Columbia Management
A FleetBoston Financial Company

Perspective on Investments

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The outcome for the U.S. economy and financial markets in 2003 will depend heavily on the resolution of Operation Iraqi Freedom.

In our opinion:

- During the first quarter of 2003, uncertainty about the future, especially the potential for war, clamped brakes on the drivers of the U.S. economy and stocks.
- Now that war has broken out, the second quarter of 2003 may firmly establish the U.S. on the path to improvement or it may usher in a downturn, depending on the speed and success with which the war is resolved. The longer it takes, the greater the risks to the economy. If the U.S. wages a quick, successful war, then the economy and U.S. stock prices would improve by exploiting the foundation already laid by stimulative fiscal and monetary policies.
- Even with a successful military outcome, the U.S. will confront other challenges from budget and trade deficits, the dollar, and weaker international cooperation.

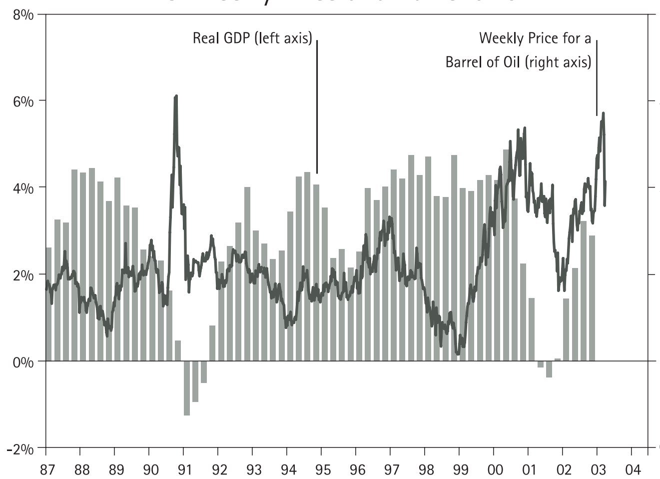
Iraq Put U.S. Economy and Stocks on Hold

The U.S. economy and stock market soared during the 1990s, driven by almost ideal conditions. Since the peak in 2000, however, uncertainties, risks, and other problems have multiplied. For example, the U.S. has experienced the collapse of the dot-com bubble and of capital spending, terrorism, the threat of war, and the corporate governance scandals. Despite these negatives, the economy has expanded moderately since the 2001 recession and, so far in 2003, the major stock market benchmarks have stayed above lows set in July and October 2002.

However, neither the economy nor equities have mustered the momentum to make a decisive recovery. During the first three months of 2003, investors, consumers, and businesspeople appeared almost paralyzed by the uncertainties of war with Iraq.

Exhibit 1

Year Over Year % Change in Real GDP Vs. Weekly Price of a Barrel of Oil



Source: BEA, NIPA tables; Wall Street Journal

As a result, oil prices surged, consumer and business spending were muted, the dollar sagged, and Treasury prices rose as stock prices slid. This convergence of events has prevented economic growth from accelerating.

For example, higher energy costs tend to dampen economic activity, as shown in Exhibit 1. In the 1990-1991 recession, the gross domestic product fell by 1.5% on the heels of oil prices exceeding $35 per barrel. During the first quarter of 2003, oil prices hit 1990 levels, pressuring the economy.

Prolonged uncertainty about Iraq and higher energy prices moderated the consumer spending that has placed a safety net under the economy and stocks. It also delayed the capital spending – spending by corporations on plant, property and equipment – needed to help bring the economy out of its malaise. Consumer confidence has fallen during the first quarter of 2003. If this trend were to sap consumer spending before capital spending accelerates, the economy and stocks may suffer further. In our opinion, however, the U.S. is well positioned to avoid such a downward spiral, assuming a favorable outcome in Iraq.

Underpinnings of Growth

We believe that President Bush is highly motivated to avoid an economic decline. He knows the longer the Iraqi war drags on, the less time the economy will have to gather momentum prior to the election in November 2004. Ideally, he would like a quick military victory accompanied by the introduction of additional stimulus for the U.S. economy.

Many of the preconditions for economic growth already exist. Monetary and fiscal policies are stimulative. Interest rates and inflation are subdued. Indeed, Treasury interest rates are at their lowest in two generations of investors. Overall liquidity has been improving. In other words, the Fed is giving banks the ability to make loans and provide credit, so businesses and individuals can increase their spending and investment. This should enhance economic activity once uncertainty recedes.

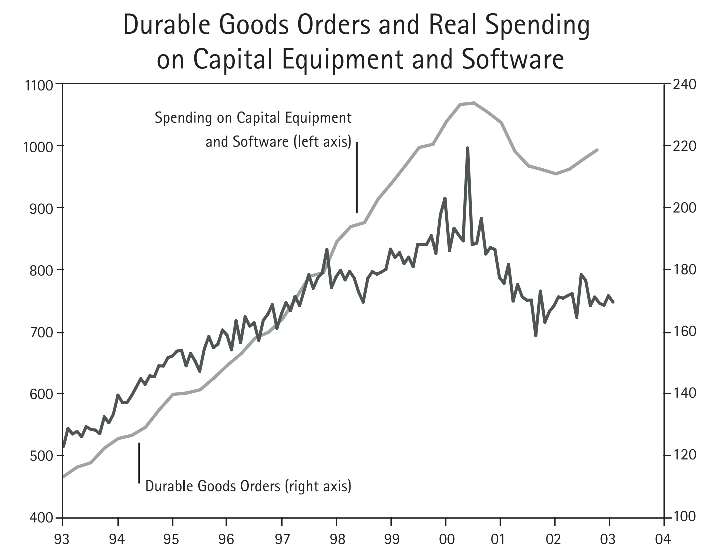
In addition, consumer spending should be helped by 2002's federal tax reductions combined with moderate wage and employment growth. On top of this, President Bush has proposed more tax cuts, which are being debated during the second quarter with an amended version likely to be voted on by August. The consumer should be in a position to support, though not accelerate, economic growth.

The key to higher, sustainable real growth is capital spending. Corporate operating profit growth has been positive since the second quarter of 2002 on a year over year basis. Indeed solid double-digit growth, although from a depressed base from the year before, was registered during the fourth quarter of 2002. This higher corporate profitability has provided the incentive for somewhat higher capital spending, as seen in Exhibit 2. Real business spending on equipment and software as well as new durable goods orders have been drifting higher since mid to late 2001.

One provision of the pending tax bill, the elimination of double taxation of dividends, could be especially helpful by reducing the cost of capital. Such tax relief would provide a shot in the arm to business investment spending.

The likelihood of improved business activity is also reflected in the narrowing of bond quality spreads. In other words, even as investors have flocked toward the safe haven of Treasuries, they have shown an increased appetite for corporate bonds, driving down the premium over Treasuries that corporations must pay to attract investors. Investors appear to be anticipating some economic improvement, which would raise corporate revenues, cash flows, and earnings.

Exhibit 2



Source: Bureau of the Census; BEA NIPA tables

Potential Challenges

Once investors can see beyond the Iraqi conflict, they will face four other issues.

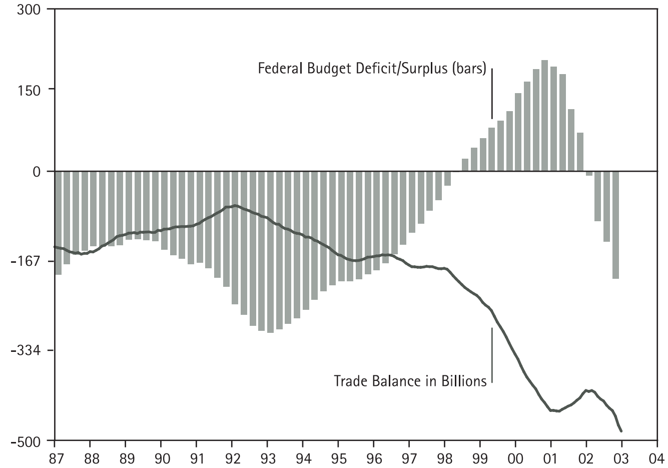
First, rising government budget deficits are an issue for the first time since 1993. The federal budget deficit may soar to over $400 billion, nearly 20% of its $2.4 trillion budget, for the fiscal year ending September 30, 2004. State and local budgets, hurting from weak economic performance and from the loss of capital gains revenues, are cutting spending and increasing taxes and fees. These state actions will dampen the positive impact of federal policies.

Second, the U.S. faces an equally large trade deficit because we are buying over $400 billion more in goods than we sell to foreigners, as shown by Exhibit 3. Foreign investment has financed this deficit, but this may change once non-U.S. markets become more attractive to investors.

Third, international relationships were damaged during the Iraqi debate. Mending differences with countries such as France and Germany will take considerable effort. In the meantime, this may impair the U.S. ability

Exhibit 3

Federal Budget Deficit/Surplus 12 Month Running Total and Trade Balance 12 Month Running Total



Source: Bureau of the Census; Department of Treasury

to cooperate with other countries in addressing other geopolitical and trade issues.

Fourth, the budget and trade deficits as well as weakened international cooperation contributed to a sell-off in the U.S. dollar over the past year. Further erosion in the dollar may eventually lead foreign investors to reduce their exposure to U.S. financial assets. However, this is not likely soon because the prospects for economic growth in the other industrialized economies appear more muted than in the U.S.

The impact of these issues could be partially offset if U.S. economic growth were to reaccelerate to an annual rate of 3% or more – a rate that would slow the growth of budget deficits and keep the U.S. attractive to investors.

In our opinion, the U.S. has a good chance of achieving such growth. Assuming that the Iraqi situation is resolved by mid-year without unanticipated negative circumstances, we believe that we would again see, as we experienced in the opening days of the war:

- Lower oil prices
- Firmer U.S. dollar
- Rising consumer confidence and stock prices
- Falling prices for Treasury bonds

In summary, the current quarter could be pivotal for Iraq, the economy, the final shape of the tax bill and President Bush's reelection effort. The resulting environment should be more encouraging as economic growth reaccelerates and capital spending trends upward. New uncertainties and risks will surface, but we believe their impact will be manageable thanks to improved economic activity.

Please contact your adviser to learn more about the significance of this information for your portfolio.

Author Harvey Hirschhorn is Columbia Management Group's Head of Active Asset Allocation and Investment Strategy.

Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that the forecasts will come to pass. The opinions expressed are those of the contributor and are subject to change.

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