LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.
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Outlook & Trends

Consumers and investors adopted a more positive outlook after the end of the war in Iraq. Stocks and bonds rallied with increased optimism, fueled by money created by an accommodative government monetary policy. The economy, however, has yet to agree. Is the stock market rally a predictor of good things to come or merely a trap for over-enthusiastic investors? Will mortgage rates continue to fall? Will employment conditions improve? To navigate through the uncertainty, it is helpful to have a perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. Hopefully this letter will help you with the perspective.

Economy

Despite aggressive government policies reducing interest rates and taxes, business activity remains sluggish, but could pick up as the economic "fog of war" recedes. The most recent reading indicated that the economy was growing at a 1.4% annual rate during the first quarter. Some economists predict that 3% growth will be required before employment improves substantially. Other than increased optimism about future conditions, measurements of actual business activity such as industrial production and capital goods orders, have experienced only minor improvements so far.

Activity has been more visible in the financial side of the economy. Lower interest rates and higher government deficits usually create economic growth accompanied by monetary inflation. Over the last year, despite the extensive stimulus, the Consumer Price Index increased only 2.1% and has been flat over the last three months. This time around, the stimulus has produced record savings deposits, a bull market in bonds, record mortgage refinancing, and a record number of houses sold. The lack of the desired improvement in business activity so far has produced recognition of the possibility of <u>de</u>flation. The Federal Reserve said, "…the probability, though minor, of an unwelcome substantial fall in inflation [i.e. deflation] exceeds that of a pickup in inflation…". Based on this belief, the government has reversed its course of the last 30 years and is following policies to increase inflationary pressures. In addition to lower interest rates and taxes, the dollar has also fallen in value versus foreign currencies, making imported goods more expensive and our exported goods more competitive.

Financial Markets

Prices of both stocks and bonds have been rising. Both areas have their unique and current risks.

Bonds have continued their bull market that has been in place for the last 3½ years. Treasury bond yields have been at the lowest point seen in decades, which caused their prices to be correspondingly high. When interest rates rise again, bond prices will fall, so there is substantial risk in this area. The Federal Reserve believes that inflation and rising rates are not an immediate threat, however, which presents savers and fixed income investors with a dilemma. Is it better to accept the risk of bond prices falling, or face the risk of continually losing purchasing power in savings accounts and money market funds, where the reduced interest rates are so low they do not keep pace with even today's low inflation?

Stocks rallied off the recent low that corresponded to anxiety about the Iraq war. The rally started off as short sellers covered their positions, then broadened out sufficiently to look as though the economic stimulus and tax initiatives may be having their desired effect in turning the trend around. This rally is anticipating rather than reflecting an improvement in business conditions and profits, which could lead to disappointment and lower prices, if the economy does not cooperate. A caution can be noted from the number of advisors that are bullish, which outnumber the bearish ones by a 3:1 margin. Historically, when the thinking gets this lopsided, a pullback or flat period is just around the corner. By the same token, the American Association of Individual Investors' poll shows a margin of 8:1 bulls to bears for the investing public. It classifies only 8.6% of investors as bearish. A reading this low has occurred during two intervals in the last 16 years. The first time was in August 1987 at the market peak, which led to the crash in October 1987. The second was in September - November 2000, at and just after the stock market peak that led the recent, multi-year bear market. This observation is not necessarily predictive, but does suggest that there still is risk in stock investments.

Planning

The Jobs and Growth Tax Relief Reconciliation Act that was recently signed into law reduces income taxes on earned income in several different ways: eliminating the "marriage penalty", accelerating rate reductions, and providing additional child credits. In addition, the Act reduces the tax on previously taxed corporate dividends as well as long-term capital gains. From an investment viewpoint, the Act does not significantly affect the benefit of current tax deferred accounts like 401Ks, IRAs or 529 plans, but does tend to increase the relative benefit of investment in the stock of dividend paying companies vs. bonds (particularly municipal bonds), savings accounts, and real estate investment trusts in taxable accounts.

The long stock bear market and bond bull market may have thrown off your asset allocation as bonds increased in value and stocks decreased. You may be surprised to know that your asset allocation decisions define 91% of the returns (and risk) that your investments will achieve. Selection of specific stocks or bonds provided by your mutual fund managers affects only 4% of your returns. This may be a good time to re-evaluate your asset allocation strategy in light of changes to your financial plans.

If you would like help managing your investments or planning how to reach your financial goals, please give us a call.

Dave
DAVID C. LINNARD
President

Barby
BARBARA V. LINNARD
Vice President

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