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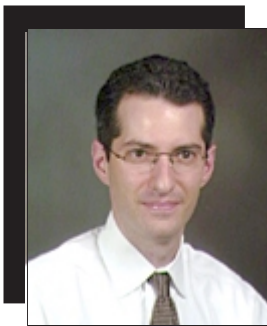
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By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than ten years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group where he managed a \$100 million portfolio. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the Association for Investment Management and Research (AIMR) and the Houston Society of Financial Analysts (HSFA).

“Reality Economics” - Don’t Get Voted Off!

Since the stock market has historically been a leading indicator of the economy, the stock market’s impressive ascent since March of this year may mean that a solid recovery is just around the corner. In fact, many economists believe that an economic rebound is already well underway.

Or, is the jaw-dropping market rally just one giant head fake before the economy stumbles from the effects of higher unemployment and lackluster capital spending?

So, what is the *real* state of the economy?

The Numbers Look Good, But...

Economists as well as many other professional market forecasters pour over reams of statistics like new car sales, durable goods orders, the unemployment rate, and new housing permits looking for any clues as to the near term direction of the largest and most powerful economy in the world.

So far, the numbers support the “recovery in progress” theory. According to a recent survey conducted by The Wall Street Journal of 53 leading economists, the U.S. economy is expected to grow at its strongest pace in almost four years during the second half of 2003. GDP is forecasted to grow at an annualized rate of 4.7% in the 3rd quarter and 4.0% in the 4th quarter.

The good news is that these current rosy predictions may be right on track and the U.S. may be finally pulling out of a horrendous three-year economic funk. The bad news is that economists’ optimistic predictions and government statistics are less than accurate and are often revised downward.

So how can we be sure if this is a real economic recovery with sustainable job growth and higher corporate profits, both essential ingredients to keeping consumer and business spending up?

Reading the Tea Leaves

For those that enjoy market forecasting and digging into the numbers, there is no shortage of readily accessible government data to evaluate. Information regarding the state of the economy is continuously released on a host of government websites.



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The chart below outlines just a few places where current and historical economic data can be found. These sites also contain tools for conducting advanced searches and queries of data.

Government Entity	Key Statistics
Dept. of Commerce’s Bureau of Economic Analysis www.bea.doc.gov	- GDP and corporate profits - International balance of payments - Personal income and outlays
U.S. Dept. of the Treasury www.ustreas.gov	- Interest rates and yield curves - International capital movements
The Federal Reserve Board www.federalreserve.gov	- Industrial production - Household debt-service burden
U.S. Dept. of Labor – Bureau of Labor Statistics www.dol.gov and www.bls.gov	- CPI and PPI - Unemployment rate and new jobless benefit claims - Productivity

Ask the Citizen Economist

If you are not a “numbers” person and are more sensory inclined, you too may gauge the true state of the economy, perhaps even more accurately than the professionals.

Every one of us interfaces with the economy. Whether you are a white collar professional, a student, a stay at home parent, or are unemployed and looking for work, you interact with and observe the economy on a first hand, continuous basis. Who better to assess the pulse of the economy than the very citizens that live and breath it?

So what do you observe now when you take a good look around you and take a reality check? Are the signs suggesting an imminent recovery or are they flashing, “Thanks for playing, but America has voted, and you’re not coming back for the next round.”



Here are some examples of how to forecast using reality economics.

Take the travel industry for example: Do you keep receiving mailers from your favorite airline or car rental company thanking you for your business by presenting you with a complimentary upgrade even though you haven't traveled for months? According to the principles of reality economics, getting valuable stuff for free from distressed companies is a negative economic indicator.

On the flip side, have you and your spouse finally decided to take that trip you've been putting off but find that all the good flight times and nice hotels are booked (too bad for you, but a good sign for the economy)?

Are the stores and restaurants you go to more or less crowded than they were six months ago? Do you hear of more friends and acquaintances losing jobs than getting new ones? Are employees at your company busy working hard on new projects or hanging around talking about who is going to win Big Brother and Survivor?

Do you find yourself staying in and watching more television than going out for a fun yet more expensive night on the town? Are you unemployed and thinking about changing your career path? Or, are you a student and envious of the cool jobs the graduating students just got? Are you hunkered down thinking about extending your studies with a double or triple major?

Have you convinced yourself that Supercuts would do a fine job cutting your hair?

You get the point.

What's the Impact on Investments?

If the economy has turned the corner and is on sound footing, the outlook for the stock market over the next couple of years is good. Corporate earnings should continue to rise, bringing even higher future stock prices. If earnings for the S&P 500 index grow by roughly 13% (as forecasted for 2004) and the current p/e for the S&P stays constant at roughly 18x forward earnings, the S&P should advance by at least 10% from today's level over the next year or so.

In this scenario, bonds will likely suffer somewhat, as inflationary fears persist pushing up interest rates and bond prices down.



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On the other hand, if the recovery peters out, stocks prices may fall as quickly as they've gone up. Bonds and other fixed return investments will offer a better return than stocks.

What Do the Signs Tell SMS?

Our view is that there seems to be a discrepancy between the upbeat economic projections from the professional economists and what the theories of "reality economists" suggest. However, we believe the citizen economists should soon be revising their outlook upward. A combination of tax relief and increased business spending should be rippling through the economy bringing greater tangible prosperity and improved sentiment along the way.

However, as long as there is no shortage of would-be contestants for "Fear Factor", willing to down a live cockroach shake for the chance to win \$50,000 (pre-tax), we remain skeptical of this economic recovery. Until the show goes off the air for lack of willing contestants, we remain cautiously optimistic and have positioned client portfolios appropriately.