The RORER REVIEW

SPRING, 2004

*A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC*

## *PRODUCTIVITY GALORE!*

In past Rorer Reviews we have written of our optimism regarding the U.S. economy. Recent evidence suggests that the economic recovery is broadening, so it should come as no surprise that we are every bit as optimistic today as we have been for the past several quarters. Interest rates are at historic lows and have continued to fall in the face of a strengthening economy. The 10-year Treasury note, which began the year yielding 4.26%, finished the first quarter at 3.84%. While there is little doubt that the next move by the Federal Reserve will be to raise interest rates, Chairman Greenspan has indicated that he may choose to hold off until the unemployment rate falls significantly, perhaps into the 4% range, from its current level of 5.7%.

Another stimulus has been President Bush's tax incentive program. Consumers and investors have gotten their fair share, with lower tax rates on income and dividends among other allowances. Also, corporate America has been encouraged to invest in capital equipment to take advantage of the Accelerated Depreciation Allowance. This incentive, which is scheduled to expire at yearend 2004, allows the investing company to depreciate a full 50% of the purchased asset's value in the first year for tax purposes.

Perhaps due to these tax benefits and continued economic strength, spending on capital equipment has increased meaningfully, bolstered by double-digit growth in technology spending in the fourth quarter of 2003 and continuing into the current year. Incredibly enough, several analysts estimate that technology spending in 2004 will surpass the single year record of roughly $468 billion set in 2000! This is not to say that the more traditional forms of capital expenditures such as machinery, tractors, etc., haven't also begun to rise nicely. One just has to look at the robust results of many companies in the Industrial Sector to see that they indeed have. Nevertheless, spending on technology by business and government is now well over 50% of overall capital spending in the U.S. versus less than 25% just 30 years ago.

**LARGE CAP RELATIVE VALUE EQUITY**
**10 LARGEST HOLDINGS AS OF MARCH 31, 2004***

**Hewlett-Packard Co.**
**J.P. Morgan Chase & Co.**
**Lowes Co.**
**Marsh & McLennan**
**MNBA Corp.**
**St. Paul Companies, Inc.**
**Target Corp.**
**United Technologies Corp.**
**US Bancorp**
**Viacom, Inc - Class B**

This heavy spending on technology capital equipment has had many benefits, not the least of which is the incredible gain in productivity we have witnessed over the past several years. Thus far in the new millennium, productivity, as measured by output per worker, has risen at an annual rate of 3.55%. This compares to growth rates of 1.9% and 1.45% for the decades of the 1990's and 1980's, respectively. With continued steady advances in networking, the Internet and telecommunications, this improved trend is likely to continue for the foreseeable future.

These productivity statistics have broad implications for both employment and inflation. Certainly, our current unemployment rate of 5.7% is not considered high by historic standards. In fact, before the late 1990's, an unemployment rate of less than 6.0% was considered to represent full employment and an area where the economy was likely to overheat. We believe recent positive employment trends are likely to continue given recent strength in corporate profits, help wanted advertising and consumer sentiment. However, by this point in

most economic expansions job growth has typically been much more robust.

We think a great deal of the answer lies in the productivity numbers, which actually accelerated to a 5.4% rate of improvement in 2003. In the fourth quarter of that same year, corporate compensation, or total dollars spent on employees from the factory floor to the executive suite, as a percent of corporate GDP declined to its lowest level in over 40 years. Our workforce is producing more goods and services than ever, and we're paying less for them. In other words, Unit Labor Costs are at or near historic lows. This, in turn, has helped keep wage pressures under control for most of the past decade. Even today, with a rapidly growing economy and corporate profitability nearing an all time high, wage pressures are virtually non existent. We believe these factors will help keep inflation at bay going forward.

As good as all of the above statistics make us feel about the future of the U.S. economy, there are several issues on which to keep a watchful eye. First is the weak dollar. Thus far, the dollar's weakness against major foreign currencies has been a benefit to our economy. As the greenback has fallen, goods produced in the U.S. have become more attractively priced to the international consumer. This provides a meaningful benefit to those U.S. based companies doing business internationally, especially in Europe and Asia. However, if the dollar's decline versus other currencies becomes too steep, or the movement in the dollar becomes too volatile, confidence in the U.S. economy, both here and abroad, can be shaken. While we believe this is an unlikely event, under this scenario the Fed might be forced to raise interest rates earlier than planned to defend our currency.

The second issue we are paying close attention to is rising commodity prices. As the economies of the world have expanded in unison, demand for basic materials such as copper, lumber and oil has increased dramatically. This is especially true in developing countries such as China and India. The result has been meaningful increases in the price of most of these basic materials. The good news, thus far, is that China and India have used these commodities to produce goods that have then been exported to other countries and sold for less than comparable goods produced domestically. In other words, these countries are exporting deflation. So, while rising commodity prices are often a precursor to inflation, this dynamic, along with the great strides made in productivity mentioned above has, as of yet, helped keep price increases at bay.

The third caveat to our bullish economic outlook is terrorism. Unfortunately, the bombings in Madrid, Spain on March 11th and the continuing news of violence in Israel and Iraq are reminders of the devastating nature of these events. While terrorism in its essence is unpredictable, for now, at least, it is a very real part of today's economic landscape.

We believe we are in for a very constructive stock market, but one in which risk tolerance is on the wane. In 2003, as the economy continued to improve and the stock market began its dramatic rise in the second quarter, investors' appetite for risk seemed limitless. Is the company losing money? Buy it. Does the stock have a dividend yield? That's boring, what else have you got? This type of atmosphere is typical in a young bull market.

However, as we move into a slower yet steadier growth phase of the economic cycle, along with the attendant concerns about interest rates, the weaker dollar and rising commodity prices, investors become increasingly attracted to less risky equities. This has already begun to occur. For the past several weeks, the stocks of companies with earnings have outperformed those without earnings. Likewise, stocks that pay a dividend have outpaced those that do not pay dividends. While this trend is obviously in its infancy, we believe that as the economic recovery broadens and matures investors will focus more and more on the importance of earnings and dividends. Moreover, we believe that our clients will be the beneficiaries of this trend since our disciplined investment process starts with a universe of high quality companies and seeks those stocks that have attractive relative value and positive earnings momentum. At Rorer Asset Management, our commitment to constructing a portfolio of high quality stocks has been unwavering and it is our belief that such stocks will lead the market averages in 2004.

April 1, 2004

* The views expressed represent the opinions of Rorer and are not intended as a forecast or guarantee of future results. The Ten Largest Holdings are not investment recommendations and may no longer be held in an account's portfolio.

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