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### SUMMARY

- Economy and market wait on Iraq.
- Stocks slip lower in first quarter.
- Potential for “double dip” recession.
- Market showing signs of resilience.

### FIRST QUARTER 2003 REVIEW AND OUTLOOK

by Whitney Brown

In the first quarter the market and the economy seemed to be held hostage by the situation in Iraq. The daily diplomatic drama and subsequent invasion kept investors glued to their media outlets of choice and their wallets glued to their pockets. Stocks played the old down-up game we've seen for about a year now, with the down side getting the upper hand once again. The major averages finished down for the quarter, with the exception of the NASDAQ, which squeezed out a very slight gain.

Before the missiles started flying, investors remained very wary of the market, and stocks moved lower in the absence of buying interest. There has just been too much uncertainty regarding Iraq, North Korea and the economy. Once it became obvious that the war was on, stocks began to move sharply higher. As we have noted many times before, the market abhors uncertainty. The start of the war, for better or worse, gave the market a green light to go ahead and begin discounting

#### Year 2003 Stock Market Performance

	First Quarter
S & P 500	-3.6%
Dow Jones Industrial Average	-4.2%
NASDAQ Composite	0.4%
Morgan Stanley EAFE	-8.8%

the effects of it. The positive response of the market reflects expectations for a quick victory and a renewal of economic growth in the U.S. after a hard winter, high gas prices, and an unwillingness of businesses to commit to capital expenditures in unsettled times.

News on the economic front is mixed, and there are renewed concerns about the economy slipping back into recession. This would be what some call a “double dip.” Jobless rates are up; manufacturing activity is

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**First Quarter 2003 Review and Outlook (continued)**

*(Continued from page 1)*

down; gas prices are high; home sales are down; a harsh winter in the East put a crimp in retail sales; and the refinancing boom may be close to playing out. The Fed recognizes this and has kept interest rates low, with a willingness to make them lower if necessary.

But monetary policy can do only so much if people are unwilling to borrow money. The Bush administration would like to take up where the Fed has left off by instituting a massive fiscal stimulus plan based primarily on tax cuts. That would put money in people's pockets without the need for borrowing. With the president up for re-election next year, there is little doubt that the administration will pull out all the stops to get the economy going again.

The chart below provides an interesting historical perspective on how economic stimulus in the run up to presidential election years has had a

positive effect on the stock market. The top of the chart shows that the stock market historically has been quite good in the 3rd year of a Presidential term. The bottom of the chart shows a composite of the strong monetary and fiscal policy stimulus applied to the economy during the same period. If we will have any extended relief from the bear market of the past three years, this year would be the time to expect it.

It has been disconcerting for the market to perform poorly in the first quarter because it is usually a very good time of the year for stocks. However, the internal strength of the market has improved significantly beyond what is reflected in the market averages. In the first part of March, the market approached but did not go below the low point established last October. The market moved up strongly from that point, and many more individual stocks now are in positive price trends than earlier this year. The statistics that track selling versus buying indicate that

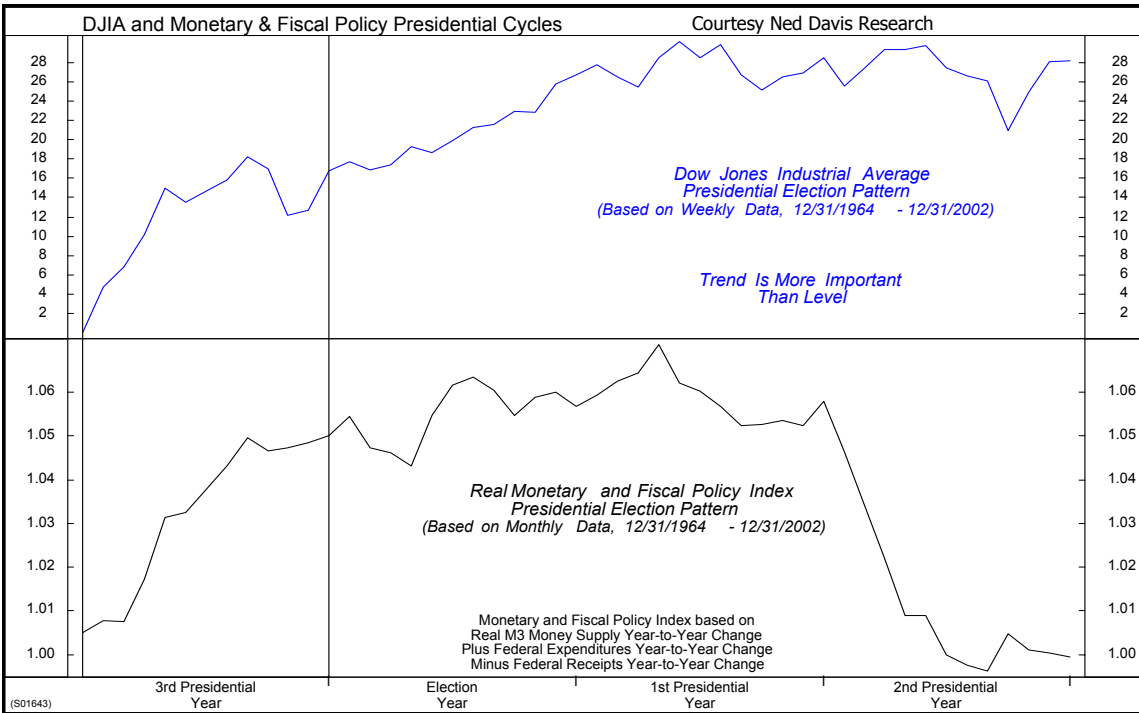
investors are more willing to hold stocks now and less willing to sell upon every whiff of bad news. Simply put, the market is more resilient now than it has been in many months.

The next desirable step would be for the market to move up out of the trading range in which it's been stuck for the past eight months. Such a move to a higher high would confirm that the market is in a new uptrend of some consequence. Whether that uptrend would be the start of a new major bull market or just a cyclical bull within a longer-term bear would remain to be seen. For more on long-term trends in the market please see the article on page 3.

Investors seem to have something to look forward to now. The takeover of Iraq is going well with, so far, no retaliatory terrorist strikes at home or abroad. A brutal and corrupt regime has been terminated. Oil and gas prices may well return to more normal levels. With Iraq under control, President Bush will push hard for his domestic agenda,

especially the economic stimulus package. Hopefully, the economy and corporate profits will respond favorably.

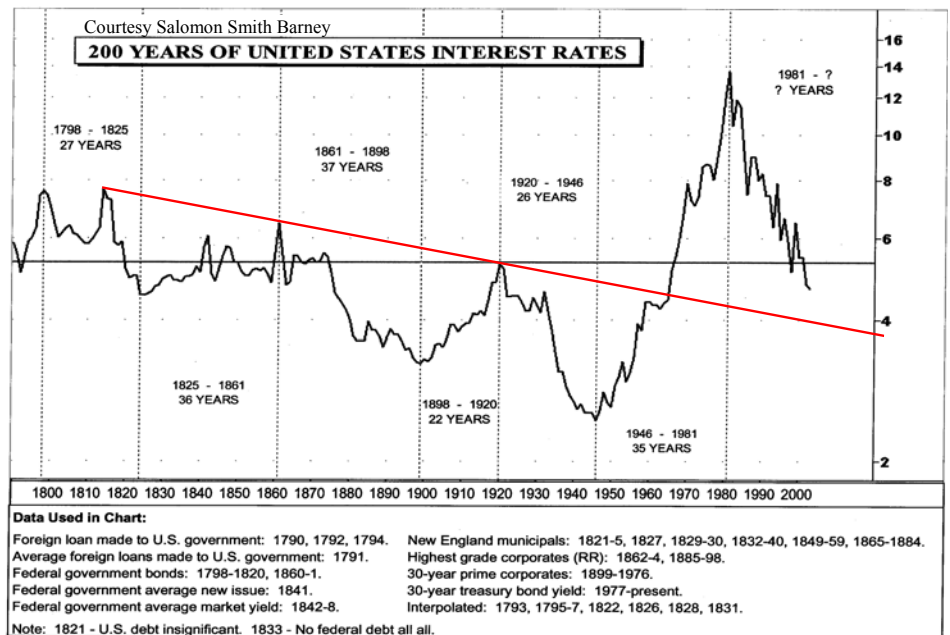
While there continue to be major issues of concern to investors, such as still high stock values and excessive debt in the economy, the climate seems more favorable for stocks now than it has been in quite some time. We will continue to monitor the market and act to either take advantage of investment opportunities or preserve capital as conditions dictate.



## LONG-TERM INVESTMENT TRENDS

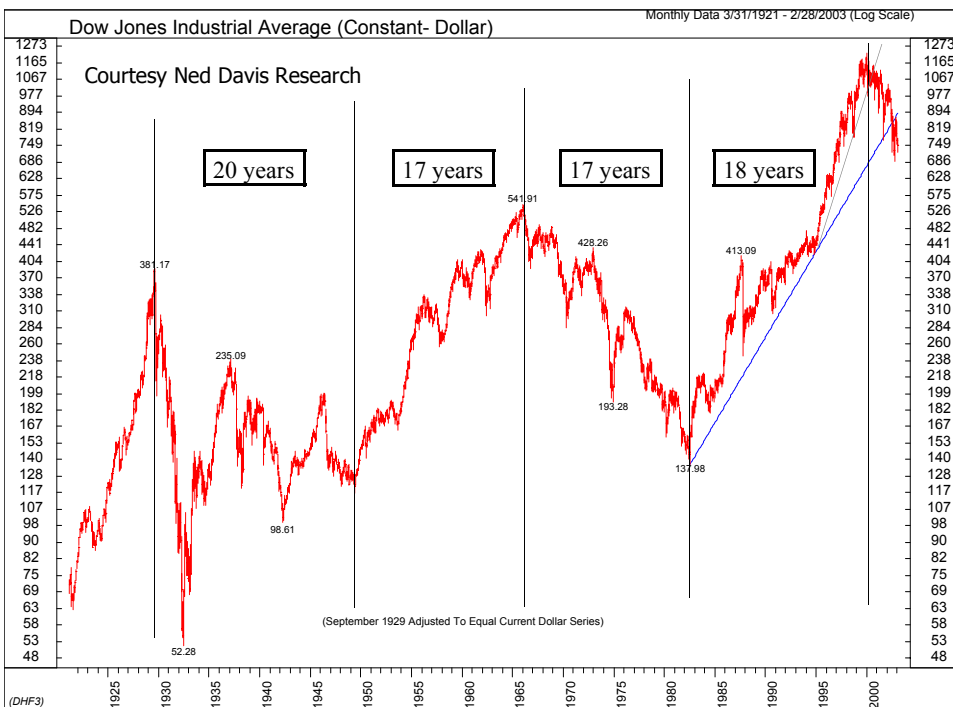
by Walter Dixon

Regardless of differences in their basic investment philosophies, most reasonably experienced investors agree that securities prices move in very long-term trends. The elemental forces of supply and demand dictate these trends, with an excess of demand (buying) creating an uptrend and an excess of supply (selling) creating a downtrend. A trend will continue in its primary direction, up or down, until something changes the relationship between forces of supply and demand. When this balance changes, sometimes after a brief period of equilibrium, the trend reverses and moves in the opposite direction for quite a long time until, again, a point of equilibrium is reached. After equilibrium, the formerly weak opposing force reasserts itself; and the long-term trend reverses. The two accompanying graphs show this quite clearly.



The 200-year graph of long-term U.S. interest rates displays a remarkably regular cycle of about 60 years to complete a down-up

repetition. Starting in 1798, we can also observe that the duration of the up and down trends alternates between approximately 25 and 36 years. The 80-year chart of the Dow Jones Industrial Average (inflation adjusted) shows a strikingly similar duration of the three latest long-term trends of 17-18 years, preceded by a more volatile 20-year period from 1929 to 1949.



Long-term trend analysis is virtually ignored by professional investment managers, its study being left mostly to the academicians. One reason is that, unlike cycles observed in nature such as the lunar or solar cycles, investment cycles defy rational explanation. They're not purely scientific; and they can't be explained in strictly economic terms. Their causes are more related to traits found in human nature -- self interest, greed, complacency, fear -- and are,

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### Long-Term Investment Trends (Continued)

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therefore, not so precisely quantifiable.

Supplementing our fundamental security and economic analysis, we study long-term graphs of security prices and financial ratios, such as dividend yields and price-earnings ratios, to gain historical perspective. Obviously, it's easier to make money by investing *with* the major trends, rather than *against* them. A buy-and-hold equity strategy should be highly successful in a long-term bull market. However, it could be disastrous in a long-term bear market.

Referring again to the graphs, we can readily discern the staying power of long-term trends, both up and down. For that reason a break in a long-term trend should not be taken lightly. Once a trend is broken, prices usually move forcefully in the opposite direction for a long time. We also become especially watchful when a trend that has persisted for quite a long time becomes "long in the tooth."

In the 80-year stock market chart we noted with concern the break in the 18-year up trend that took place

last July 2002. We admit that we don't know exactly *why* the break occurred; however, it's enough to note that it did, in fact, occur. This, in conjunction with our other ongoing concerns relating to historically high stock valuations, intensive media coverage of the stock market, and overall debt levels, caused us to take some defensive portfolio actions.

Regarding interest rates (bond prices rise, as interest rates decline), the downtrend in long-term rates that began 23 years ago is still in force. Noting the alternating length of uptrends and downtrends, one could conclude that the decline in rates has much farther to go, at least in time if not degree. *Why* this should be so we don't know for sure. However, we remain alert to the possibility.

So...we may be in the early stages of a long-term bear market for stocks; and interest rates are at historically very low levels. Investors naturally ask, "Where can I find good returns?" We will address this concern in detail in the June issue of Investment Outlook.

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