Quarter Notes
Firestone Capital Management, Inc.

Jack M. Firestone, CFP
Carol G. Kaufman, CFP
www.firestonecapital.com

July 2003 | Third Quarter 2003 | Volume 11 No. 2

Market Rebounds

Is the economy beginning to recover?

Can this continue and for how long?

The U.S. Stock markets staged a dramatic recovery in the second quarter. The broader large cap market S&P gained 15% and the Dow rose 12.4%.

A recovery in the battered tech sector pushed NASDAQ, nearly uninterrupted to a 21% gain.

Since the October 2002 low, the S&P has gained 25.67%.

Interest rates fell as Fed Funds dropped to 1%, the lowest level in 45 years.

1500 San Remo Ave.
Coral Gables, FL 33146
Tel: 305-669-2119
Fax: 305-669-1976
jack@firestonecapital.com
carolk@firestonecapital.com

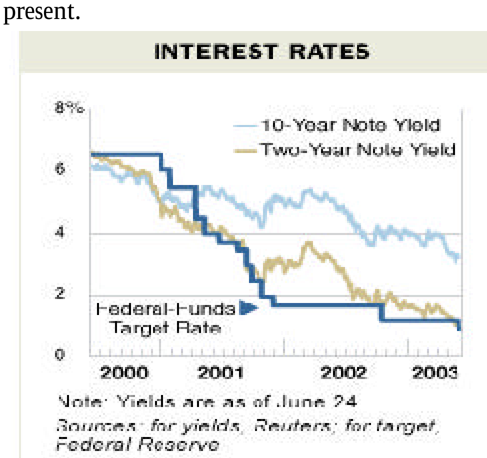
Stock Market Recovers - What's Ahead for Investors?

What is driving this market? Is the economy really recovering? What do we anticipate for the rest of the year? And what are we doing about it?

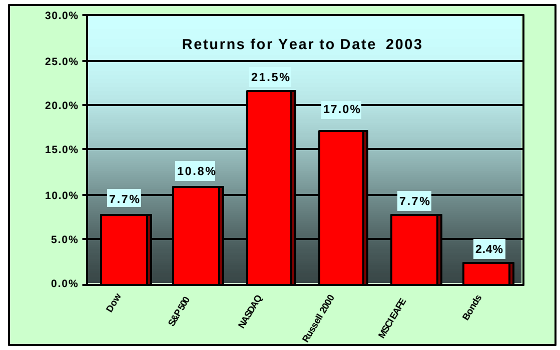
With the market gains over the past quarter, we believe the market has already priced in a reasonably healthy economic recovery. But there are reasons to be concerned going forward including record levels of individual and corporate debt, global overcapacity, growing U.S. trade deficits and finally stock prices that have not yet returned to measures of intrinsic value.

However, there are several reasons to think that equities have room to grow, chief among them is a huge amount of uninvested cash which is earning next to nothing in money markets. Investors have begun to redeploy some of this cash, investing in stocks. Further positive signs include: the passage of a $350 billion tax cut with generous dividend and long-term capital gains reductions; historically low interest rates allowing households and businesses to reduce interest costs and strengthen their balance sheets; and a weaker U.S. Dollar making our goods less expensive in foreign markets.

With the S & P up more than 25% since the October 2002 low, how much higher will we see stock prices at year's end? Has the market gotten ahead of itself? We believe it may have. How much further investor sentiment and greed will push the indices we can't possibly know, but the market will eventually reach an equilibrium. For stock prices to go higher, profits, capital spending, pricing power and a generally better economic and employment outlook must be present.



Note: Yields are as of June 24
Sources: for yields, Reuters; for target, Federal Reserve



Another concern is consumer spending. Many households are spending money they don't have. Refinancing with record low interest rates, they are then spending the equity once held in their homes adding mountains of additional debt to their personal balance sheets. State budget deficits are cause for additional worries. The benefits of a federal tax cut could be offset by increases in state taxes and user fees.

The Federal Reserve, citing fears of deflation, cut the Fed funds rate to just 1% , the lowest rate in 45 years. With inflation running just over one percent, real interest rates are now effectively zero. Although the Fed has indicated its willingness to keep interest rates low, we believe that in the not too distant future rates will rise, creating capital losses in longer term bond positions.

If interest rates rise due to renewed economic growth, this would be a positive occurrence. But if rates rise due to the need to defend the declining value of the dollar from a precipitous fall, this would be negative for the economy. For now, those still feeling the pain of their stock losses have chased bond yields driving up bond prices so high that bonds look as risky as stocks looked in March of 2000.

Economists are worried that business capital expenditure is not picking up. Profits are beginning to recover slowly, not because businesses are gaining pricing power, but because they have cut expenses to the bone. However, as profitability begins to improve, companies will have huge earnings leaverage. Unemployment, especially among white collar, middle management continues high. Length of time between jobs continues long. And replacement jobs rarely pay what the lost job did.

Highlights of the New Tax Law

- *Top tax rate drops to 35%.*
- *Other brackets drop 2%.*
- *Qualifying dividends will be taxed at 15%.*
- *Long-Term Capital Gains taxed at maximum of 15%.*
- *Increased standard decuction for married couples doubles single deduction to $9500.*

Is a market correction inevitable?

While the market may have gotten ahead of itself, it is difficult to "fight the tape" as momentum appears to be driving stock prices higher. Economic growth in the U.S., this year, is expected to be a lackluster 2-3%. But tax cuts, deficit spending, a weak dollar, unlimited expansion of the money supply combined with low interest rates might rekindle the economy.

If this is how we see the future, what are we doing about it? We feel that we are entering a time where advisors must be proactive. This doesn't mean we are giving up on traditional asset allocation. It means that **we believe that more aggressive and timely rebalancing is required, allocating tactically in light of economic and market conditions.**

Asset classes which behave differently from the traditional stock and bond investments need to be introduced into portfolios. We are taking profits when asset classes have run up. We are looking opportunistically for "bargains" in assets that, though battered and out of favor, have good fundamentals which are likely to be recognized. We will search for growth and opportunity where we find it. We have spent a great deal of energy in the last year searching for assets classes that have a low correlation to U.S. stocks and bonds.

We have identified managers, and investment teams who we feel can provide added value. We have looked for and found asset classes at reasonable prices to add to our traditional investment mixes. We are prepared to diversify risk in portfolios by using more tactical allocation strategies.

Specifically here is what we have been doing:

- ☑ Taking profits in stocks from recent gains.
- ☑ Reducing duration of our bonds to protect against interest rate risk.
- ☑ Add alternative assets to the portfolio mix.
- ☑ Identifying assets with low correlation to U.S. stocks and bonds.
- ☑ Using changes in the treatment of dividends and tax policy to our clients advantage.
- ☑ Being opportunistic in our moves, identifying and moving quickly as we observe trends.
- ☑ Looking for merger and acquisition opportunities as the economy recovers.

Alternative Asset Classes

For many years we have used "alternative investments" in our clients' portfolios. Investments such a real estate and TIPS (Treasury Inflation Protected Securities) are examples of these alternative investments.

During the past year we have researched many different investment alternatives to come up with ideas we now feel ready to implement. Most of these alternative assets are actually variations of the more traditional asset classes. Some are inherently risky strategies when used on a stand alone basis. These might include emerging market stocks and debt, commodities and merger arbitrage strategies. Additionally we have looked at long/short strategies where mutual fund managers can buy "long", profiting when a stock rises and also can "sell short" in order to profit when stocks decline. We have also used oil and gas MLPs (master limited partnerships). In looking to add an absolute return component to our portfolios, We have begun to selectively use a mutual fund whose underlying investments are hedge funds. In other areas, we are still looking for appropriate investments including international real estate and timber.

We are introducing some of these investments into a tactical category in portfolios with the expectation that they will enhance the risk/return characteristics for the portfolio as a whole.

Why do we feel the need to go "outside the box" enhancing our investment choices? We believe that over the long term, the U.S. economy cannot grow faster than the growth in our Gross Domestic Product (GDP) plus inflation. The value of businesses and their stock prices should reflect that growth but little more.

In the last decade conditions were very different. We had declining inflation, falling interest rates, a strong dollar, decreasing government deficits vs GDP, and rising consumer and corporate debt fueling economic growth. Now these trends are reversing. So with a 1½% dividend yield on stocks and 3% growth in earnings plus 2% inflation, we are anticipating returns on U.S. markets to be well below historical returns, probably no more than 6-7%. Of course, if there are too many investors chasing too few stocks, P/Es would increase and returns could be better. But if P/Es revert to historical norms, returns would be worse.

In the past we have been able to look to bonds to soften the volatility of stocks, but at these low interest rates, bonds are not low risk.

For these reasons we have been rebalancing portfolios to increase diversification, preserve clients' wealth and improve risk adjusted return. In these volatile economic times, there are no guarantees. But we will do our best to make a difference for our clients.