MONTGOMERY BROTHERS WEALTH MANAGEMENT

Mid 1Q 2004 Investment Outlook

February 14, 2004

"Surprise! Surprise!"

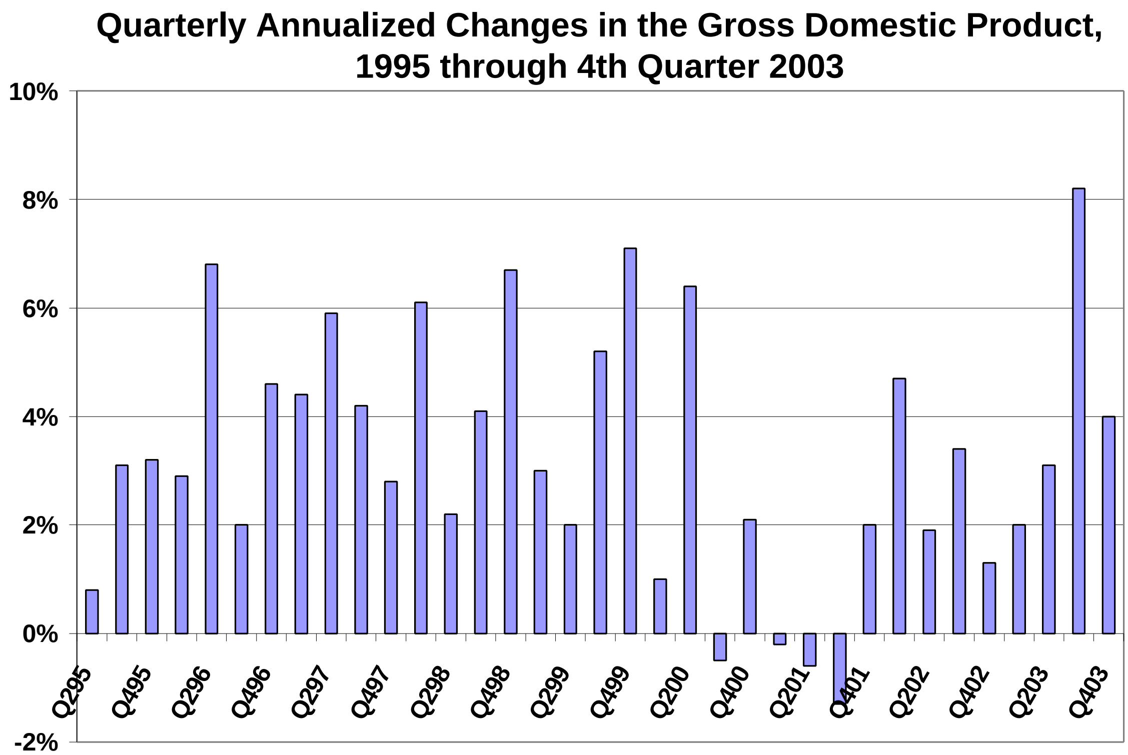
Given the explosion in the availability of information and the proliferation of "experts," Montgomery Brothers is surprised at how often the news of the day is characterized as a "surprise." Examples abound in economics, sports, the stock market and politics. For example, Howard Dean's brief flirtation with the Democratic Presidential nomination was considered surprising to most pundits, but his nearly instantaneous political meltdown came equally as a surprise to many. Similarly, John Kerry, who had been left for dead on the political roadside suddenly became the surprising, and now presumptive, front runner.

Somewhat less surprising is that Senator Kerry actually leads President Bush in several of those silly "if the election were held today" polls. But Kerry has been on a tear, and Bush has been in a slump. What's more surprising is the disfavor that Bush has fallen into with Conservatives. MBI has always questioned George Bush's conservative bona fides, feeling that he was more of a Texas populist than a true conservative. However, absolutely no one should be surprised that true believer, liberal Democrats hate Bush. After all, he cut taxes for the wealthy (i.e. those with jobs) and opposes gay marriage. But what are "conservatives" going to do? Vote for the Democrat who one poll tells us is the 7th most liberal member of the U.S. Senate and another says is left of Ted Kennedy? We'd be surprised.

The financial markets started this year figuring that President Bush was the proverbial mortal lock for reelection. If recent trends continue, that assumption could increasingly be called into question. Given MBI's economic outlook, things should be looking suprisingly good for Bush. But don't be surprised by additional surprises.

Economic Outlook

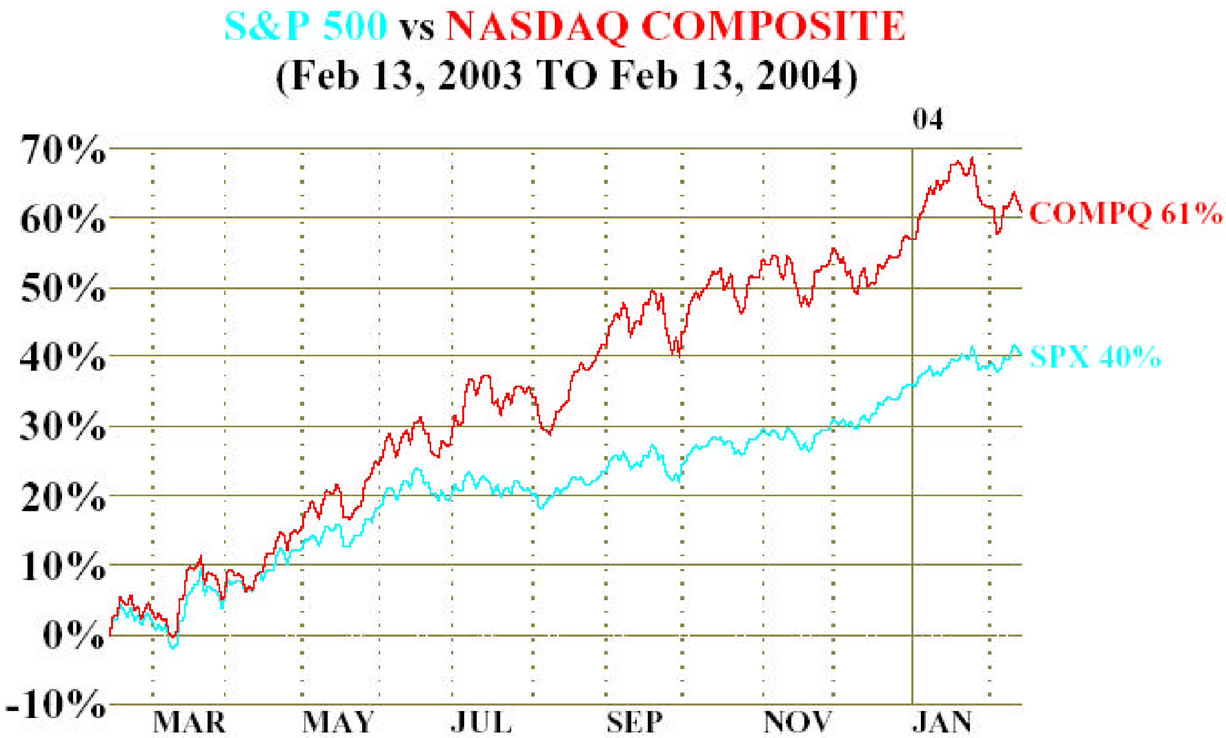
After the surprisingly strong economic growth of 2003's third quarter, 4Q 2003 GDP growth was (preliminarily) announced to be a disappointing 4%. Except for 3Q 2003, there had not been a 4% GDP growth quarter since the first quarter of 2002 (and before that 2Q '00). MBI expects that fourth quarter 2003 GDP growth will be revised upwards. At any rate, it's hard to dispute that the U.S. economy is back in an expansion phase, having now shown GDP growth for nine consecutive quarters.

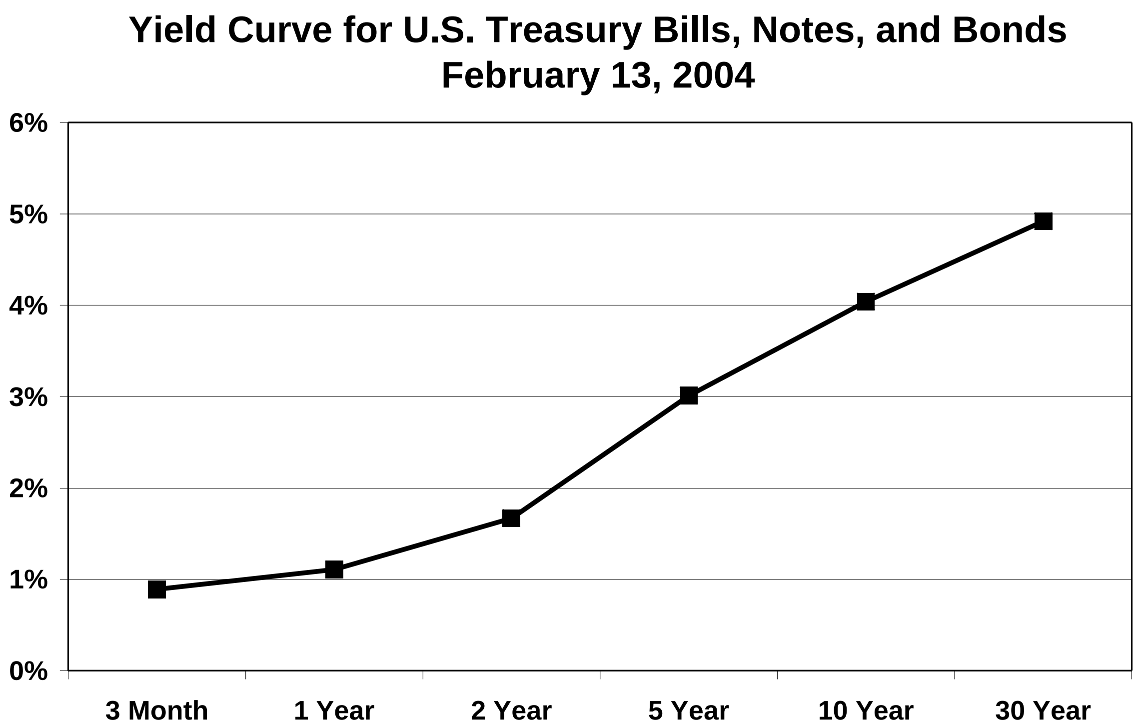


But wait! There's less! Jobs growth remains surprisingly weak, so experts tell us that this can't be a "real" expansion. MBI is relatively confident that job growth will accelerate before the election, but we'd be surprised to see the 2.6 million new jobs the Bush administration is forecasting.

We continue to expect that inventory (re-)building and capital spending will pick up the slack from a flagging (but still strong) consumer sector. The corporate sector, unlike the consumer sector, has reliquified and is seeing growing profits and cash flow. Order rates are strong and backlogs are rising. Additionally, there is still a tremendous amount of monetary and fiscal stimulus coursing through the economy. By anybody's definition, $500 billion budget deficits are stimulative and the Fed has been less than coy on its expansionary monetary policy.

Recently, business loan demand from banks has begun to expand for the first time in four years, and various surveys indicate that business is growing increasingly confident in the outlook. The leading economic indicators point to strong growth. Importantly, two of MBI's favorite ***real world*** economic indicators, the stock market and the yield curve (see below), point to strong growth.


S&P 500 vs NASDAQ COMPOSITE
(Feb 13, 2003 TO Feb 13, 2004)
04
70%
60%
50%
40%
30%
20%
10%
0%
-10%
MAR
MAY
JUL
SEP
NOV
JAN
COMPQ 61%
SPX 40%


Yield Curve for U.S. Treasury Bills, Notes, and Bonds
February 13, 2004
6%
5%
4%
3%
2%
1%
0%
3 Month
1 Year
2 Year
5 Year
10 Year
30 Year

In our research, we've found virtually no periods following such strong and sustained upmoves in stock prices and/or such positively sloped yield curves when subsequent economic growth wasn't above normal.

Additionally, the bull market in stocks along with still increasing home prices has nearly restored domestic wealth to the previous highs of early 2000. This makes consumers feel weathier and allows them to borrow more which, in turn, puts them in the position, not to mention the proper frame of mind, to ***spend***. Now, if employment starts to grow, even we might be surprised at how fast the economy could expand.

Interest Rate Outlook

During his semiannual Humphrey-Hawkins testimony to Congress Alfred E. Greenspan gave a surprisingly upbeat assessment of the economic outlook. After the mandatory tut-tutting about the budget and trade deficits, the Fed Chairman presented a "what me worry?" forecast for economic blue skies and green lights. He reiterated that the Fed could be "patient" about raising rates but there was no longer a pledge to leave rates at nearly half-century lows for "a considerable period of time." Regardless, the markets reacted with exuberance, we'll find out later if it was or wasn't irrational, pushing interest rates down and stock prices up. Greenspan must only wish that he could deliver Humphrey-Hawkins testimony every day.

As we've mentioned before, it is our belief that the Fed is trying to drive the enormous reservoir of liquidity out of money market instruments and into longer duration assets - especially stocks and bonds - and, eventually, into the "real economy." Given the high cost of sitting on the sidelines and the recent flows of cash into equity mutual funds, it looks like the Fed is succeeding.

Nevertheless, Montgomery Brothers remains skittish on the outlook for bonds. We believe that while you might earn the coupon, there is little or nothing in the way of capital gains potential from owning bonds. With intermediate and long term interest rates at multiples of money market rates it is, indeed, tempting to bet on maturities. We're trying to avoid this temptation.

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Stock Market Outlook

Back in the wild and wooley days of the "bubble," the true believers kept telling us that "stocks ***always*** go up" and to "buy every dip." While ***always*** covers a long period of time and that nearly three year bear market was one hell of a "dip," the true believers are back. The stock market has been on an increasingly parabolic rise for almost a year now. The increasingly frustrated bears and the underinvested bulls keep looking for a correction but, so far, to no avail. Most pundits have been surprised.

Even though the stock market didn't get cheap during the bear market and certainly isn't cheap now, MBI feels that there is additional upside potential. While we believe that you can expect another 5% to 10% upside, ***never*** underestimate the stock market's ability to go to extremes. Corrections, or at least a correction, should not be surprising but will be a surprise when it finally comes.

MBI had been expecting that investors would start to rotate from smaller capitalization, lower quality stocks into larger cap, blue chip growth stocks, but that hasn't happened yet. From the beginning of 2004 through Friday (February) the 13th, the "average" S&P A or better rated stock rose by 2.1% while the average S&P B or lesser rated stock rose by 9.0%, compared to the increase of 3.8% for the S&P 500 average itself. Similarly, over the same time period, the Dow Jones US Large Cap, Mid-Cap and Small-Cap indices appreciated 2.8%, 4.5% and 4.7% respectively, compared to 3.3% for the US Total Market Index. And you don't even have to pay up for these large capitalization, Blue Chip stocks whose current P/Es and PEGs (Price to Earnings Growth rate) are lower than those of the S&P 500. Additionally, many of these companies' earnings are expected to grow faster, while their debt is often lower and their dividend yields are usually higher than the S&P 500 average not to mention their lower-quality counterparts.

As stocks rise, "investors" no longer view risk as they did when stock prices were falling. Now, all too many fancy themselves to be high risk takers. But, Surprise! Surprise! Risk tends to rise and fall with prices. Unfortunately, we feel that by sending out signals that interest rate hikes are on hold, the Fed is encouraging greater risk taking than we believe to be prudent. When you can buy quality at a discount, Montgomery Brothers believes that is the way to go. We think that there will be many surprises during the remainder of 2004. We only hope that more will be pleasant than not.

Happy Valentine's Day

John E. Montgomery

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