



## ECONOMIC OVERVIEW

**THE YEAR 2003 ENDED WITH THE ECONOMY SHOWING SOLID ECONOMIC GROWTH, FOLLOWING WHAT HAD BEEN A YEAR OF TRANSITION.** For the full year, Gross Domestic Product (GDP) recorded a growth rate of 3.1% as strong gains in the second half of the year, averaging 6%, led to increased economic confidence and improved expectations. Economic growth during the year was more balanced as gains within the consumer and governmental spending sectors were joined by significant improvement in business spending and capital investment.

During 2004, continued economic growth in the area of 4.1% is anticipated as the continuing stimulus of prior tax cuts and tax refunds this year continue to bolster consumer spending. Corporate spending has shown marked improvement over the past six months and should continue to show solid growth during 2004 based on increased corporate profitability coupled with temporary depreciation benefits that were included in the 2003 tax legislation. The monetary and fiscal stimulus created by the legislative initiatives of 2003 may well create the strongest year over year profit comparison during the first half of the year.

Unemployment levels that peaked last year at 6.4% should continue to show gradual improvement as the year progresses, resulting in an average rate of 5.4% during 2004. Inflation levels remain well under control currently, with the year-end core consumption deflator up only 0.7% over last year's levels. While inflation should record an increase in 2004, the rate of gain will be relatively modest despite the higher energy prices and sharp increases in governmental deficits and the weakness in the US dollar. Full year 2004 inflation rates are expected to show modest gains to the area of 1.8% to 2% for the year.

While the economy is much healthier, 2004 is a Presidential election year. The rhetoric and alternative political priorities will create additional uncertainty as the campaign process accelerates. One thing is for certain, the 2004 Presidential campaign is shaping up to be one of the most interesting and controversial in some time.

Finally, while the outlook for the economy is much improved over the past year, the financial markets have already discounted a great deal of the improvement. Currently valued at 19 times expected 2004 earnings per share as measured by the S&P 500, valuations are no longer significantly undervalued unless the current economic recovery continues beyond this year.

### The Demand Side – Real GDP

GDP growth should show above-average momentum during 2004, with full year gains in the area of 4.1%. The consumer continues to be in a relatively healthy position based on the reduced cost of consumer debt that resulted from the massive mortgage refinancing wave of the past three years.

Consumer confidence should show gradual improvement as we move through the year given a decline in the national unemployment rate. Historically low interest rates will keep the automobile and housing-related industrial sectors running above trend line levels, albeit below the recent peak sales records. The decline of the US dollar over the past few years should also result in strengthening demand within the export markets, especially with improving economic activity in Europe and the Pacific Rim.

Corporate spending is expected to become a growing factor in domestic economic growth, as gains in corporate profits coupled with temporary accelerated depreciation guidelines and increased capacity utilization rates stimulate investment spending. Federal government spending growth should begin to slow from 2003 levels due to escalating concerns over the budget deficit.

## THE SUPPLY SIDE

Following two years of zero to negative growth comparisons, the manufacturing sector has finally begun to show improving trends over the past six months as shown by the accompanying chart. The potential for sustainable growth beyond 2004 has become more likely as capital spending has been joined by consumer and government spending to create a balanced support for the overall economy.

## INTEREST RATES

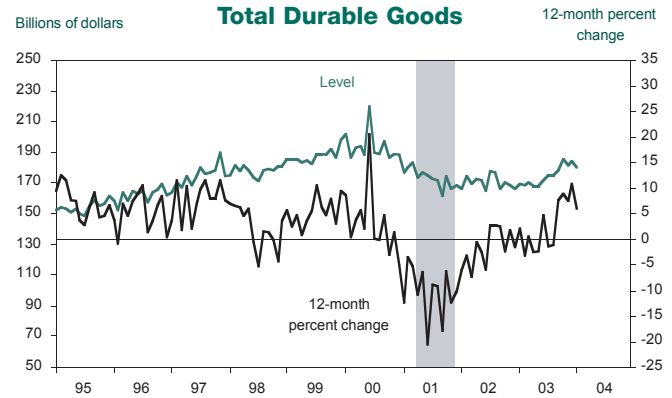
The fixed income market is taking cues from payroll data, retail sales, and business investment in technology. The most recent bout in the fight for economic expansion has been against falling Treasury yields set in motion by lower than expected increases in non-farm payroll numbers for February. This sent prices upward, substantially improving the quarterly performance of fixed income holdings. While not pushing rates to the lows of June 2003, the 10-year Treasury bond hit a recent low yielding 3.68%. With Spain suffering its own version of September 11th, foreign investment flowed back into the safe harbor of US Treasury securities. Trading concluded in March with a substantially overpriced condition. In other words, current interest rates are too low to attract buyers.

## FIXED INCOME OVERVIEW

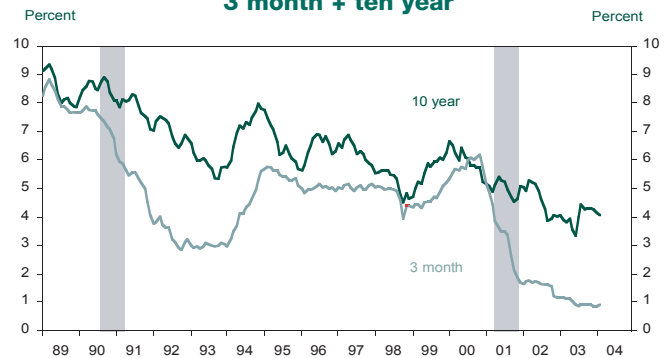
Bonds have exhibited strong performance in the first quarter, in particular bonds rated below investment grade, or with some questionable stories behind them. We have elected to maintain a safer stance by avoiding the addition of these risky alternatives, choosing quality over added risk for performance. Through the first quarter, the Federal Reserve has managed its goals of controlling inflation and supporting full employment. Unless this situation changes, they have no reason to fuel the rise in interest rates until much later this year.

Bulging dealer inventories and improving payroll numbers should work to bring bonds back to a reasonable equilibrium by the end of the year. Interest rates will continue to attract buyers to the housing market and the dollar's current historical weakness has already prompted greater US exports. Technology orders are up substantially, productivity should top out soon and inventories need to be restocked. All are precursors to hiring and an expanding US economy. An expanding economy translates into higher interest rates, but at a gradual pace this time around. At a 1% Fed funds rate, if the Federal Reserve moves too quickly, they could stunt the economic growth that is needed in the US economy.

### Manufacturers' New Orders



### Total Interest Rates 3 month + ten year



An expanding economy translates into higher interest rates.

## EQUITIES OVERVIEW

The fundamental underpinnings for positive equity returns remain intact, despite concerns regarding strength and sustainability of the economic recovery, an inevitable shift in monetary policy, torpid employment growth and valuations in some of the more economically sensitive stock groups.

We remain committed to our view that equity prices will continue to be a function of the underlying strength in earnings, in the absence of any significant upward revision in valuations. Over the last twelve months, the corporate sector has enjoyed a strong rebound in both revenues and earnings, as well as the quality of those earnings. In the fourth quarter of last year, we witnessed a marked improvement in corporate profitability, as earnings rose about 27% year-over-year, on a revenue gain of almost 10%.

The sectors that experienced the most significant earnings growth relative to a year ago are those more closely connected to the capital goods side of the economy. This is consistent with a global and domestic upturn in industrial demand for equipment, construction-related machinery and infrastructure demand from countries such as China and India. In addition, year-over-year earnings comparisons were favorable, given the more depressed levels of a year ago.

With the outlook for continued earnings growth coupled with the potential for gradually increasing interest rates beyond 2004, equities remain more attractive than bonds for the time being. Expectations, however, will have to be brought back to more reasonable levels, as appreciation will most likely be in line with earnings growth of the specific companies. The sharp broad market rebounds created last year by rapid price earnings expansion are now behind us.

### OUR PERSPECTIVE : A look back at equity returns in 2003

In 2003, investment returns were dominated by smaller companies...the smaller the company, the larger the return.

We analyzed the returns of companies with market capitalizations of \$100 million and greater. We wanted to see if small companies performed better than large companies – we discovered that small companies of lesser "quality" did even better.

The methodology we employed was straightforward. First, we eliminated companies from the universe that have less than \$100 million in market cap. Frankly, there are so many micro-cap companies (under \$100 million in market cap) that we did not feel it necessary to "scrub the data" at that level. Next, we divided the universe of stocks by market cap segments presented in the box above. As the data indicates, smaller companies, on average, did significantly better than larger ones. Even within particular market cap segments such as large cap (above \$1 billion in market cap), the same result was true...the smaller the company within the segment, the higher the return on average.

Next, we looked at quality factors that we think are important when assessing a stock's long term investment attractiveness. Return on Equity, Return on Assets and Return on Capital were chosen as proxies for quality, as they are important factors in our own research efforts. In all, we analyzed approximately 4,000 stocks.

Market Cap Segment	Market Cap Average (\$M)	Last 12 Months Price Change
\$50B +	\$113,908	27%
\$25 – 49.9	\$ 33,822	45%
\$10 – 24.9B	\$ 14,881	38%
\$5 – 9.9B	\$ 7,031	46%
\$1 – 4.9B	\$ 2,229	51%
\$.750 – .999B	\$ 861	66%
\$.50 – .749	\$ 620	65%
\$.100 – .499B	\$ 165	77%

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Market Cap Segment	Market Cap Average (\$M)	Return on Equity	Return on Assets	Return on Capital	Last 12 Months Price Change
\$50B +	\$113,908	23%	12%	15%	27%
\$25 – 49.9	\$33,822	19%	8%	11%	45%
\$10 – 24.9B	\$14,881	18%	10%	12%	38%
\$5 – 9.9B	\$7,031	16%	9%	10%	46%
\$1 – 4.9B	\$2,229	15%	10%	10%	51%
\$.750 – .999B	\$861	12%	8%	8%	66%
\$.500 – .749	\$620	13%	8%	9%	65%
\$.100 – .499B	\$165	12%	7%	9%	77%

In an almost linear fashion, smaller companies with lower "return on" ratios performed better than larger companies with higher ratios. Clearly, investors preferred companies of lower quality in 2003. Historically speaking, this phenomenon is typical as the market anticipates economic strength and the companies that are most sensitive to a firming domestic economy appreciate the fastest. The question is in the sustainability of lower quality, smaller companies as the economic cycle matures.

Additionally, within the large cap segment in particular, an equal-weighted basket of S&P 500 "A" rated stocks, the highest rating on the S&P Earnings and Dividend Ranking scale, underperformed an equal-weighted basket of "C" rated stocks by 28.7% (Source: CSFB Quantitative Research).

We are optimistic about the future prospects for equity returns in general, and for high quality large cap stocks in particular. As always, we will continue to focus our research efforts on established companies with a demonstrated ability to sustain strong growth rates through different stages of the economic cycle.

## AT THE FIRM

As we wrote to you in January, six professionals were added to the partnership roster of the firm: Ernest E. Cecilia, CFA, William S. Covert, CPA, Steven R. Klammer, Esq., Robert C. Lodge, Cole P. Vastine, ChFC and Malcolm C. "Skip" Wilson, CFA. Importantly, each of these individuals invested their own capital into the firm, which is a strong statement indeed about the commitment of these individuals to the organization and its clients. Additionally, each of the new partners has served on the firm's Management Committee and has played leadership roles within the firm for some time now.

While some of you already work with one or more of these professionals, you may not be familiar with others. We invite you to meet each of our new partners the next time you are in for a visit. They would be delighted to meet you.

As always, we welcome your thoughts and comments. We look forward to seeing you soon.

Robert Lodge | *Managing Director* | Davidson Quarterly Review is a publication of Davidson Capital Management.

## DAVIDSON CAPITAL MANAGEMENT

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