

The Strategic Global Investors Newsletter™

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Overview

The United States real GDP for the second quarter grew (inflation-adjusted) at an annual rate of 3.3%--well above analysts' expectations estimate released by the Bureau of Economic Analysis. This is more than double the 1.4% rate for each of the previous two quarters. During the third quarter, we expect growth of around 4% and in the fourth quarter the GDP growth should be around 5%. That is in comparison to the European Union GDP growth of less than 2%. Due to the fact that inflation is rising, the Treasury market has seen an increase in volatility since the beginning of July, with the 10-year bond volatility rising to almost 136 basis as a high degree of uncertainty regarding Federal Reserve policy and the inflation outlook weighed on the markets. What does this mean for investors?

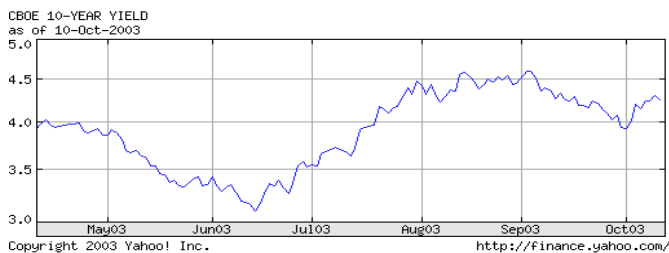
Let's look at Wall Street. People on Wall Street are still making a lot of money. Things are down, but they're nothing compared to what they *could* be. Employment is essentially the same on Wall Street as it was a few years ago with many people still making huge salaries. There's tremendous leverage in the system. Everyone has played the bond market in the last two years. Now everyone is back in stocks. In addition, we do not know how many derivatives there are in the world. Nobody knows. Just an example, you may remember Japan in 1989 and 1990 when the Japanese Nikkei average was at 40,000. Well, the Japanese average today is about 10,000, up from 7,000 three months ago. The Japanese mutual fund industry has lost 95% of its assets in that period of time. That is a bear market. The dollar's trading range is about 1.15 to 1.18 dollar per Euro. In my previous newsletter I predicted the dollar would go to 115 Euros and it went to

118, which was above my target price. Then the dollar recovered to 1.0875 before losing about 10% in the last three months. **Even during the current difficult political and business climate in Europe, the dollar will remain in the 1.16-1.18 trading range for the next 30 days. After that if the Fed and the U.S. government do not change their monetary policy, we will see deterioration in the exchange rate of the dollar to 1.20-1.25 against the Euro.** This prediction assumes that there will be no terrorist attack on U.S soil during this period. I hope it won't be the 1970's all over again, when in four years the dollar lost about 200% against major European currencies. At the end of the first quarter 2004, or beginning of the second quarter 2004, the dollar should rebound to around 1.10-1.12 against the Euro.

At the end of September, the nation's housing market showed no sign of cooling off. August sales of existing single-family homes rose 5.5% to an annual rate of 6.47 million units, setting yet another record for the second consecutive month. Sales were 22% higher than in August 2002. Sales of new single-family homes rose 3.4% in August to an annual rate of 1.15 million units--12.2% higher than for the same period the year before. The increase in real estate prices nationwide is the first demonstration of a high inflationary monetary policy. Commodity indexes are responding accordingly and prices on commodities are going through the roof.

Now let's look at the government's monetary policy. National Debt is rising at an unprecedented pace, and the current trade deficit shows no sign of abating. The sound monetary policy seems to have been forsaken. If the current account deficit remains around 5% of

GDP and the economy grows at 5% in nominal terms, America's debt will reach 40% of GDP in 2007. According to the Department of Treasury, U.S. external debt has risen to a total of 1.4 trillion dollars. Can America afford this kind of indebtedness? That depends on the interest rates it must pay. So far so good, but foreign investors' recent interest in American assets may begin to falter. The decrease of investment in American assets is reflected in exchange rates. The dollar lost about 20% against the Euro in the last 12 months.



Consistent with the scenario above the Treasury department issued \$65 billion in Treasury notes for the month of August. For the month of September, the Treasury issued \$68 billion notes. For the October-December quarter, the Committee of the Treasury recommended financing which included three \$25 billion monthly 2-year notes, three \$20 billion monthly 5-year notes, a \$25 billion 3-year note for issuance in November and a \$20 billion 10-year note issued in November followed by a \$16 billion re-opening of that 10-year note in December. These issues do not take into consideration of future expenditure for the reconstruction of Iraq.

In the month of August, the yield on ten-year Treasuries went up to almost 4.5%—some 145 basis points (bps, or hundredths of a percentage point) above their lows in June. Now it stands around 4.25%. What is happening? The biggest cause seems to have been the hedging activities of holders of mortgage-backed securities. In particular, this means the activities of Fannie Mae and Freddie Mac, two quasi-government-guaranteed agencies which are the biggest holders of mortgage-backed securities, a bigger

market now than the Treasury market. When Treasury yields fall, the duration of mortgage-backed portfolios also falls because homeowners swap old mortgages for new, cheaper ones. To hedge against this, fund managers buy Treasuries. Conversely, when yields rise, they sell Treasuries. As recently as 1994, this turned into a vicious circle of rising yields and more hedging. **So be ready for a substantial increase in yield on the 5, 10, 20, and 30-year U.S. Treasury bonds.**

The Stock Market

Between 1998 and the beginning of 2002, money managers in a typical asset allocation dedicated about 75% in American assets and 25% in the rest of the world. This year asset allocation in U.S. assets should be substantially lower. Gold and the euro cash markets both remain mired in triangle trading ranges after steep corrections from earlier this year. The commodity currencies are also correcting here, and we would expect them to eventually lead the charge higher as realization of the global economic recovery gains steam advances in the weeks and months ahead. Our gold and commodity models remain bullish, and our forex models lead us to believe that a longer-term dollar decline will come to a stop at around 120-125 against the Euro.



Note that foreign markets are slightly losing steam, which may indicate the correction in US stocks has a way to go. Longer-term indications remain bullish that despite unprecedented global central bank and global fiscal policy stimulus, the environment is likely to be more volatile than any investors have witnessed since the 1970s. Financials now make up about 30% of

the S&P today and that's where the excesses are. I don't think you have to be a genius to know that that's where we have had the massive excesses of the past five years. We hedge most of the stocks we invest. For those unfamiliar with our hedge strategies, basically, we have rigorous criteria for hedging single stocks. Now is the time to exercise discipline in order to avoid losses, and take advantage of potential gains. We keep about 65% of our portfolios in Euro, Canadian Dollar and Australian Dollar. The rest 35% in U.S. dollar.

The life sciences sector remains the most dynamic, and I will explain why. In the past 25 years after massive investments of billion of dollars in the life sciences sectors, we are now beginning to reap the benefits of such investments. With the industrialized countries' population rapidly aging, we have now about 250 million people over 50. Aging is the main issue regarding the human body breaking down to diseases. In addition a poor diet consisting mostly of sugar and fats, lack of exercise, environmental pollution, and immobilization of the body via computer work is taking its toll. We are now at a new stage of research into genomic, proteomic, nanotechnology, and discovering bionic miracles of body parts made with cutting-edge devices made possible by marrying electronics and biology. I remain bullish in investing in this arena. The selection of stocks and private companies requires an understanding of both science and finance. The life sciences sector is still the last frontier in investing and it is the most exciting. For investors to be able to identify the right company is a serious challenge. I suggest you to hedge your stock investments with put and call options to reduce the extreme volatility of the biotech sector.

Our preferred stock list

Life Sciences: ABC*, ABT*, AXCA, ARDM, ARQL, ASTM, AVE*, BEC*, BIO* BRL*, CEGE*, CEPH*, CHIR*, DNA*, DVSA*, DSCO, GSK*, GILD*, IVX*, KG*, MCK*, MLNM*, MEDI*, NTY*, NicOX, NBIX*, NRM.TO, PRCS, PPD1*, SRA*, SCLN, SYT*, and WPI*.

REIT's: GLB, KIM, ASN, HMT, and SHU. Only preferred shares.

Our preferred list of mutual funds:

BGRFX, OAKGX, RYSEX, VGENX, VSEQX, VGSTX.

* Shares with options.

**Indexes: DJI 9674 - NASDAQ 1915- S&P500 1038- Russell2000 519.06 - Amex BTK 473.83
10-Year Treasury Bond 42.48- U.K. FTSE 100 4311 - Euro-U.S. dollar 1.178**

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