

Zemenick & Walker

Market Perspectives

An Investment Advisory Firm, Established in 1987

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The State of the States

The Bush Administration expects the federal deficit to reach \$450 billion this year, the largest fiscal year deficit ever. With a stagnant economy, recent tax cuts, and increased defense spending, a deficit of such magnitude is not surprising. Yet with all the public discussion about the problems surrounding a massively underfunded federal budget, many Americans are unaware of budget problems much closer to home.

For the past three fiscal years, nearly every state in the union has fought an uphill battle to balance their budgets. The National Conference of State Legislatures (NCSL) reported in its April 2003 State Budget Update that in the past three years alone, states have been required to close a cumulative \$200 billion budget gap, because unlike the federal government, most state constitutions prohibit the running of deficits. At the beginning of the 2003 fiscal year, which began July 1, 2002, forty-six states reported a budget shortfall totaling \$49.1 billion. Through various actions, state legislatures trimmed the 2003 shortfall to \$21.5 billion by the end of January.

These actions have not come without cost. The Center on Budget Policy and Priorities reports that during fiscal 2002 states dipped into their reserve funds to the tune of \$19 billion, drawing an impressive cumulative reserve fund of \$41 billion down to just \$22 billion in one year alone. Reserve funds that amounted to 10.4% of state budgets at the end of 2000 now account for *Continued on Page 2*

Focus on the Economy

Many market prognosticators have been predicting a recovery for the U.S. economy for quite some time. However, in the first half of 2003 some adopted a less optimistic tone, citing the possibility of deflation and a weakened job market as threats that could send the economy into a downward spiral. Entering the second half of the year it appears these fears may be dwindling and that the economy could potentially be poised to accelerate into the material, sustained recovery for which everyone has been waiting.

Perhaps the most positive news is that deflation concerns are abating. Widespread, persistent deflation probably scares economists more than anything else, because traditional policy tools do not work in that environment. The Fed could employ other tactics such as influencing exchange rates, or reducing longer-term interest rates by buying 10-year Treasuries. However, no one actually knows with any certainty how effective these actions might be. Fortunately, this does not appear to be a challenge that policymakers will confront any time soon. On the contrary, the weak dollar, rapidly growing government deficit, and expansive monetary policy are all typically associated with an inflationary environment.

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As mentioned above, the Fed has maintained an accommodative monetary policy in an attempt to stimulate growth and ward off deflation. It recently cut its benchmark overnight lending rate to 1%, the lowest level in 45 years. Low interest rates have helped drive consumer spending as mortgage refinancing has pumped billions of dollars into the pockets of consumers, according to the Mortgage Bankers Association of America. The federal government also took action to ensure consumer spending remains strong by passing a new tax relief package. *Continued on Page 3*

The State of the States

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under 3.5%. Moreover, the NCSL reports that twenty-three states tapped capital improvement funds (i.e. highway and other special projects) to cover budget shortfalls in fiscal years 2002 and 2003, and sixteen states siphoned tobacco settlement money for that purpose as well. Even after consuming all of this sidelined cash, states are still coming up short.

The result has been and will continue to be drastic reductions in spending. For example, The Rockefeller Institute of Government reports that from fiscal year 2001 to fiscal year 2002, the increase in the largest cumulative state expense (elementary and secondary education) fell from 8.0% to 3.3% annually, only slightly above inflation, which averaged 2.2% over the same period. During those same two years, general state budget expenses dropped from a 7.9% increase in 2001 to a 3.3% increase in 2002. Although final 2003 budget figures are pending, experts at the Rockefeller Institute of Government estimate general budget expense growth of just 1.3% for fiscal year 2003, a growth rate well below inflation.

Unfortunately, the road does not get easier from here. Although the recent stock market rally has given rise to some optimism, states are still struggling with budget shortfalls for the upcoming fiscal year, which began July 1, 2003. During the early part of the calendar year, as states were drafting their fiscal year 2004 budgets, the NCSL reported that thirty-six states faced a cumulative budget gap of \$68.7 billion. In nineteen states, the budget gap exceeded 10.0% of the state's budget, including Missouri and Illinois, whose gaps approximated 15.0% and 13.2%, respectively.

However, for the upcoming budget, state lawmakers will not have the luxury of drawing down the now depleted reserve funds. Thus, Arturo Perez of the NCSL believes the budget cuts for fiscal year 2004 may be the most severe yet. For example, at least twenty-one states have proposed across-the-board funding cuts for K-12 school districts. Lawmakers have specifically targeted lowering per pupil aid, reducing transportation funds, chopping teacher salary matching programs and/or paring class size reduction funds. The second largest expense for states, Medicaid, has not escaped the axe either. At least twenty-seven states plan to contain Medicaid costs through reducing benefits and eligibility, reducing provider rates, scaling back services, and/or freezing certain enrollments. Additionally, over half of the states are trying to reduce state employee expenses through wage freezes, health care program

adjustments, and/or the elimination of vacant positions. Other areas facing cuts include higher education, corrections, and information technology upgrades to name just a few.

Ironically, given the current budget mess, most states have thus far avoided tax increases. While many states have proposed targeted increases—tobacco, alcohol and gaming are the most frequent targets, the NCSL reports that as of the end of April, only six states were considering increasing personal income taxes. Donald Boyd of the Rockefeller Institute of Government believes President Bush has succeeded in his marketing of tax cuts, and subsequently states feel it is politically out of favor to “buck the trend”. And with states unwilling to increase their own taxes, they have increasingly lobbied Washington for aid, only to find a federal budget awash in red ink as well.

So how did states find their way into the current budget mess? Recessions and sour equity markets have gripped the economy before, yet state budget problems seem much more severe this time around. The U.S. Bureau of Economic Analysis reports that real per capita state tax revenue declined 7.4% in fiscal year 2002 from the previous year. This is more than double the next largest decrease, which occurred during the 1990-91 recession, when real per capita state tax revenue decreased 3.5% in fiscal year 1991. In the 1980-82 recession real per capita state tax revenue declined just 2.0% during the most severe part of the recession, fiscal 1983.

The core of the problem, says John Springer of the Center on Budget and Policy Priorities, is that states are increasingly seeing their industrial tax bases exported overseas. Services, which states generally do not tax, are becoming an ever-increasing portion of overall economic activity. In response, rather than shifting the collection of tax revenues from industrial tax bases to services or even personal income taxes, states attempted to mitigate the problem by turning to capital gains taxes. This worked well in the 1990's as state tax revenues soared and reserve funds grew to record levels. However, now that the stock market has succumbed to a 2+ year bear market, the capital gains taxes on which states have come to rely so heavily have all but disappeared. Add to this an aging population and skyrocketing health care costs, and the problems facing state lawmakers only get worse.

States unquestionably have numerous problems to resolve. Whether through spending cuts, higher taxes, or other revenue producing measures such as bond issuance, states will be required to shore up some \$70 billion in budget shortfalls over the course of the upcoming fiscal year.

As a result of the budget struggles, states are beginning to see their credit ratings downgraded by the major credit rating agencies. For example, just recently, Moody's lowered the credit rating on state of Connecticut debt from AA2 to AA3. To reduce the risk to clients, Zemenick & Walker actively monitors the credit ratings of states and specifically avoids any uninsured state debt below a AA rating. Additionally, Zemenick & Walker evaluates AA rated state debt for suitability on a case by case basis ■

**Highest Estimated State Deficits as % of General Budget
As of April 2003**

	% of Budget	Proj. 2004 Deficit
Arizona	25.0%	\$1,500 million
Alaska	25.0%	\$600 million
New York	24.0%	\$9,300 million
California	20.6%	\$17,500 million
Oregon	17.0%	\$850 million

Focus on the Economy,

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In stark contrast to the strength displayed by consumers, the corporate sector has continued to deliver lackluster growth. However, due to impressive efficiency gains businesses have been able to earn more on fewer revenues. When revenues finally improve, increased operating efficiencies should be a catalyst for far greater profitability. In fact, many analysts believe profit growth will begin to surge in the second half of the year. According to a survey conducted by Thomson Financial, the average analyst forecast predicted a jump in profits of 13% in the third quarter and 21% in the fourth quarter.

Equity markets have certainly cooperated with those hoping for a return to more prosperous times. In the second quarter the

S&P 500 and Wilshire 5000 rose 15.39% and 16.03% and year-to-date the two indexes are up 11.76% and 11.98%, respectively. These bullish numbers provide welcome relief after three years of negative equity returns.

Of course not all indicators are positive. The labor market, for example, is still struggling. The unemployment rate increased to 6.4% in June, which is its highest level since April 1994 and was higher than the 6.2% median forecast. Rising unemployment threatens to weaken consumer spending and negate the considerable efforts of Federal Reserve Chairman Alan Greenspan and President Bush to strengthen it. According to a Bloomberg News survey, "the economy needs to grow at 3% or faster to prompt hiring, something it has not done in consecutive quarters since the last six months of 1999" ■

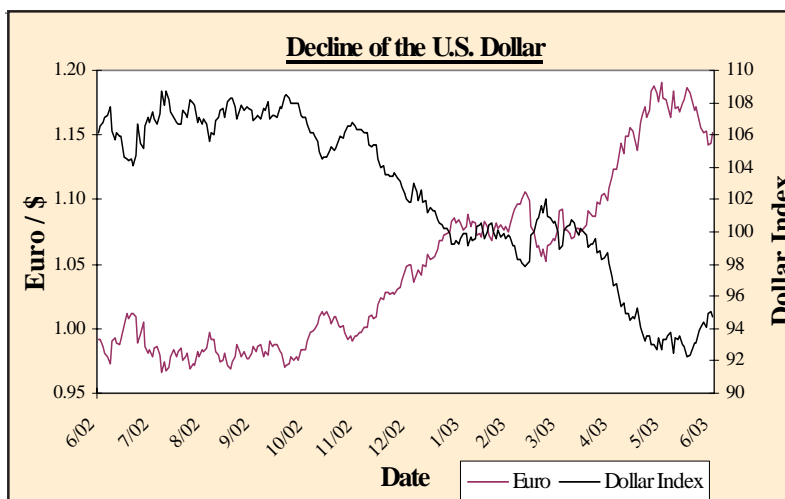
Foreign Currencies Rise Against U.S. Dollar

Over the past twelve months the U.S. dollar has fallen precipitously against most major world currencies. This improves the competitive position of U.S. companies and can help boost their international sales as U.S. goods and services become cheaper relative to foreign products. If the dollar's fall is significant enough U.S. businesses may even get a degree of domestic pricing power. This, in turn, reduces deflation risk for the U.S. economy.

However, any gains realized by U.S. businesses may be muted because both Japan and Europe are currently faced with slumping economies. A weak dollar can hurt exports to the U.S. which contributes to a further reduction in economic activity. Any increased economic weakness in Japan and Europe could be harmful for U.S. businesses, causing their sales in those markets to decline.

An extended drop in the dollar also makes investing in U.S. financial markets less attractive to foreigners. For example,

assume that a German investor exchanges euros for dollars to purchase U.S. stocks and bonds. If the euro subsequently rises against the dollar, the investor will lose money when exchanging the funds from the dollar-denominated investment back into euros. Many people feared that a substantial decline in the dollar would spur an exodus of foreign investors from U.S. stocks and bonds. However, due to the perception that the U.S. continues to be the safest place in the world to invest and because of a recent rebound in equity markets, this has not occurred.



The graph on the left shows the performance of the euro against the dollar (the maroon line) from June 30, 2002 through June 30, 2003 on the *left* axis and the performance of the dollar index (the black line) -- an average of the exchange rates between the dollar and six major world currencies -- on the *right* axis. As the graph demonstrates, the euro gained about 16% in the last year against the dollar while the dollar index lost about 11% against a basket of foreign currencies over the same period of time ■

Zemenick & Walker Recognized in Bloomberg Survey

We are proud to report that Zemenick & Walker Inc. ranked thirteenth in the nation and number one in Missouri on the third annual list of Top Wealth Managers, as reported by Bloomberg in the July/August issue of *Wealth Manager*, its popular publication for financial advisors. The list includes the top 370 independent advisory firms in the country, as measured by average client account size. Though we do not actively seek such accolades, it is extremely satisfying for a respected, independent source to place us in such high standing among our investment advisory peers ■

Our Mission

Zemenick & Walker is committed to providing superior investment advisory services to high net worth individuals, trusts, not-for-profit organizations, and retirement plans. As a fee-only, non-discretionary advisor, Zemenick & Walker eliminates potential conflicts of interest, giving clients a disciplined, business-like approach to the investment of their capital ■

By the Numbers

<u>Interest Rates</u> (Mnthly data since 1970)	<u>High</u>	<u>Date</u>	<u>Low</u>	<u>Date</u>	<u>June 2003</u>
Federal Funds Rate	20.00%	May-81	1.00%	June-03	1.00%
3-Month T-Bill	16.30%	May-81	0.92%	June-03	0.92%
10-Year Treasury	15.32%	Sept-81	3.33%	June-03	3.33%
30-Year Mortgage	14.67%	July-84	5.23%	June-03	5.23%
<u>Stock Indices</u> (Daily data since 2000)	<u>High</u>	<u>Low</u>	<u>6/30/03</u>	<u>% from High</u>	<u>% from Low</u>
DJIA	11,723	7,286	8,985	(23.36%)	23.32%
S&P 500	1,527	777	975	(36.18%)	25.42%
NASDAQ	5,049	1,114	1,623	(67.86%)	45.67%
Wilshire 5000	14,752	7,343	9,343	(36.67%)	27.24%
EAFE	1,774	857	1,026	(42.18%)	19.69%

President Bush Signs New Tax Relief Package

On May 28th President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the third major tax cut package in three years. Official estimates place the cost of the tax cut at about \$350 billion, but according to experts, such as CCH, the true cost over ten years could be closer to \$850 billion. To help mitigate the total cost the tax bill includes various “sunset” provisions, which specify that the cuts expire at various times between now and December 31, 2010 if not renewed by Congress before then. The bill addresses a number of different aspects of the tax code including marginal tax rates and tax rates for dividends and capital gains. The following is a very brief summary of some of the major changes to the tax code ■

- **Marginal Rate Changes** Retroactive to the beginning of 2003 the 38.6%, 35%, 30%, and 27% tax rates become 35%, 33%, 28%, and 25% respectively. After 2010 these rates fall back to 2001 levels.
- **Capital Gains** The maximum net capital gains rate immediately falls to 15% from 20%. The current capital gains rate falls to 5% and then to 0% in 2008. This applies to all sales and exchanges that take place on or after May 6, 2003. These rates reset to 20% and 10% beginning in 2009.
- **Dividends** Retroactive to the beginning of the year, dividends received by individuals will be taxed at 15%, though individuals with low income will only pay 5%. As with capital gains, the 5% tax falls to zero in 2008 before dividend tax rates return to the original, pre-JGTRRA, levels in 2009. There are a number of exceptions to this rule and the definition of a “dividend” is very specific. For more details you should contact a tax professional.

Source: CCH Tax Briefing: Jobs and Growth Tax Relief Reconciliation Act of 2003

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