



**All That Buzz**

**Increased Spending + Declining Inventories + Low Inventories To Sales =**

**The Chicken or The Egg**

**Historically The Best Leading Indicator**

**The Good Old Times**

**Leading The Charge Upward**

**The Top 100 Performers**

**"Salvage Value"**

**Quote of the Quarter**

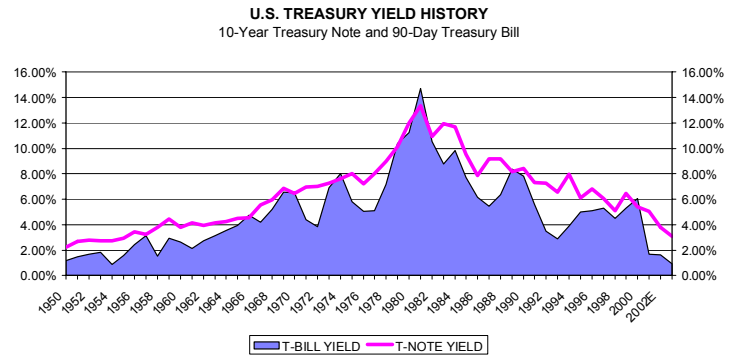
*"I have never seen this much stimulus in my life. I believe something has to happen in 2004. We don't see it yet but I believe we will."*

George David, Chairman, CEO United Technologies Corp.

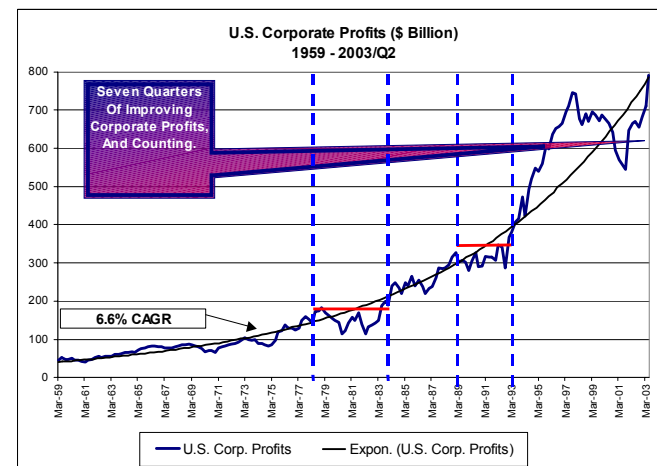
**All That Buzz**

Early in the summer the weather was quite miserable in a large part of the country. The heavy spring rains had carried over into the summer in many parts of the country. Much of the East Coast experienced at least eight consecutive weekends of torrential rains. Adding to the misery, several Federal Reserve Board Governors shook the deflationary "hornet's nest", stirring a swarm of press reporters and economists who began to rage about deflation. The U. S. dollar weakened as the Fed reduced short-term interest rates and the bond market

panicked, driving 10-year U.S. Treasury notes to 3.11%, a low not seen since the early 1950s.



Well, the rains passed and the sun escorted the emergence of the summer season. Likewise, the economy rose from the depths of despair with a reported 3.1% growth in 2<sup>nd</sup> Quarter GDP (Gross Domestic Product). Real Final Sales grew by 4% as consumers held firm with their spending. Better yet, the elusive Capital Spending rose to the occasion as Corporate Profits



increased for the seventh consecutive quarter. Since, we've had reports of Durable Goods Orders and Factory Orders improving at the same time that Inventories continue to be depleted. In fact, without the decline in inventories, 2<sup>nd</sup> quarter GDP would have been stronger. And yes,

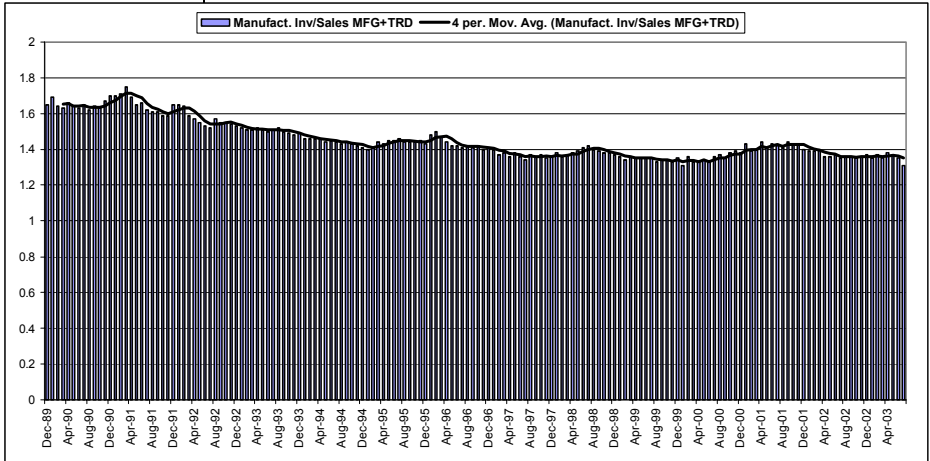
measures of inflation ticked higher (as measured by the CPI and the Personal Consumption Deflator), but remained at reasonably low levels.

As one could imagine, deflation fears have reverted to fears of future inflation. The 10-year Treasury yield catapulted to as high as 4.6% in short order, the U.S. dollar strengthened on indications of a stronger economy, and "all that buzz" began to swirl as prognosticators speculated as to when the Fed would raise interest rates.

**Increased Spending + Declining Inventories**

**+ Low Inventories To Sales =**  
Economic indicators continue to point toward improving economic conditions.

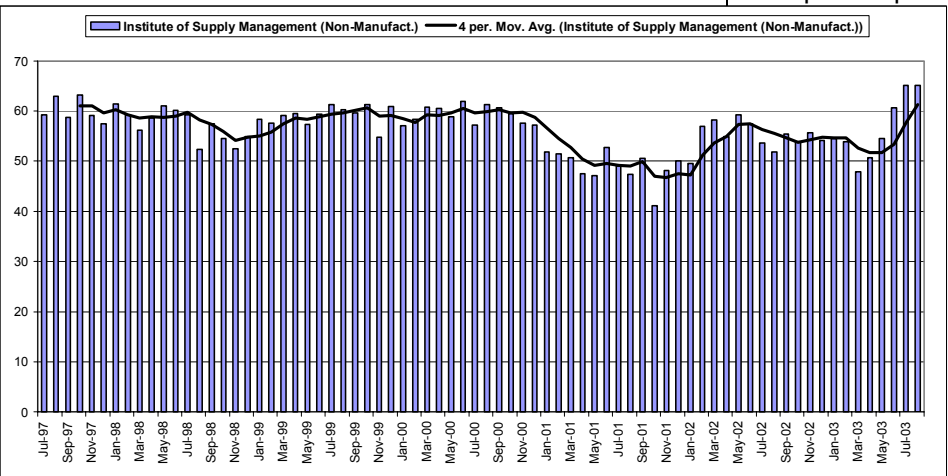
The LEI (Index of Leading Economic Indicators) has compiled four consecutive reports of improved index measures. The service sector, which constitutes approximately 85% of our economy, has risen to a level not ever seen since the survey began in July of 1997 (ISM Service Index). The manufacturing sector



inventories, businesses will be required to rebuild inventory, increasing Industrial Production.

**The Chicken or The Egg**

As earlier stated, Corporate Profits have continued to improve quarter after quarter, since September 2001.



The economic downturn that manifested itself in the year 2000 as the Fed raised interest rates and tightened money supply, appears to have gone full cycle. From the feast of year 2000 to the ensuing famine, current surviving and thriving corporations have been offered the opportunity to improve their financial fitness. Low interest rates have offered a low cost of capital, which has provided a catalyst for financial restructuring.

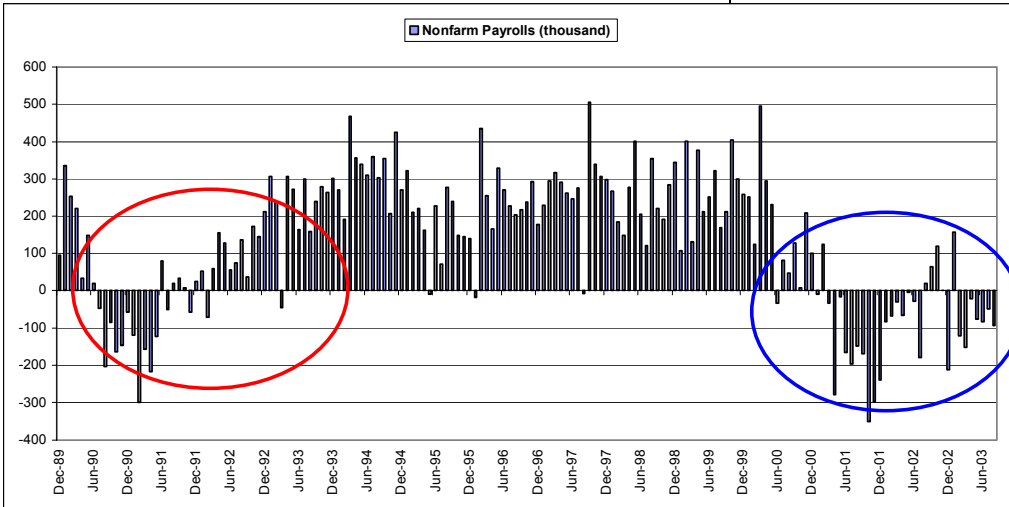
Simultaneously, corporations have used the downturn to reduce costs and eliminate redundancies with the objective of improving productivity. As such,

(approximately 15% of our economy) is reported to be expanding again (ISM Manufacturing Index) and has even experienced a level of pick-up in pricing power. Nonetheless, we have no illusions of rampant growth. Our expectations are for continued steady economic improvement.

Corporate Non-Farm Productivity soared in the 2<sup>nd</sup> quarter, improving by a high 6.8%. And there lies the problem, according to some.

Our optimism for growth is further guided by the continued decline in inventories, as sales and spending rise. The combination of unprecedented Monetary Stimulus, Fiscal Stimulus via tax reductions and increased government spending, as well as improved Corporate Profits, provides the fuel for increased Corporate and Personal Spending going forward. Manufacturing and Wholesale Inventory-to-Sales ratios are reported to measure at near record low levels. Assuming continued spending and current lean

After fears of inflation, then fears of a double dip recession, and recently the fears of deflation, the latest cry of a falling sky is the cry of the "jobless recovery". Granted, for the 2.8 million people who lost their jobs, it's bad. And for those of us who have a job, we are blessed. But the cry from the wild is reminiscent of the early 1990s. Note in the chart that though the recession ended in March of 1991, employment did not even begin to accelerate until 1993. Job creation did not become strong until much later, in line with improved productivity and growing corporate profits. So which came first, the chicken or the egg? Since increased productivity aids increased corporate profits, which comes first, jobs or profits? As with the economy, these things take time.



rising forward earnings estimates for corporate America.

**The Good Old Times**

NOT SO FAST! History also demonstrates that a rise from a cyclical downturn is fraught with bouts of market surges followed by market retrenchments. Given that investment markets are forward looking, this should come as no surprise. The markets often advance too rapidly on monetary stimulus, then retrench, allowing time for further economic development to catch up. All the while corporate America

fundamentally advances, building shareholder value.

So the "Good Old Times" are back since we have everything completely figured out? NOT AT ALL! The previous three years have been difficult, to say the least. Some way or another, current times are not particularly easy. According to a major Wall Street research firm, more than 80% of "Core" investment managers have under performed market returns. *"The sharp move by smaller and more speculative stocks had caught many portfolio managers off guard, and hurt relative performance."*

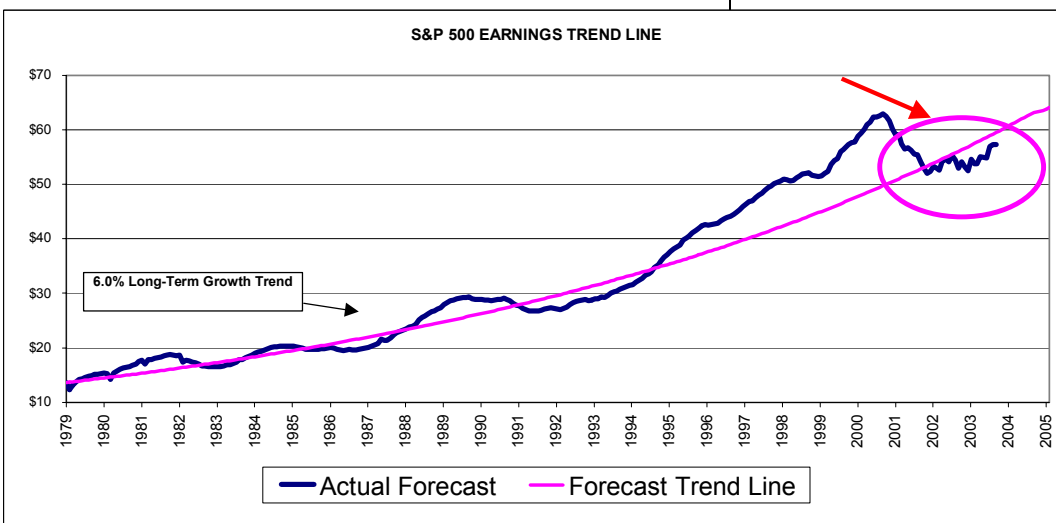
**Leading The Charge Upward**

When dissecting the YTD (year-to-date) performance of the S&P 500, interesting challenges are revealed. The YTD index performance of the S&P 500 companies is 14.9%. Finally, positive market returns! But let's take a closer look at what is driving this return. The average stock that began the year at less than \$15 has advanced by 54.7%. The average stock with a price less than \$5

has risen by 88.2%. At the opposite extreme, the average price increase of companies that began the year with stock prices greater than \$50 have increased a "whopping" 9.1%. Further analysis identifies a highly correlated inverse relationship between beginning period stock price and stock price performance with a correlation coefficient of -0.88. Clearly, this year's stock rally has been primarily driven by low-priced speculative stocks, most of which our investment

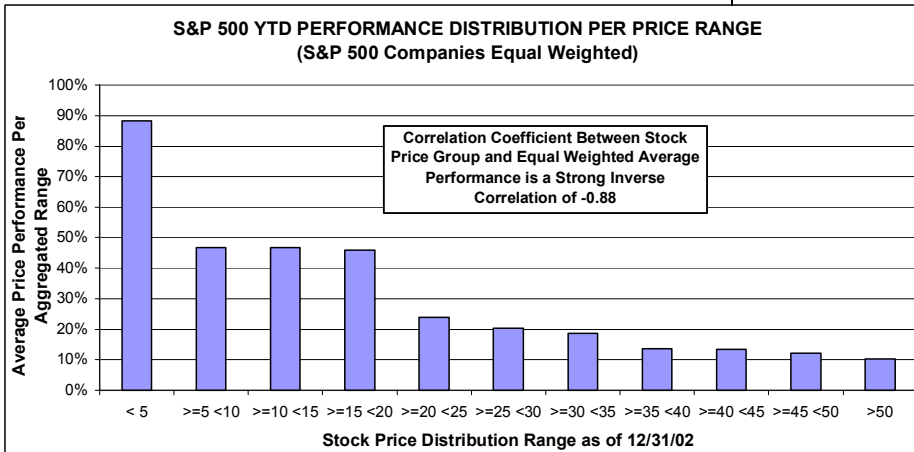
**Historically The Best Leading Indicator**

In the past 15 months there have been three distinct periods of extreme pessimism and anxiety: July 2002, October 2002, and March 2003. Since the July 2002 low, market returns for the Dow Jones Industrial 30, the S&P 500 Index, and the NASDAQ Index are 15.7%, 21.5%, 49.6%, respectively. As has often been the case in the past, a meaningful market advance that rises with seemingly no economic justification has marked the broadening of an economic recovery. More recent annals of history demonstrate this occurrence in 1998, 1995, 1991, and 1982. Underneath the blanket of fear and despair cast upon the investment community lurks improving fundamental conditions, frequently under elusive camouflage. Such has been the case today as Corporate Profits have compounded quarterly. Going beyond the macro view of profits, year-over-year earnings of S&P 500 company earnings have been slowly and almost methodically advancing, building value. As a result, this phenomenon has given cause for



discipline would never even allow us to consider.

downturn at a rate of +8% while the S&P 500 Index annualized a 6% loss.



### “Salvage Value”

Well, the top performing companies must have some redeeming quality for the stocks to rise, right? Yes, they do in fact. They are still components of the group of largest and most profitable companies in the world, the Standard & Poor’s 500. It is highly likely that these companies are going to be around for a long time. It is also probable that the stock prices were beaten to a level often crudely referred to as “Salvage Value”. Nonetheless, these probabilities offer little indication of the long-term sustainability of superior

growth. No doubt, some will rise again to the levels of the elite, and for certain, we will be searching for those companies that have the ability to command leadership and sustainability in their respective fields. We trust we will find a few opportunities along the way that demonstrate the qualities and attributes dictated by our philosophy and discipline. But clearly, neither our belief nor the dictates of our commitments will allow us to speculate in valuations of salvage.

Unquestionably, the markets have risen in anticipation of cyclically improving economic conditions, speculative or not. Measures of economic indications have been reported that confirm the anticipated views of the equity markets. Many raise questions as to whether the markets have more than fully discounted economic improvements. Others question the sustainability of the economic recovery. Emphatically, the current economic and market environment is not perfect, with much unevenness and questionable investment activity. But given that we experienced “perfect” conditions once before, March 2000, maybe we should consider seeking conditions of equilibrium instead.

### The Top 100 Performers

That was just price! Now let’s drill down on the Top 100 Performers, with an average YTD return of 72.6%. These must be industry-leading companies, right? Well, exactly one third of the “Top 100 Performers” carry the dubious distinction of a B- or C financial rating by Standard and Poor’s, measures that we intentionally filter out in our screening process. Another 17 are not rated. Well, they must have demonstrated tremendous earnings power? Collectively these companies have a 3-year earnings growth rate of *negative* 2% and averaged a 32% earnings *loss* in 2002. Return on Equity (ROE), simply the net income generated by the business as a percent of the business’ net worth, recently measured 12.7% for this group. This is compared to the average 15.3% ROE of the market in general, and a ROE of 22.8% delivered by the typical Godsey & Gibb Associates equity investment holding. Additionally, the 2002 earnings for Godsey & Gibb holdings added shareholder value with a +13% increase and compounded earnings during the three-year

This report is intended solely for the clients of Godsey & Gibb Associates. This material is for informational purposes only and is not intended to be a recommendation for the purchase or sale of any individual security.