



GDP for the fourth quarter of 2002 came in as expected at 1.4%. However, current forecasts for 2003 first quarter and annual GDP continue to be revised downward.

Consensus estimates for 1Q2003 is between 1.5% and 2.5%, down from a previous forecast of around 3.5%. So far, most of the reported data looks fairly weak. Unemployment remains high as increased productivity of current workers and falling utilization of existing capacity delays re-hiring.

At this quarter's FOMC meetings, the FED left the benchmark federal funds rate at 1.25%, a 41 year low. Fed governors have previously noted that "geopolitical uncertainty has caused a restraint on the expansion of the economy." The FED gave no additional comments at the recent March meeting, although they promised "heightened surveillance" of the economy

*The FED's decision to hold rates steady suggests they still believe the current economic weakness is "related to war tensions and is not a lasting deterioration in consumer or business spending and investment plans."* Economists, however, believe that further deterioration in personal consumption or employment could result in an interest rate reduction before the next FOMC meeting.

If the FED is correct in assuming growth will accelerate once the Iraqi war is over, then inflation may become the overriding issue. Higher oil prices and a growing government deficit are both issues that have caused higher inflation in previous years. However, Greenspan's successful fight against inflation allows latitude in today's efforts to expand the economy. And, the volatility of energy prices is not expected to significantly affect core inflation unless it continues for some time. FED Governor Ben Bernanke said "it's appropriate to run a deficit while the economy is weak, but...the real issue is the long-

term pattern and whether it is brought under control and is sustainable."

Although the Federal Reserve says the economy is resilient and the fundamentals are basically fine, others, including Treasury Secretary, John Snow, see fundamental problems preventing a return to accelerating growth. Martin Feldstein, president and CEO of the private National Bureau of Economic Research, says "the economy is fragile, more rate cuts may be needed, and President Bush's tax cuts are a necessary fiscal stimulus for economic improvement."

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It is possible the FED may be holding its remaining 'ammunition' (up to 1.25% of additional rate cuts) until more information on the war's impact is available. They may also want the chance to counteract a potential longer-term shock to confidence, such as the possibility of deflation. Lehman Brothers economist, Russell Jones, issued a report on the likelihood of deflation. Jones believes there is little doubt that deflation will spread from Japan to other industrial economies.

*A persistently falling price level can be very damaging to real activity, as experienced in the 1930s.* However, according to Jones, "the circumstances that led to the Great Depression are unlikely to be repeated, partly because the science of macroeconomics has evolved enormously and policymakers should have learned lessons from....past errors."

Central banks can use an array of policies to prevent, or work out of deflation, including expanding monetary policy, ignoring the balance sheet in favor of expanded open market operations, and encouraging currency depreciation. Unfortunately, these tools were misunderstood in the 1930s. However, if the FED must fight deflation, their actions will likely fly in the face of their long established policies by setting the stage for future inflation.

**Staff:**

**Grace Y. Lau, CFA**  
President

**Mindy L. Ying, MBA**  
Executive Vice President

**Terri M. Eisenhauer**  
Portfolio Manager

**Matthew Henderson, CFA**  
Portfolio Manager

**Carter A. Pearl, CFA**  
Portfolio Manager

**John Reimer, MBA**  
Portfolio Manager

**Christine M. Bell**  
Director of Operations

**Jane Hu**  
Operations Manager

**Pierre Chan**  
Consultant

**Offices:**

**Phoenix:**

1432 E Northern Ave  
Phoenix, AZ 85020

Tel: 602-997-8882  
888-997-8882

Fax: 602-997-8887

**Los Angeles:**

2540 Huntington Dr.  
Suite 105  
San Marino, CA 91108

Tel: 626-286-4029  
888-295-4419

Fax: 626-286-0624

**Website:**

[www.pacwestfn.com](http://www.pacwestfn.com)

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**First Quarter Results**

The first quarter of 2003 was similar to the beginning of 2002. There was a great deal of optimism about the year ahead and the possibilities for equity returns. Like the start of last year, strategists talked in terms of probabilities of a positive year on Wall Street. It seemed unrealistic to expect another off year for stocks. Although we are still quite a ways from the end of the year, many are again predicting a back-end loaded 2003. Hopefully, the outcome will be better than 2002.

In much of the first quarter, investors played the waiting game. First, we waited for a war with Iraq to begin. Toward the end of the quarter, we were waiting for the war to end. The market experienced a significant run-up during the middle of March, as the prospect of a war became certain. Many believed Operation Iraqi Freedom would follow a similar time-line as the 1991 Gulf War. A short war would yield lower oil prices and hopefully boost the economy. However, it became clear by the end of the quarter that this might not be the case. A more prolonged war seemed more certain. The market then began giving back some of the war rally gains by the end of March.

The Dow Jones Industrial Average (Dow) fell 4.2% during the first quarter, while the S&P 500 Index was off 3.6%. The tech-laden NASDAQ was the leading index, up 0.4%, while the Russell 2000 Small Cap Index declined 4.5%.

In terms of sector performance, it was basically a mixed bag in the first quarter. The defensive Health Care sector performed best, but the speculative technology stocks were also solid performers. Other defensive areas such as Staples and Utilities sold off during the quarter. The struggling telecom sector pulled back after a very strong fourth quarter of 2002.

PacWest continued to overweight the more defensive economic sectors as well as several undervalued cyclical sectors. We continued to underweight the overvalued technology and telecom groups. Also, we maintained overweight cash positions in client portfolios for continued defensive positioning.

S&P Economic Sector	1st Qtr Returns	Index	1st Qtr Returns
Cons.Discretionary	-1.6%	Dow Jones	-4.2%
Consumer Staples	-7.0%	S&P 500	-3.6%
Energy	0.0%	NASDAQ	0.4%
Financial	-5.7%	Russell 2000	-4.5%
Health Care	0.9%		
Industrial	-5.5%	<b>2002 Returns</b>	
InfoTechnologies	-0.6%	Dow Jones	-16.8%
Materials	-7.9%	S&P 500	-23.4%
Telecomm	-15.1%	NASDAQ	-31.5%
Utilities	-4.3%	Russell 2000	-21.0%

**Investment Style Performance**

After getting off to a strong start early in the year, the market cooled down in mid-January before picking up again in March. Overall, the quarter ended flat to down. Growth stocks came out on top in the quarter as some speculation regarding a spending pick-up and short covering took place. Many of the beaten down tech and telecom sectors managed to get a temporary boost. Typical value stocks with higher dividends raced ahead as investors focused on the potential dividend relief in President Bush's tax package. The stocks later cooled, as the realization took hold that the relief may be scaled down before it becomes a reality.

Lipper	1st Qtr Returns			2002 Returns		
	Growth	Core	Value	Growth	Core	Value
Large-cap	-1.5%	-3.1%	-4.9%	-28.1%	-21.2%	-19.7%
Multi-cap	-0.8%	-3.1%	-4.2%	-29.8%	-21.7%	-17.6%
Midcap	-1.6%	-3.8%	-4.2%	-28.5%	-17.4%	-14.7%
Small-cap	-3.7%	-5.2%	-5.8%	-27.6%	-19.2%	-11.2%

Even though they still ended the quarter in the red, growth stocks turned in the best overall performance. Value funds experienced a rather difficult quarter as worries increased regarding some companies' ability to prosper or even survive this difficult economy. Some of the more cyclical stocks failed to turn in a strong performance due to worries over the economy. Additionally, the higher dividend paying stocks relinquished their early gains.

As more stocks have fallen in price, and earnings growth is constrained, the line between growth and value stocks has blurred. No longer can many companies fit into one category while ignoring the considerations of the other. Investors must look carefully at both criteria to make profits in the future.

**Expectations for 2<sup>nd</sup> Quarter**

It is very difficult to predict how the economy and stock market will react after the war concludes. In the short run, it wouldn't be surprising to see a tradable relief rally in stocks. However, this may not be sustainable.

One of the significant questions being asked right now relates to what degree business spending is being stifled by the war. It is evident that some businesses simply are curtailing spending until a war outcome is more certain. However, it is not clear as to whether the lack of business spending relates more to the war or to lackluster business conditions. Economic reports at the end of the quarter revealed that manufacturing has slowed significantly. Some of this is most likely war related, but some is probably not. It is important to note that the economy was slowing before the U.S. went to war. Actually, the economy was slow before September 11th, 2001.

It is difficult to see a significant acceleration in business spending simply because the war ends. Instant clarity will not be

gained by a coalition victory. There will still be much uncertainty regarding international affairs even after the war concludes. For example, post-war clean-up/occupation of Iraq could lead to additional unrest in the Middle East. Also, North Korea has yet to be dealt with in relationship to their nuclear weapons program.

It is also important to note that a pick up in economic activity does not necessarily convert into higher stock prices. A portion of this up-tick has already been priced into the equity market. And, valuations of many of the stock indices are already higher than historical averages (excluding the bubble period of 1998-beginning of 2001).

PacWest's strategy will be to continue to look for companies with solid fundamentals selling at attractive valuations. Over time, these stocks will work out well. We see 2003 being similar to 2002 in that stock selection will be critical to equity performance. Also, taking gains in client accounts and preserving capital will continue to be of the utmost importance.

<b>Sector</b>	<b>PacWest % (03/31/03)</b>	<b>S&amp;P 500% (03/31/03)</b>
Cons. Discretionary	15.0%	13.8%
Consumer Staples	15.0%	9.2%
Energy	4.0%	6.2%
Financial	15.0%	19.9%
Healthcare	13.0%	15.6%
Industrials	16.0%	11.3%
Info Technology	7.0%	14.8%
Materials	6.0%	2.7%
Telecom Services	0.0%	3.7%
Utilities	5.0%	2.9%
REITs	4.0%	-----

The above table compares PacWest's current weightings with those of the S&P 500 Index:

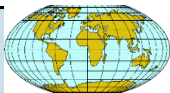
### **Defensive Equity Investing**

Equity analysis has changed quite a bit from the methods utilized in the 1990's. Before the Enron debacle, many buy and sell-side analysts took management at their word. There was not a great deal of analysis that took place. This is precisely why so many were taken by surprise when companies' accounting frauds were discovered. Today, things are much different. The financial community is once again (and rightly so) performing their analytical duties.

PacWest is focused on evaluating companies from a defensive perspective. As the last decade was concerned more with high growth companies, value oriented stocks probably make more sense in the current environment. We still look at how a company is growing earnings and revenues, but the price we pay per share is a key consideration. To gauge valuations, we look at metrics such as price to forward earnings, price to sales and price to cash flows. We analyze the metrics on an absolute basis and relative to their peers and to the market. Additionally, we discount a companies future cash flows to the present at their cost of capital to arrive at an intrinsic value for the shares. Also, our multi-factor, Growth-at-a-Reasonable-Price (GARP) model helps us to decide what a stock is worth.

Aside from valuations, fundamentals are critical. We analyze the financials of all of the companies we follow, looking for "red flags" that could signal problems or accounting fraud. After a thorough analysis is concluded, we make a decision on the stock. Many times, we implement stop orders as a method of preserving capital. In these situations, we will err on the side of caution. Preserving capital is much more important than taking risks in the current environment.

Investing in the '90's was something that many could do with success. Valuations and financial statement analysis weren't as important. However, things have once again moved to the status quo where securities analysis matters. Investing defensively requires this understanding.



### **International Markets**

The international markets struggled to keep up throughout most of the first quarter. Even with a recent bounce in March, the majority of the indices ended the quarter with poor performance versus the U.S. markets. Europe was especially hard hit and accounted for a large portion of the losses in many international funds. Contributing to the losses in Europe was an accounting scandal at Dutch supermarket chain, Ahold. This led to additional worries over potential scandals elsewhere in Europe.

There weren't many bright spots as the world economies continued to suffer. The worry over the potential impact of war and the relationships between various governments and consumers also contributes to the negativity. Travel and tourism is certainly a concern, as many countries rely on foreigners to boost the local economies. Our economies continue to be interrelated and weakness in the U.S., Asia and Europe will each have an impact across the world.

Some countries managed to achieve small positive returns. These included Australia and Canada, which turned in returns of 3.21% and 3.11% in U.S. dollars. In local currency, the return for both countries was approximately -4.00%. The weaker dollar again helped U.S. dollar based returns this quarter. Venezuela was one of the hardest hit with a loss of over 20%. The continued political problems and ongoing oil strike have put them under increasing strain.

The international markets will continue to focus on some of the same problems as the U.S. High oil prices, difficult economic conditions and the worry of the ongoing war will put a strain on any substantial gains in the near future. We will continue to maintain a weighting in international funds to benefit from diversification and the currency impact of a weak dollar.

# MARKET SUMMARY

## PacWest Financial Management Inc.

1432 E. Northern Ave.  
Phoenix, AZ 85020



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### Fixed Income Markets

Investors seeking safety and income are faced with a dilemma. In previous years, bonds provided a hedge against the volatility of equities. After 3 years of declining equity markets, more investors are seeking relief by adding or increasing bonds. However, *today's low interest rates have raised bond prices, making them expensive to other investment choices.*

Cash seems a poor alternative, returning only around one percent (1%), but the uncertainties of the war make the decisions on reinvestment difficult. The direction of future interest rates is uncertain when based on market fundamentals, so cash becomes a viable choice for the short duration.

To reduce the short-term cash held in money market funds, and to marginally increase the returns on cash, we are buying U.S. Treasury bills for 30 to 91 days where possible. *Treasury bills, guaranteed by the U.S. Government, are the most liquid of all investments, needing only a 1-day turnaround to cash; the same as money market mutual funds.*

Current yields on T-bills are around 1%, and the income is exempt from state taxes, raising the real return. The liquidity and guarantee make them an excellent alternative to cash. The very short maturities also provide us with a time cushion during the initial war period before reducing cash to reinvest in equities, or longer-term bonds.

The financial markets are hoping for a fairly short

war immediately followed by a decent recovery. That expectation, plus high oil prices and a rising deficit, have led to *a widespread perception that interest rates will rise.* At this point, we believe the perception will become reality. We expect to see some period of higher rates as the Iraqi war ends.

On the other hand, if deflation really becomes an issue, Federal Reserve and fiscal policies may cause interest rates to fall further, especially on the longer end of the yield curve. The outlook on deflation probably will not become readily apparent until after the expected post-war euphoria subsides and economic fundamentals again become the focal point.

#### U.S. Treasury Yield Table

Maturity	3 Mo.	6 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/30/01	1.72	1.81	3.14	4.41	5.09	5.54
12/30/02	1.19	1.22	1.58	2.70	3.78	4.74
3/31/03	1.11	1.10	1.49	2.73	3.83	4.86

We continue to look for short to intermediate callable bonds and preferred stock for the majority of our purchases. However, some of our buys are in intermediate to longer-intermediate (7-10 years) maturities to offset the possibility of continued low rates. Yields on Treasury Inflation Protected bonds (TIPs) are lower across all maturities than at year-end. Until deflationary issues have been put to rest, TIPs are not an appropriate bond purchase choice for our clients' portfolios.