

## **The Good the Bad and the Middle East**

Although the last few days of the third quarter were down (a repeating occurrence lately) we have now had the first two positive quarters for the U.S. stock markets since 2000. It could even be said that the bear market ended during the 4<sup>th</sup> quarter of last year. Some lows appeared in September and the market was down again in the beginning of October but since then the trend has been up.

Well what's the good news? Interest rates. Although they bounced up during the summer they are lower now. This could keep the housing market strong and help get the economy back into full gear. The economy is showing signs of recovery with the GDP rising by over 3% in the last quarter. The stock market is recovering, rising 13.2% through September 30, 2003 (according to CNBC<sup>1</sup>). Although some of the gains were lost during the last few days of the quarter thus far October has gotten off to a good start. On Friday, October 3<sup>rd</sup> the employment numbers for September came out and for the first time in quite a while the economy created new jobs, 57,000 new jobs were reported for September and the August job data was revised to a loss of 41,000 versus the 93,000 that was originally reported by CNBC<sup>2</sup>. As I write this, the first few earnings reports have started to hit the newswires and they are above expectations. Both Pepsi and Apollo Group beat street estimates according to CNBC.

What is bad? There are some troubling clouds on the horizon. Although interest rates are still low they are showing potential for increase if the stock market continues to advance. This is the principal of supply and demand. If short-term investors think that stocks are on a run, chances are good that bonds will be sold and stocks will be bought. Although that is good from an income standpoint it will put pressure on bond values. This means that we must watch the fixed income parts of your investments with greater scrutiny. We are positioned for a rising interest rate environment, however we must take care that the rise in stocks are not offset by losses in bonds. In the area of health care there is political trouble for the pharmaceutical industry. We have been overweighting health care in your portfolios and feel that it is still a good long-term investment. However, we believe that the rising sentiment regarding increasing drug costs and the demand by many U.S. governors that congress allow importation of drugs from Canada (for government employees) will create a political hot potato. The significant difference in price for U.S. versus Canadian drugs will put enough pressure on that industry to cause it to underperform the broad market as a whole. Therefore we have started to reduce our exposure in this industry to a market neutral position until this issue is resolved (hopefully by next fall's election).

Finally we must mention the Middle East. With Israel's attack on Syria and almost daily attacks on our troops in Iraq, the tensions in the Middle East remain on the front page. OPEC has lowered its production quotas and the Palestinians continue their homicide attacks. Saturday's bombing in Haifa killed 19 civilians including infants and children and was probably the impetus for Israel's first attack of Syria since the 1973 Yom Kippur War. The enormous cost for our occupation of Iraq, the constant loss of our young men overseas, and the apparent lack of definitive evidence of weapons of mass destruction is

leading to the lowest approval rating for President Bush since his election. This will all add fuel to the political fires and add uncertainty to next year's election. And we all know how the market can react to uncertainty.

Where do we stand? We believe that the markets will continue to rise albeit at a lower pace than the first 3 quarters of the year. We feel that the economy will continue to improve and inflation will remain benign, and the Federal Reserve Board will keep interest rates low enough to help the economy continue its recovery. This should lead to an improving job market, which will also stimulate the economy and the stock market. Therefore, notwithstanding any significant escalation of trouble in the Middle East we can expect good sailing in the near term.

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<sup>1</sup> CNBC October 1, 2003

<sup>2</sup> CNBC October 7, 2003

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