repeated warnings of terrorist threats and the never-ending bear market, the intrepid consumer just spends on. Hopefully, business spending and, certainly, Federal government spending will come to the aid of the economy and take some pressure off consumer spending.



Business spending has already started to lend an economic hand. Business inventories have increased for eight months in a row and capital spending for items other than buildings has risen for four consecutive quarters. The Institute for Supply Management (ISM) Index, formerly known as the National Association of Purchasing Managers (NAPM), has been above the 50% expansionary demarcation line for three consecutive months (and 11 of the past 12 months), largely due to solid increases in durable goods orders and expanding industrial production.



Similarly, government spending is increasingly expansionary. While state and local governments struggle to balance their budgets, the Federal government is off on a tax cutting and spending bender that would make any regal potentate proud. With the merest tip of the hat to fiscal responsibility, Congress is raising discretionary spending by almost 8% for fiscal 2003 which additionally automatically raises the bar for future spending even higher. The President will probably sign the budget legislation even while lecturing about spending prudence. (And this budget does NOT include the cost of a war with Iraq and that's only another $100 billion or so.) It's a good thing we have a fiscally responsible monarch in the White House. Who knows what the deficit would be if it weren't for all this fiscal restraint?



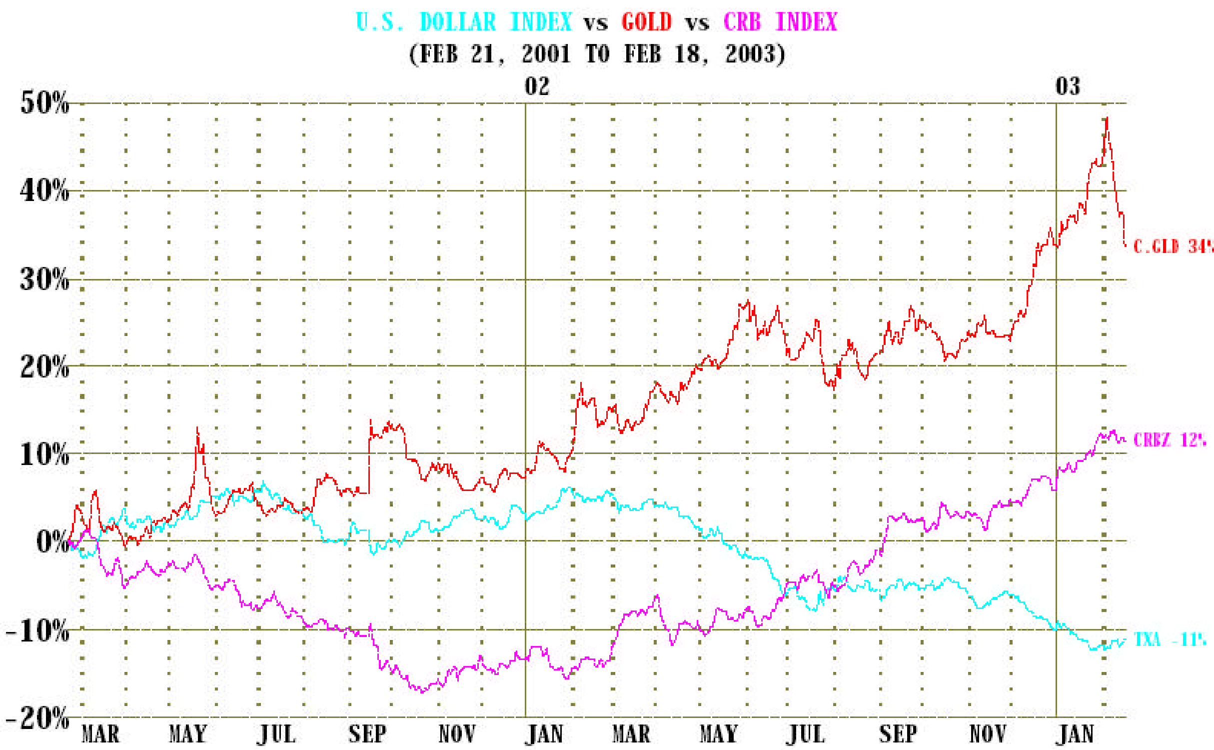
In spite of 2002 ending on a weak (quarterly) note, GDP for 2002 expanded by almost 2.5%, which is not far from the U.S. economy's longer term trend of 3% per annum growth. Montgomery Brothers expects 2.5% growth at a minimum for 2003 and economic surprises are likely to be on the upside. Such surprises are likely to start with an upward revision in 4Q 2002 GDP growth.

Interest Rate Outlook

Whew! Alan Greenspan, the once and future king of monetary policy, has spoken. While we had been worried about the economic outlook, Greenspan assured us in his recent Humphrey-Hawkins Testimony that as soon as this Iraqi war thing gets resolved the U.S. will be off to the economic races. He also implied that no economic stimulus was really necessary since, as soon as the War with Iraq was resolved, the economy would be just fine. He gave tacit support to ending the double taxation of dividends, warned about the evils of budget deficits, and claimed that (except for the possible war) the U.S. economy faced few big problems until later in the decade. I know that I was greatly relieved!

Conservative-chic now claims that budget deficits have no impact on interest rates but common sense says that supply and demand factors impact the cost of everything. Currently, there is a surplus of savings looking for an investment home while the demand for borrowing, other than by the Federal government, seems muted. Consumer credit is growing at the slowest rate in a decade and corporations seem content to pay down (or refinance existing) debt rather than do new borrowing. Therefore, upward pressures on interest rates seem nominal for the foreseeable future.

Additionally, the Fed is likely to keep short-term interest rates low and monetary policy expansive until unemployment starts to decline. Expansive monetary *and* fiscal policy can sow the seeds of inflation which are likely to be reaped somewhere down the economic pike. But that's considered a worry for later. Nevertheless, the inflationary storm warnings are out as can be seen from the charts below.



While various and sundry geopolitical problems can be used to explain the weakness in the dollar, the upward spike in the price of gold, and the multi-year highs in commodity prices, MBI is an inflationary conspiracy theorist at heart.

Given our above consensus economic growth forecast and our concerns over inflation, Montgomery Brothers believes that the best is over for the bond market, even though we see no major increases in interest rates any time soon. More anecdotally, with interest rates at 40+ year lows and money pouring into bond mutual funds at record rates, our contrarian antennae are on end. Bonds have been King for the past three years. Historically, the reign for bonds has been shorter.

Stock Market Outlook

Stocks were King for the better part of two decades and ruled supremely from 1995 until the first quarter of 2000. We are now approaching the third anniversary of the Bulls' abdication and the ascendancy of the Bear. The Bear's reign has turned out to be more tyrannical than most thought possible and his rule longer than anyone feared. But like the reign of every monarch, Bear markets end too! But When? Now would not be soon enough for us.

The emerging consensus is that once the Iraq situation is resolved, or at least the war has begun, the worst will be over for the stock market. This was the case at the beginning of the Gulf War in 1991 and is reaching holy grail status among investors. Unfortunately, the best analogies are often the worst forecasts but the thesis seems plausible to us. The uncertainty of a possible war with Iraq has most assuredly hurt the economy and stock market. If, somehow, a peaceful resolution were to happen it would certainly be a huge positive. Conversely, a protracted war would be an additional (or continuing?) negative. Anything in between is at best a guess.

In Montgomery Brothers' opinion, one of the most ironic aspects of this Bear market is how little damage has been done to the economy in spite of how awful the bear market has been. In our opinion, this bear market has been all about the elimination of the overvaluation of stocks which resulted from the blow-off of the secular bull market of the 1980s and 1990s, and not about problems in the economy. With the exceptions of telecommunications and, to a lesser extent, technology spending, there were few economic excesses during the late 1990s.

Besides valuation, corporate profits (for a variety of reasons, some economic, others accounting related) collapsed. The combined decline in valuations *and* corporate profits has led to this painful Bear market. As a result of this three-year Bear market, stock market expectations and valuations are now far more reasonable but still higher than is necessary for a true Bear market bottom. Montgomery Brothers believes that the bottoming process is ongoing and looks for the volatile trading range to continue. However, we believe that, short of some sort of unforeseeable catastrophe, we've seen the lows for this Bear market cycle. We, therefore, are lowering the MBI market code alert to yellow – for still scared but less so. The ongoing terrorist alerts and geopolitical uncertainties will continue to play havoc with the financial markets, and, possibly, the economy. Nevertheless, MBI is raising our estimated trading range for the S&P 500 from 750 – 950 to 800 – 1,000 for the rest of 2003. Additionally, we are becoming less negative on the tech area though we still find decent valuations among tech stocks as rare as benevolent monarchs.

We can't close without commenting on the current angst facing all of us. The following recently came across our computer: "Washington (Reuters)- The U.S. government first urged Americans to seal a room with duct tape and plastic sheets. Now it says people should cover their mouths with a cloth and wash their hands to cut down on further contamination from a chemical, biological, or nuclear attack!" I know that if "they" drop a nuke on D.C. the first thing I'll think about is washing my hands.

February 19, 2003 John E. Montgomery

140 BROADWAY, 44TH FLOOR
NEW YORK, NY 10005
212-320-3010 PHONE
212-320-3040 FAX
800-959-0164 TOLL FREE

1730 RHODE ISLAND AVE. NW, SUITE 206
WASHINGTON, DC 20036
202-861-2380 PHONE
202-861-6036 FAX
888-293-6668 TOLL FREE

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