Investment Policy & Strategy Group

Capital Market Outlook 2004

Implications for Portfolio Strategy

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NEW DRIVERS FOR GROWTH IN 2004

Highlights

- *Our outlook is positive for equities and other asset classes tied to the economy.*
- *Capital spending has reached trough levels and should accelerate. $810 billion in corporate cash balances and $300 billion in "free cash flow" is available to fund future capital investment.*

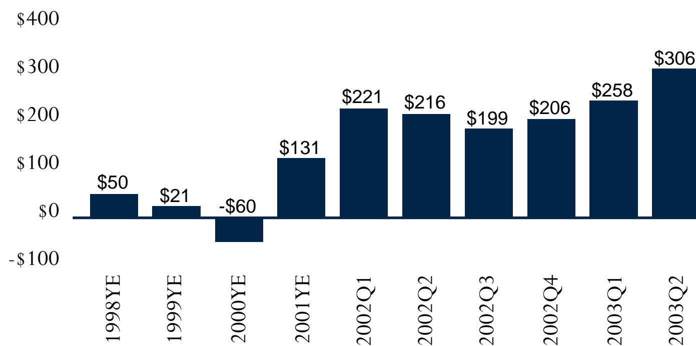
Coming into 2003 we encouraged investors to overweight equities relative to defensive assets such as Treasuries. It turned out to be the correct call in 2003 as confidence returned to investment and business decision-making. We expect that the re-emergence of job growth and a mix of stimulative fiscal and monetary policy will allow the economy to expand by at least 5 1/2% with a 2 – 2 1/2% inflation rate. Economically sensitive assets including equities, high yield debt, convertible debt and REITS should outperform Treasuries in this environment. By contrast, accelerating growth increases the possibility of loss for longer dated Treasuries. Our index of economic activity that we publish regularly in our *Strategy Comments* correctly measured a significant improvement in many aspects of the economy that led up to the recent resurgence of job growth. The recovery that began well over a year ago accelerated throughout 2003 and is expected to prove sustainable through 2004. Economists are now raising their estimates for growth next year according to a recent survey published by the Philadelphia Federal Reserve and Wall Street analysts are similarly raising 2004 profit forecasts. Ample liquidity, supportive monetary and fiscal policy, an improving business climate, lowered risk aversion and access to inexpensive capital are all potential sources of upside surprises in 2004. The following touches on some of the key points to consider for portfolio construction in the upcoming twelve months.

RISING LIQUIDITY

And The Re-Emergence of Capital Spending

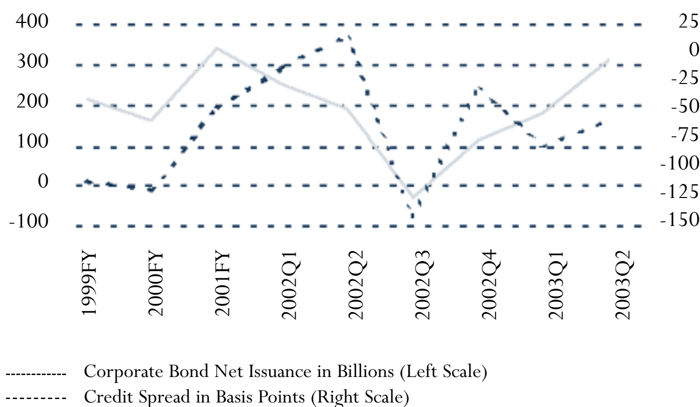
U.S. Corporations Free Cash Flow Above $300 Billion

$Billions; Quarterly Figures at Annualized Rates



Net Issuance of Corporate Bonds Improved in 2003

$Billions; Quarterly Figures at Annualized Rates



1. For the sake of this analysis we define free cash flow as economy-wide after tax profits plus depreciation less capital expenditures.

The period of contraction following the stock market's peak in 2000 was accompanied by ever-increasing levels of pessimism and anxiety. Since then, attitudes—shared by both consumers and businesses—have reversed sharply and corporate businesses have rapidly refortified their balance sheets through restructurings, refinancing, and cost controls to improve free cash flow.

This chart shows the impressive improvement in internally generated "free cash flow"[1]. After declining by $60 billion in 2000, corporate "free cash flow" by non-financial U.S. corporations just topped $300+ billion during the third quarter according to Federal Reserve data. This net cash from operations, in combination with increases in cash from borrowing, drove corporate cash balances to over $810 billion compared to $486 billion in 1997. This liquidity could provide a source of funds for investment as pent-up demand for capital and labor is released into the economy. Cash can also be used to retire additional equity through stock buy-backs, pay higher dividends to shareholders, or for acquisitions—all positive points for equities.

Cash flush businesses, recently awakened from a three year hibernation, are now also finding it easier to access inexpensive capital through corporate bond issuance. While the bond market fretted the specter of deflation earlier this year, corporate bond prices staged a significant rally that helped spark a wave of $300 billion in debt issuance in 2003. The bond market's rally helped shrink credit spreads, and therefore the cost of borrowing, while simultaneously granting increased access to the bond market as a source of financing. Newly issued debt serves a variety of useful purposes including refinancing of existing higher cost debt, filling financing gaps between cash flows and capital expenditures, replacing equity with lower cost debt in the capital structure, or financing future planned expenditures. Whatever the motive, the renewed ability for corporations to borrow at attractive rates is now greatly enhanced.

RISING LIQUIDITY

And The Re-Emergence of Capital Spending

There is a downside to all this frugality, of course. Capital spending has clearly suffered in recent years as businesses retrenched. Capital spending is now running below depreciation rates at 89% of economy wide depreciation—something we firmly believe to be unsustainable over the long term. Investment in capital expenditures has fallen from $957 billion in 2000 to $783 billion today. Corporations now invest 72% of gross cash flow versus 107% of gross cash flow in 2000. Historically, this level of investment was not sustainable and represents "maintenance" spending on capital and not the proper level of spending in a normally functioning economy (see chart below). This should reverse over time as it did following the Cuban Missile Crisis in the early 1960s and the oil shocks of the early 1970s. Right now, the catalysts to reverse this trend are being put in place. These 2004 catalysts include a lowering of risk aversion by consumers and business managers, an opening up of capital markets, continued low interest rates, and new tax incentives for business investment. By effectively raising the after-tax return on capital through a reduction in capital gains tax rates, there is further motivation for businesses to become more active in investing for future growth.

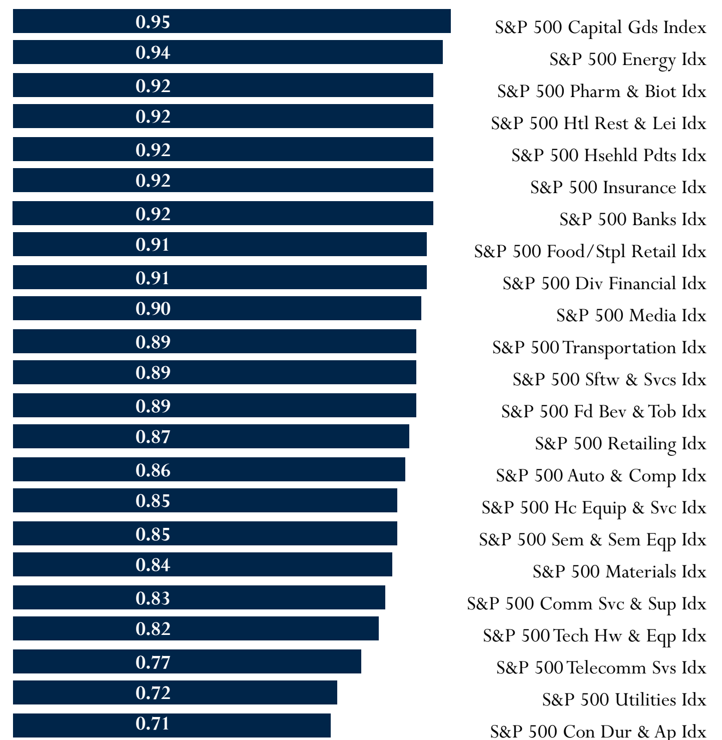
The combination of ample cash, tax incentives, and greater optimism is the right mix for a sustained capital spending cycle beginning this year. While the economy benefits as a whole from investment in productive capacity, some groups are more closely tied to changes in the capital spending cycle. Since 1989, for example, capital goods and energy companies top the list of groups most closely correlated to changes in capital spending (see table). In light of this, we recently increased our recommended portfolios weights among economically sensitive asset classes (see our August 25th *Strategy Comment*).

Percent of Gross Cash Flow Spent on Capex

Now at Levels Not Seen Since Early 1970s

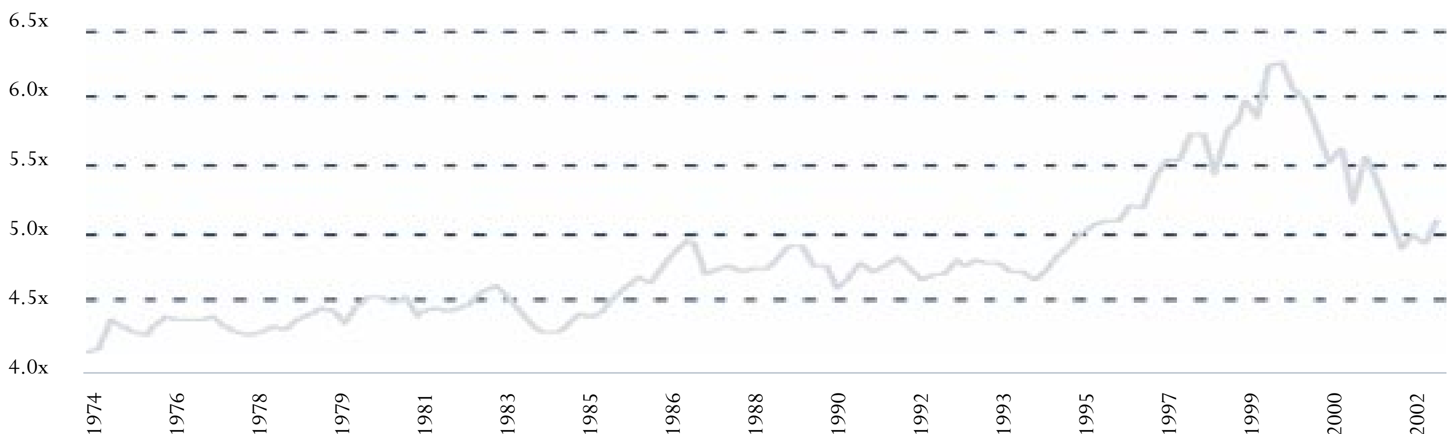
Correlation of Industry Group Performance to Capital Spending

(1989-Present)



Wealth in America is near record highs and is an increasingly important contributor to the resiliency of the U.S. economy. While this might sound like an outlandish claim following a difficult bear market, recent statistics put out by the Federal Reserve places the aggregate net worth of all American households at over $41.248 trillion. Importantly, despite the NASDAQs fall from grace, this number is only 5% below the record set in 2000 at $43.4 trillion. This net worth figure includes both sides of the balance sheet—all assets and all liabilities including real estate, bank accounts, financial assets, private business values right alongside total mortgage and revolving debt such as auto leases and credit cards. Because assets are well diversified, and because more Americans are invested in a greater number of asset types, the economy appears to have become less susceptible to shocks and more resilient to dislocations such as the NASDAQs dramatic slide and even the terrorist attacks of 2001. Gradually, Americans are becoming wealthier in absolute terms and also relative to their incomes (see chart). As this occurs, expect that the average duration of the business cycle becomes longer with less volatility.

Net Worth Relative to Income

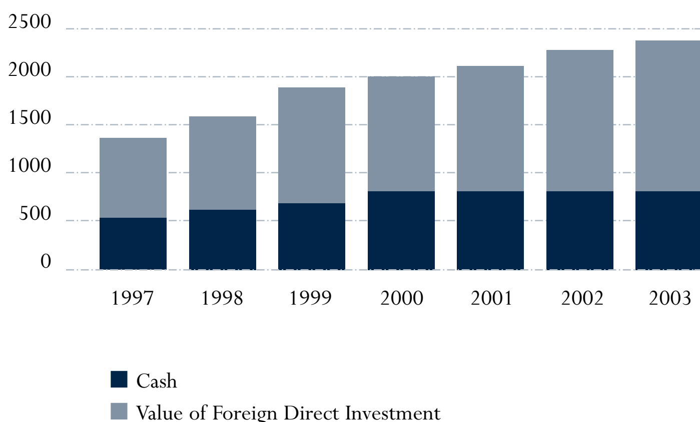


GLOBALIZATION CONTINUES

"Leaks" Outside of The U.S.

At the same time U.S. corporations were refortifying, they were also extending their presence in local markets abroad. This is one area where investment continued especially for the largest of U.S. multinational companies. In time, ongoing investment in overseas markets allows companies to tap the potential future growth of emerging markets, reduce costs for delivering products and services at the local level. As the chart below shows, the level of investment in foreign countries by U.S. corporations is now well over $1.5 trillion. If we add cash holdings to this value, the combined "war chest" consisting of foreign direct investment and cash is rapidly approaching a record $2.5 trillion or 25% of annual gross domestic product—giving large multinational countries considerable leverage to benefit from overseas growth opportunities as they emerge.

Foreign Direct Investment and Cash Holdings Reach Record
$Billions



The year 2004 may mark the beginning of a global recovery with positive implications for foreign markets, trade, and large U.S. multinational companies. Recent anecdotal evidence of global recovery includes the exceptional performance of emerging market equity indices during 2003, tentative signs of improvement in the Japanese economy following a decade-long slump, and recent improvement in confidence and business activity among several European nations. To position our recommended portfolios accordingly, we recently recommended that investors begin increase exposure to large capitalization domestic equities. Our recommended large capitalization weight in our exchange traded fund model portfolio is now 35% of assets compared to 25% of assets earlier this year (see our October 6th *Strategy Comment*).

Trends in globalization and trade play a critical role in determining the performance of the largest multinational companies. The largest transnational companies include General Electric, Ford Motor Company, General Motors, Exxon Mobil Corporation, IBM. These five companies not only account for 25% of the equity capitalization of the Dow 30, but also receive 50% of their revenue from abroad according to the United Nations' 1999 World Investment Report. During periods of expansion, these companies disproportionately benefit from rising global demand for goods and services. Keep in mind that growth in exports to the rest of the world ranged from 4 1/2 to 12% during the 1990s—far in excess of the global economy's growth rate of approximately 3% per annum during that period or our nation's own growth for that matter. The downturn in the global economy in recent years reduced the ability of these companies to generate growth in repatriated foreign earnings. We expect that the performance of these companies and others like them will continue to be impacted by global developments and weigh heavily on index performance.

STYLE INVESTING

Equal Weighting Recommended

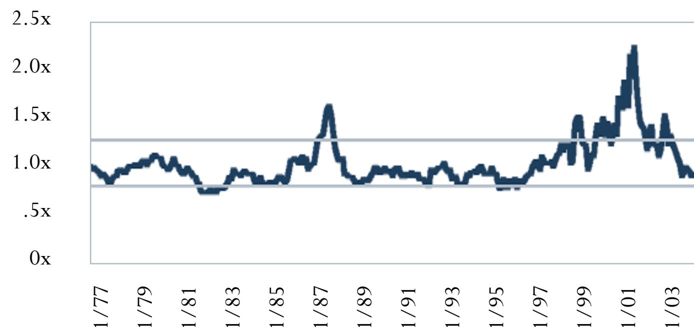
Value and growth both worked well in 2003. Through the time of this writing, the average S&P/Barra value index is up 32% compared to a 29% increase in the average growth index. Our recommended portfolio allocation has been balanced 50/50% between growth and value. This neck-and-neck performance is an improvement for growth stocks that underwent a significant correction over the past 3 1/2 years. During that period, value outperformed growth by 30%. At 3 1/2 years, the current value cycle is longer than the average 2.8 year value cycle seen over the past 50 years. The longest cycle ran for 8 years during the 1980s. Much of the 1970s also favored value. As a general statement, value dominated stock market performance throughout most of the 1970s and 1980s as high levels of inflation eroded the value of future earnings potential for growth-oriented companies. The 1990s "mega-cycle" favoring growth was, to a large extent, a result of winning a 25-year global battle against inflation.

Currently, both indices are within what we consider to be "normal" historical valuation ranges and inflation has reached multi-decade lows. Our valuation index for growth companies compares the inflation-adjusted price-to-earnings multiple on the index to underlying profitability defined as return on equity (ROE). Similarly, our valuation index for value stocks compares inflation-adjusted price-to-book multiples to average ROE. As the charts below show, both indices are currently well within their historical valuation ranges using our measures.

While we recognize that the value cycle is growing "long in the tooth" at 3 1/2 years, neither index appears significantly out of line in terms of valuation. Our recommended portfolio weighting based on style, therefore, remains balanced at 50/50%.

Style Investing—Growth Style

Inflation Adjusted P/E Relative to ROE



Style Investing—Value Style

Inflation Adjusted P/E Relative to ROE

SIZE INVESTING

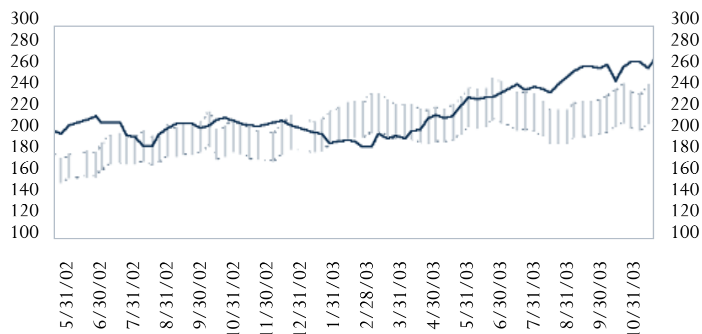
Large Cap Becoming More Attractive

For five years now, large capitalization stocks have underperformed small capitalization stocks. Our valuation approach by size indicates that the valuation disparity that existed in March, 2000 (where large capitalization stocks were 70% overvalued relative to small capitalization stocks) has now reversed that that small-and-mid-cap companies are now slightly overvalued (see charts). We base this on comparing multiples on a forward-looking basis relative to inflation adjusted Treasury yields. To account for liquidity issues, we adjust multiples on small-caps based upon the tendency for these companies to trade at a slight discount[2].

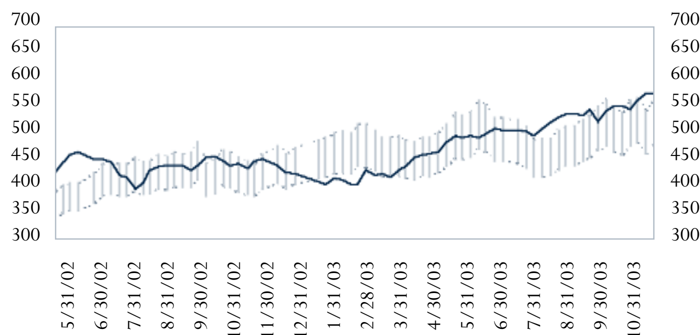
These smaller companies, however, have the advantage of being more directly levered to the U.S. economy without the burden of multinational exposure. At present, it is expected that earnings for the S&P 600 SmallCap index will grow by 25%—more than double the 12% expected growth for the S&P 500 companies. For the time being, this higher growth rate is a positive for small companies. We are, however, mindful that the lion's share of the valuation gap that existed a few years ago has been diminished and that the global economy appears to be stirring. With this in mind, we recently increased our equity exposure among large capitalization companies from 25% to 35% of portfolio weight. Should current trends continue, we expect that this weight will increase further in the months ahead.

2. Size premium from Ibbotson 2002 Yearbook

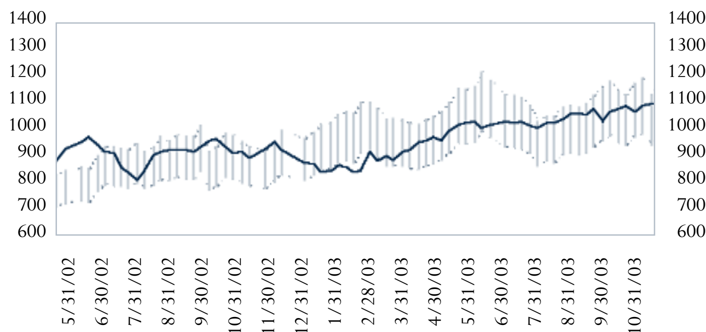
S&P 600 Versus "Fair Value" Range



S&P 400 Versus "Fair Value" Range



S&P 500 Versus "Fair Value" Range

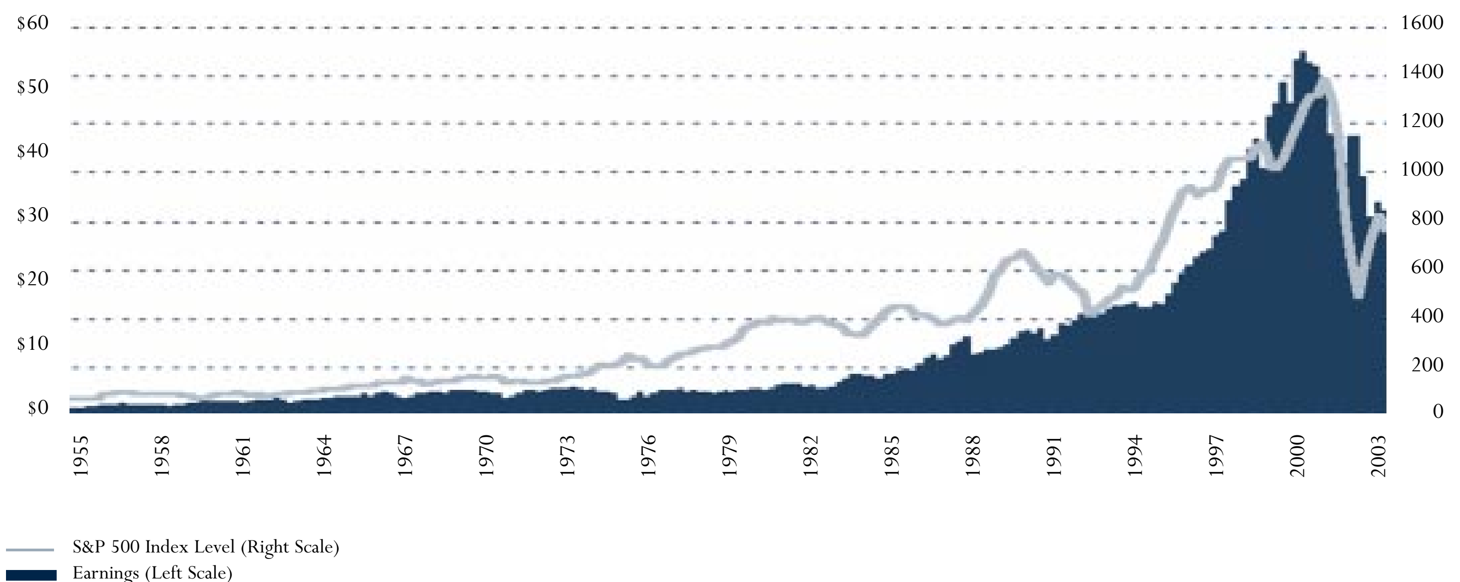


"Fair Value" Range Using 3.5% ERP & 90BP Size Prem
"Fair Value" Range Using 4.5% ERP & 90BP Size Prem
S&P Index Value

Ultimately earnings drive stock prices. Since the 1950s, the performance of the S&P 500 is 92% correlated with the underlying earnings growth of the index (see chart below). 2004 should mark a landmark year, in our view, as profits return to levels not seen since the late 1990s. We expect that an expanding economy coupled with high levels of productivity growth will allow profits to expand to a reasonable 8% of total GDP. At 8% of GDP, economy-wide profits would likely translate into roughly $58 in S&P 500 earnings.

S&P 500 Versus Reported Earnings

92% Correlation



SUMMING UP

Our outlook for the coming twelve months is positive or equities and other asset classes tied to the economy. Well-capitalized businesses should accelerate spending on capital and labor in 2004. Availability of capital, cost reductions, tax incentives, restructuring efforts, and lessened risk aversion are significant catalysts for economic growth over the medium term. Earnings growth is expected to continue in 2004 with S&P 500 earnings reaching $58. Our initial target for the S&P 500 for year-end 2004 remains 1,180 and 11,000 for the Dow 30.

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ISG25001 12/03